Appendix 8.3 (*cont.*)

| S.No. | Country name | EVI |
|---|---|---|
| 114 | Costa Rica | 23.99 |
| 115 | Bangladesh | 23.77 |
| 116 | Israel | 23.35 |
| 117 | South Africa | 22.43 |
| 118 | Pakistan | 22.21 |
| 119 | Turkey | 19.33 |
| 120 | Thailand | 17.92 |
| 121 | Indonesia | 17.38 |
| 122 | Malaysia | 16.55 |
| 123 | Korea (Rep. of) | 16.09 |
| 124 | Mexico | 15.47 |
| 125 | Argentina | 15.22 |
| 126 | Brazil | 15.20 |
| 127 | India | 12.20 |
| 128 | China | 4.18 |

*Source:* United Nations Economic and Social Council.

9

# Special and differential treatment for small developing economies

RICHARD L. BERNAL

## 9.1 Introduction

The international community has recognised that there are significant differences between countries at different levels of development. It is for this reason that it formally acknowledges developed countries, developing countries and least developed countries (LDCs). It was recognised that in a multilateral trading system with a standard set of rules the developing countries and LDCs would be at a disadvantage relative to the developed countries. It was also deemed desirable that the economic growth/development and structural adjustment of developing countries and LDCs should be promoted by special and differential treatment (SDT). In a multilateral trading system with such wide differences among countries, special and differential treatment is a necessity and is therefore one of the fundamental principles of the World Trade Organization agreements. It has the same validity as the most favoured nation principle and is not a derogation to be applied to some countries on a temporary basis.

Up to the present time the international community has proceeded on the basis of different levels of development. However, in addition to differences in levels of development there are substantial differences in size among economies. Small developing economies (SDEs) are a sub-set of developing countries. The SDEs are a specific type of developing country whose stability, adjustment and growth are constrained by both level of

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development and small size. Small size is an additional constraint, which distinguishes small developing economies from the genre of developing economies as a whole. The existing SDT provisions suffer from many inadequacies and do not consciously take account of small size in their design. Therefore the provisions, which give expression to the principle of special and differential treatment for developing countries, need to be revised and refined to take specific account of the issues, which arise from small size.

This chapter explains why small developing economies must be afforded special and differential treatment, identifies the characteristics of SDEs, outlines specific measures of SDT which are appropriate for these economies and establishes the direct relationship between the characteristics and the SDT measures. Section 9.2 explains why SDEs should be afforded SDT and how this is beneficial to them and the international community. Having done this, section 9.3 reviews the evolution and status of SDT and finds that there is an unresolved debate about the efficacy of SDT. Section 9.4 then examines the issues in this debate, concluding that there is a need to establish more clearly the link between the characteristics of developing countries and the existing SDT measures. The characteristics of SDEs are outlined in section 9.5 and the implications of the features for the functioning of SDEs are examined in the next section. Against this background, specific SDT measures appropriate for SDEs are set out in section 9.7. How these SDT measures address the characteristics of SDEs is explained in the following section. That leaves the question of the identification of SDEs, which is treated in the penultimate section. The conclusions are stated in the final section.

## 9.2 Why SDT for small developing economies?

Small developing economies should be afforded special and differential treatment for at least four reasons, which are important not only to these economies but also to the international community.

1. Small developing economies have structural and institutional characteristics, which affect the process of economic growth, constrain the attainment of economies of scale and scope, increase their vulnerability to external events and limit their capacity for adjustment. These characteristics are sufficient to identify small developing economies as a subset of the genre of economy commonly referred to as developing economies. Given the high degree of openness of small developing economies and their supply-side constraints, external developments have a very significant effect on their economic growth and the stability of income. The terms and conditions under which these economies participate in the world economy and their internal economic management are the critical determinants of the economic progress and capacity for adjustment in SDEs. External arrangements and internal policy must be complementary because both are necessary but not sufficient conditions for economic development. The benefits of sound economic management can only be realised if international economic arrangements do not frustrate these efforts, e.g. by protectionist barriers to export markets. SDT for SDEs must allow adequate 'policy space' as the type of policies appropriate for these economies will of necessity differ from those suitable for developed economies. Therefore, the disciplines applicable to the trade policy of these economies must be different from that applicable to the developed countries. The recognition of this for developing countries as a whole is part of the rationale for SDT.[1]
2. The availability of SDT is of considerable importance to small developing economies because of the critical influence of external trade on the growth and economic development of these economies. The significance to the international community of SDT for these economies derives from the large number of small states and the fact that their non-participation would prevent the emergence of a truly seamless world economy, leaving the multilateral trading system with less than complete membership. In addition, to the extent that SDT promotes the growth of import capacity and export production, this serves to expand world trade to the benefit of all trading nations. It is therefore in the interest of the developed countries to facilitate the integration of small developing countries into the world economy in ways that encourage their growth.
3. The political significance of this issue derives from the fact that the majority of states in the world are small. There are eighty-nine countries that have a population of less than 5 million, forty-nine have fewer than 1.5 million people, and twenty-eight have fewer than 500,000 people.[2] Indeed, the number of countries has increased

[1] Constantine Michalopoulos, *Developing Countries in the WTO* (London: Palgrave, 2001) p. 36.
[2] *A Future for Small States. Overcoming Vulnerability* (London: Commonwealth Secretariat, 1997) p. 8–10.

significantly in recent decades. At the time of World War I, there were sixty-two independent countries, by 1946 that number had risen to seventy-four and currently there are over 200. The number of small states has also increased and is likely to increase in the future, as there is a trend towards the fragmentation of states as witnessed in recent years in Eastern Europe and Africa.

4. Increasingly developed countries have balked at permitting SDT because several developing countries have demonstrated the capacity to compete effectively with developed countries in price and quality in an increasing range of goods and services. They have argued that developing countries do not need SDT and that granting it to them would undermine free trade to the detriment of all. However, small developing economies as a whole constitute an infinitesimal fraction of world trade and therefore SDT for them would not distort multilateral free trade. The eighty-six smallest economies, most of which are small developing economies, account for only 1.5 per cent of world trade and such a minute percentage could not disrupt the operation of the multilateral trading system.[3]

## 9.3 Evolution and status of special and differential treatment

Differentiated treatment is a well-established concept and practice in multilateral, regional and bilateral trade agreements. The rationale for differentiated treatment has been based on the recognition of differences in the level of development among trading partners and has as its objective the promotion of growth and development of the less developed partners. Differentiated treatment had its origin in the colonial trade arrangement and the principle has continued in various forms in agreements between countries at different levels of development. The dissolution of colonial regimes ushered in an era in which the international community accepted the responsibility to assist in reducing the desperate and persistent poverty of a considerable share of mankind. The prevailing view was that poverty reduction required economic development and that trade could be the 'engine of growth'. The procreative power of trade could be enhanced by preferential access to markets in developed countries and the nurturing of

[3] Roman Grynberg and Jan Yves Remy, 'Small Vulnerable Economy Issues and the WTO' in *Small States. Economic Review and Basic Statistics*, vol. 8, p. 28.



export capacity through protection from full or immediate exposure to international competition. This philosophy of trade-led development continues to inform differentiated treatment in the form of permanent or temporary non-reciprocity, which is embodied in several trade agreements between developed countries and small developing countries: for example, the Lomé Convention and its successor the Cotonou Agreement, the Caribbean Basin Economic Recovery Act, CARIBCAN and the Andean Trade Preferences Act.

Small developing economies have been among groups of developing countries that have been afforded SDT in a variety of forms of trade agreements. Special and differential treatment in the WTO agreements assumes particular importance for small developing economies because all other trade agreements have to be compatible with the WTO. Negotiations on SDT for SDEs must therefore be an integral component of the WTO process because these economies more than any other group of countries need a rules-based multilateral trading system. It is in their vital interest that rule-making be conducted within a multilateral framework in which decision-making is by consensus. In this type of arrangement small countries, because of their numbers, have more influence as compared with their limited leverage in bilateral negotiations with larger countries.[4]

Differentiated treatment became a part of the rules of the multilateral trading system when the concept was introduced into the General Agreement on Tariffs and Trade (GATT). Although the initial premise underlying GATT (1947) was parity of obligations between all trading nations, differentiated treatment for developing countries was acknowledged as a complementary principle. This took the form of preferential treatment for developing countries, in the form of preferential access to developed country markets through tariff preferences, and exemptions from GATT rules. In 1965, the special status of the developing country in the multilateral trading system was established with the adoption of a new Part IV of the GATT, which embodied what was termed 'special and differential treatment'. This treatment was defined as non-reciprocity for developing countries. Preferential access to developed country markets such as the preferential tariffs under the Generalized System of Preferences

[4] Richard L. Bernal, 'Small Developing Countries and the Multilateral Trade System. A Caribbean Perspective' in *Commonwealth Finance Ministers Reference Book* (London: Henley Media Group for the Commonwealth Secretariat, September 2004).

derive from the waiver in 1971 from Article I (MFN obligation) of the GATT. In 1979 the Enabling Clause gave the 1971 waiver permanent status but also indicated that SDT is not a permanent right.

Developing countries suffered a reversal on SDT during the Uruguay Round when they agreed to the concept of a 'single undertaking'. This was in keeping with a gradual but resolute shift in the attitude of developed countries towards SDT for developing countries other than the 'least developed countries'. There is a school of thought that SDT should be targeted to the least developed countries because there is no dispute about their need for assistance in integrating into the international trade system and that a process of graduation should be established for the more advanced developing countries.[5] The change began in the 1980s, reflecting a congruence of factors including:

(1) A change in the thinking in the economics profession about the role of trade in economic development and the respective roles of the state and the market. This coincided with the rise to prominence of the private-sector-led, market-forces approach to development and structural adjustment both in academic circles and in the international financial institutions. By the 1990s the so-called 'Washington Consensus' had become the dominant paradigm with many ardent exponents in developing countries.

(2) A few developing countries had emerged from the pack and proved to be competitive with developed countries in a range of goods and services, including manufactured goods, which until then had been the traditional preserve of developed countries. Developed countries became increasingly reluctant to maintain SDT for all developing countries because the advanced developing countries such as the newly industrialised countries, especially the 'Asian Tigers', would be beneficiaries. These countries, it was felt, were sufficiently competitive to assume stronger disciplines than the rest of the developing countries. The developed countries faced the dilemma that they could not eliminate SDT or the category of developing country from the WTO agreements. This prompted the developed countries to pursue a strategy of pushing to confine SDT to the LDCs and calling for the graduation of the most advanced of the developing countries. EU Trade Commissioner Mandelson has warned that 'advanced developing countries must be aware that they cannot be granted the same advantages and privileges as weak and vulnerable countries'.[6] This attitude is quite understandable given some of the countries that are entitled to benefit from SDT: for example, the World Bank's *Global Economic Prospects 2005* makes reference to 'large developing countries' including China, Russia and India.[7]

(3) Developing countries relinquished some aspects of SDT either because they were pressured or in some cases of their own volition. An example of relinquishing existing SDT under duress was when, starting with Korea, Argentina and Brazil, several developing countries gave up their rights under Article XVIII:B,[8] which under certain circumstances permits the imposition of quantitative restrictions or tariff surcharges for balance-of-payments adjustment purposes. Another example of foregoing SDT provisions is the fact that only one least developed country maintains balance-of-payments restrictions invoked under Article XVIII(B).[9]

(4) There has been less use of some SDT provisions than expected. For example, only twenty-five developing countries availed themselves of the opportunity to notify to the WTO exemptions under the Agreement on Agriculture, including investment subsidies, agricultural input subsidies and domestic support to encourage diversification from cultivation of narcotic crops.[10] The underutilisation of SDT is not necessarily an indication of lack of interest or the inappropriateness of SDT provisions but is a result of severely constrained institutional capacity, paucity of financial resources and conditionality of lending and policy advice by multilateral financial institutions.[11]

[5] Constantine Michalopoulos, *The Role of Special and Differential Treatment for Developing Countries in GATT and the World Trade Organization*, Working Paper No. 2147 (Washington D.C.: World Bank, 1999).



[6] Speech by EU Trade Commissioner Peter Mandelson, ACP Ministerial Meeting, Brussels, 1 December 2004.

[7] *Global Economic Prospects. Trade, Regionalism and Development. 2005* (Washington D.C.: World Bank, 2005) p. 3.

[8] Murray Gibbs, *Special and Differential Treatment in the Context of Globalisation* (Geneva: UNCTAD, 1998) p. 5.

[9] Amar Breckenridge, 'Developing an Issues-Based Approach to Special and Differential Treatment', Paper presented at the Inter-American Development Bank, Third Meeting of the Integration and Trade Network, 19–20 March 2002.

[10] Anwarul Hoda, *Special and Differential Treatment in Agricultural Negotiations*, Working Paper No. 100 (New Delhi: Indian Council for Research on International Economic Relations, May 2003) p. 9.

[11] Francis Mangeni, 'Strengthening Special and Differential Treatment in the WTO Agreements', ICTSD Resource Paper No. 4 (2003).

(5) Some developing countries began to evince doubt about the benefits of SDT. The 'earlier paradigm did not enjoy a consensus even among developing countries, it was viewed as ideological baggage from the past by some, or as a crutch which developing countries no longer needed and which was actually hindering their competitiveness'.[12] The view that SDT had been adverse for developing countries is in part attributable to what Whalley describes as 'the installation of meritocratic trade officials in a number of developing countries'.[13]

(6) There was a growing recognition among an increasing number of both developing and developed countries that developing countries would benefit more from improved market access and elimination or substantial reductions in subsidies and domestic support in the agriculture sectors of the developed countries than in what appeared to be the futile attempts to extract concessions from the quagmire of SDT. It is in this milieu that a number of developing countries took a strategy decision to focus their efforts in areas of negotiation other than SDT.

The concerns in developing countries about the reduced role of SDT were assuaged by the much-heralded benefits of the Uruguay Round for the global economy and in particular developing countries. Quantitative estimates of the impact of the Round varied,[14] with the most frequently cited estimates by GATT and the OECD. The GATT study forecasted an increase of $230 billion (1992 dollars) in world GDP by 2005 and world trade was predicted to grow by 12.4 per cent or $745 billion.[15] According to the OECD report, world GDP would rise by $274 billion (1992 dollars) by 2002.[16] Estimates of the impact of the Uruguay Round on developing countries ranged from $13 billion to $125 billion per annum in increased income in 1992 dollars. Several studies made the startling prediction that the gains accruing to developing countries, measured as a percentage of GDP, would exceed the benefits to be realised by industrial countries.[17]

[12] Murray Gibbs, *Special and Differential Treatment in the Context of Globalisation* (Geneva: UNCTAD, 1998) p. 4.

[13] John Whalley, 'Special and Differential Treatment in the Millennium Round', *The World Economy*, vol. 22, issue 8 (November 1999) p. 1089.

[14] For a comprehensive review of the impact of the Uruguay Round see Jeffrey Schott, *The Uruguay Round. An Assessment* (Washington D.C.: Institute of International Economics, 1994) pp. 16–18.

[15] 'Economy-wide Effects of the Uruguay Round'. GATT Background Paper (Geneva, 1993).

[16] *Assessing the Effects of the Uruguay Round* (Paris: Organisation for Economic Cooperation and Development, 1993).



However, by the time of the WTO Ministerial meeting in Seattle the majority of developing countries felt they had not realised the gains they had anticipated and SDT assumed prominence in their negotiating demands.[18]

The Ministerial Declaration of the WTO meeting in Doha in 2001 states that 'provisions for special and differential treatment are an integral part of the WTO agreements' and mandates a review of SDT provisions with the objective of 'strengthening them and making them more precise, effective and operational'. Subsequently developing countries have made numerous proposals, of which eighty-eight are being carefully studied. Up to the time of writing there has not been agreement on even one proposal of economic substance.

Special and differential treatment is embodied in the WTO agreements[19] in 147 provisions, of which 107 were adopted at the conclusion of the Uruguay Round, and 22 apply only to least-developed member countries. These measures are incorporated in the Multilateral Agreement on Trade in Goods, the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property (TRIPS), the Understanding on Rules and Procedures governing the Settlement of Disputes (DSU), and in several Ministerial Decisions. There are twelve provisions in four agreements and one decision, which are aimed at increasing the trade opportunities of developing country members. There are forty-nine provisions under which WTO members should safeguard the interest of developing countries. In addition, there are thirty provisions that permit flexibility of commitments, of action and use of policy instruments. However, measures to promote trade opportunities and safeguards are for the most part best endeavours, which are not enforceable and have not been fully implemented.

[17] Thomas Hertel, Will Martin, Koji Yanagishima and Retina Dimaranan, 'Liberalising Manufacturers Trade in a Changing World Economy' (pp. 183–215), Glenn W. Harrison, Thomas F. Rutherford and David G. Tarr, 'Quantifying the Uruguay Round' (pp. 216–52) and Joseph F. Francois, Bradley McDonald and Hakan Nordstrom, 'The Uruguay Round: A Numerically Based Qualitative Assessment' (pp. 253–91) in Will Martin and L. Alan Winters (eds.), *The Uruguay Round and the Developing Countries* (Cambridge: Cambridge University Press, 1996).

[18] Richard L. Bernal, 'Sleepless in Seattle: The WTO Ministerial of 1999', *Social and Economic Studies*, vol. 48, no. 3 (September 1999) pp. 61–84.

[19] 'Implementation of Special and Differential Treatment Provisions in WTO Agreements and Decisions', World Trade Organisation, Committee on Trade and Development, WT/COMTD/W/77, 25 October 2000, pp. 3–4.

## 9.4 Debate over the efficacy of SDT

Special and differential treatment for developing countries has been a controversial topic since it was first broached in the 1950s. There has been a vigorous debate on the rationale for, and the efficacy of, SDT. At the theoretical level there are two contending views that differ, almost diametrically, on the conditions in which trade will promote growth and economic development. At one end of the spectrum of views are the advocates of free trade and at the other are those that argue that the free trade model is not sufficiently realistic to explain the reality of international trade and certainly not the trade of developing countries. At the empirical level there has been a dispute about whether statistical data supports conclusions on positive or negative impacts of SDT on developing countries. The critics of SDT for developing countries state that SDT has not worked and that it cannot work.

1. The neo-classical theory of international trade is the basis for the advocacy of free trade as the approach to trade, which ensures that all participating countries derive benefit. Every country has a comparative advantage in some good or service and trade on this basis will generate growth and maximise consumer welfare.[20] International trade on the basis of comparative advantage as determined by their different factor endowments[21] is supposed to be best for individual countries and the world economy as a whole. The paradigm referred to by its proponents as 'the pure theory of international trade'[22] is what Hirschman[23] has termed 'monoeconomics' as its prescriptions are the same for all economies.

The assumptions of the neo-classical approach are very restrictive and bear little relationship to reality. The policy prescriptions have elicited scepticism and prompted alternative views about the role of trade in economic development, employing models which more accurately reflect the

[20] Paul A. Samuelson, 'The Gains from International Trade', *Canadian Journal of Economics and Political Science*, vol. 5 (May 1939).

[21] Eli Hecksher, 'The Effects of Foreign Trade on the Distribution of Income' (1919) in H. Ellis and L. Metzler (eds.), *Readings in International Trade* (Homewood: Richard D. Irwin, 1950) and Bertil Ohlin, *International and Inter-regional Trade* (Cambridge, Mass.: Harvard University Press, 1933).

[22] Murray C. Kemp, *The Pure Theory of International Trade and Investment* (Englewoods Cliffs: Prentice-Hall, 1969).

[23] Albert Hirschman, *Essays in Trespassing: Economics to Politics and Beyond* (Cambridge: Cambridge University Press, 1983) chapter 1.



reality of developing countries. The divergence between the assumptions underpinning this theory of international trade and reality has forced even one of the most avid proponents of free trade, Bhagwati, to concede that 'if markets do not work well, or are absent or incomplete, then the invisible hand may point in the wrong direction: free trade cannot then be asserted to be the best policy'.[24]

During the 1950s and 1960s the virtues of international trade for economic development were extolled by Viner,[25] Harberler[26] and Craincross[27] but elicited vigorous criticism from several perspectives. It was claimed that the history of the now developed countries was a vindication of free trade policies, with the experience of Britain,[28] Italy[29] and the US[30] in the nineteenth century cited as evidence. The experience of developing countries was in contrast to the predictions, prompting different explanations. Nurske[31] pointed to the lagging demand for primary products and the enclave nature of export industries was also put forward.[32] By far the most telling comments highlighted the deteriorating terms of trade between manufactured goods and primary products. Prebisch[33] and Singer[34] identified the problem of developing country trade as inherent in the structure of the world capitalist system, the international division of labour and the deformed economic structure of developing countries. The developed/industrialised countries which form the core export manufactured goods and the developing countries

[24] Jagdish Bhagwati, *Free Trade Today* (Princeton: Princeton University Press, 2002) p. 12.

[25] Jacob Viner, *International Trade and Economic Development* (Glencoe: Free Press, 1952).

[26] Gottfried Harberler, *International Trade and Economic Development* (Cairo: National Bank, 1959).

[27] A. K. Craincross, 'International Trade and Economic Development', *Kyklos*, vol. 13, no. 4 (1960) and 'International Trade and Economic Development', *Economica*, vol. 28, no. 3 (August 1961).

[28] Phyllis Deane and W. A. Cole, *British Economic Growth* (Cambridge: Cambridge University Press, 2nd edn, 1969).

[29] Robert M. Stern, *Foreign Trade and Economic Growth in Italy* (New York: Praeger, 1967).

[30] Douglas V. North, *The Economic Growth of the United States, 1790–1860* (New York: Prentice-Hall, 1961).

[31] Ragnar Nurske, 'Patterns of Trade and Development' in *Problems of Capital Formation in Underdeveloped Countries and Patterns of Trade and Development* (Oxford: Oxford University Press, 1967).

[32] Jonathon V. Levin, *The Export Economies* (Cambridge, Mass.: Harvard University Press, 1960).

[33] Raul Prebisch, *The Economic Development of Latin America and its Principal Problems* (New York: United Nations Economic Commission for Latin America, 1950) and 'Commercial Policy in the Underdeveloped Countries', *American Economic Review* (May 1959).

[34] H. W. Singer, 'The Distribution of Gains Between Investing and Borrowing Countries', *American Economic Review*, vol. II, no. 2 (May 1950).

export primary products from the periphery. The core derives a disproportionate share of the gains from international trade because of differences in the income and price elasticities of demand for primary products and manufactured goods and differences in technology, industrial organisation and the operation of labour markets, which are part of the structure of the core–periphery system. Lewis[35] argued that in a dual-sector economy with labour surplus, low productivity in the subsistence sector is the critical factor whatever the demand conditions. Myrdal[36] also focuses on low productivity which is caused by the structure of underdeveloped countries that generate a predominance of 'backward effects' (which are growth retarding) over 'spread effects' (which are growth stimulating).

The disadvantaged position of developing countries gained credence because the majority of empirical studies provided support in the form of evidence of the long-term deterioration in the terms of trade of primary products, which were the export mainstay of the developing countries. There was deterioration in the relative real prices of non-oil commodities throughout the twentieth century.[37]

Recent developments in trade theory, which incorporate imperfect competition and increasing economies of scale,[38] cast further doubt on neo-classical trade theory but do not resolve the dispute over trade and growth. Ocampo's survey of the literature concludes that new trade theories do not justify protectionism or laissez-faire industrial policy nor do they substantiate an automatic connection between liberalisation and productivity. Indeed, 'they indicate that trade liberalization should be coupled with an active industrial policy, particularly in sectors subject to significant economies of scale'.[39]

35 W. Arthur Lewis, 'Economic Development with Unlimited Supplies of Labour', *Manchester School of Economics and Social Studies*, vol. 24, no. 2 (May 1954).

36 Gunnar Myrdal, *An International Economy, Problems and Prospects* (New York: Harper & Row, 1956) and *Economic Theory and Under-Developed Regions* (London: Methuen, 1965).

37 Matthias Lutz, 'The Effects of Volatility in the Terms of Trade on Output Growth', *World Development*, vol. 22 (1994) pp. 1959–75.

38 Paul Krugman, 'Increasing Returns, Imperfect Competition and the Positive Theory of International Trade' in *Handbook of International Economics*, vol. 3 (New York: Elsevier-North-Holland, 1995) pp. 1243–77.

39 Jose Antonio Ocampo, 'New Theories of International Trade and Trade Policy in Developing Countries' in Manuel R. Agosin and Diana Tussie (eds.), *Trade and Growth: New Dilemmas in Trade Policy* (New York: St Martin's Press, 1993) pp. 121–41.



2. Based on the neo-classical theory of international trade, it is asserted that trade liberalisation can and does increase economic growth. This proposition is the position advocated by developed countries: for example, an OECD publication states: 'Exposure to international trade is a powerful stimulus to efficiency. Efficiency in turn, contributes to economic growth and rising incomes.' The report goes on to claim that in 'the last decade, countries that have been more open have achieved double the annual average growth than others'.[40] This claim is supported by empirical studies, which purport to show an association between policies of openness such as trade liberalisation and higher rates of economic growth.[41] One of the implications is that inadequate or delayed trade liberalisation reduces the growth of developing countries. In keeping with this view, many governments in developing countries misguidedly avail themselves of certain SDT measures which retard the realisation of their growth potential.

The empiricism of most of the studies that support the liberalisation-cum-growth dictum exhibits serious weaknesses. A comprehensive survey of the literature concludes that there is 'little evidence that open trade policies, which lower tariffs and non-tariff barriers to trade, are significantly associated with economic growth'.[42] The real issue is the quality of domestic policy as shown by the fact that developing countries with sound policies achieve efficiency, international competitiveness and growth and are able to take advantage of open trade regimes. Rodrik has suggested that macroeconomic stability, human resources, investment and good

40 *Open Markets Matter: The Benefits of Trade and Investment Liberalization* (Paris: Organization for Economic Cooperation and Development, 1998) p. 10.

41 Bela Belassa, 'Economic Development in Small Countries', *Acta Oeconomica*, vol. 37, no. 3–4 (1986) pp. 325–40, David Dollar, 'Outward Oriented Development Economies Really Do Grow More Rapidly: Evidence from 95 LDCs, 1976–1985', *Economic and Cultural Change*, vol. 40, no. 3 (April 1992) pp. 523–44, Jeffrey Sachs and A. Warner, 'Economic Reform and the Process of Global Integration', *Brookings Papers on Economic Activity*, no. 1 (1995) pp. 1–95, Sabastian Edwards, 'Openness, Productivity and Growth: What Do We Really Know?', *Economic Journal*, vol. 108 (1998) pp. 383–98, Jacob A. Frankel and D. Romer, 'Does Trade Cause Growth?', *American Economic Review*, vol. 89 (1999) pp. 379–99 and David Dollar and Aart Kraay, *Growth is Good for the Poor* (World Bank: Development Research Group, 2000).

42 Francisco Rodriquez and Dani Rodrik, *Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence*, NBER Working Paper 7081 (Cambridge: National Bureau of Economic Research, April 1999). For similar findings see A. Harrison and G. Hanson, 'Who Gains from Trade Reform? Some Remaining Puzzles', *Journal of Development Economics*, vol. 59 (1999) pp. 125–54.

governance should be the focus of developing countries seeking enhanced economic growth.[43] Even the Asian Tigers[44] or newly industrialised countries, which are often cited as examples of the success of outward-oriented policies, on closer examination reveal that their strategies involved selective import liberalisation over an extended period.[45] The causality is not that the economy is opened and then economic growth follows. That there is no automaticity in this sequence is evident in the numerous instances of developing countries that have liberalised their trade regimes with disastrous consequences, providing ample material for anti-globalisation and anti-free trade advocates.

3. If trade liberalisation is the best way to stimulate the expansion of trade and promote growth, any policy that deviates from this will produce second-best results and is therefore harmful. Reference is made to the fact that the majority of developing countries have not achieved the kinds of growth rates warranted for economic development and poverty reduction despite the existence of extensive special and differential treatment. More specifically, preferential market access has not prompted export expansion and thereby not promoted economic growth. Nor have infant industries graduated into competitive export industries despite extended periods of protection from the full brunt of competition from imports. Indeed, it is the competition from imports which will either eliminate industries that are not viable or force them to become sufficiently efficient to survive. The conclusion of this line of reasoning is the abolition of provisions which are intended to nurture infant industries. This amounts to what Chang calls 'kicking away the ladder', which was a key element in the development of the now developed countries.[46]

It is ironic that the developed countries that never tire of exhorting developing countries to relinquish SDT for reciprocal trade have quietly

43 Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work* (Washington, D.C.: Overseas Development Council, 1999).

44 The Asian Tigers are frequently cited as examples of the stimulating effect of openness on growth. This much-heralded 'success' has been questioned, e.g. Paul Krugman, 'The Myth of the Asia Miracle', *Foreign Affairs*, vol. 73, no. 6 (1994) pp. 62–78.

45 Alice H. Amsden, 'Trade Policy and Economic Performance in South Korea' in Manuel R. Agosin and Diana Tussie (eds.), *Trade and Growth: New Dilemmas in Trade Policy* (New York: St Martin's Press, 1993) pp. 187–214 and Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990) pp. 113–58.

46 Ha-Joon Chang, *Kicking Away the Ladder: Development Strategy in Historical Perspectives* (London: Anthem Press, 2002).



continued to deploy an array of protectionist barriers, especially against imports from developing countries. In addition, the extensive system of subsidies, domestic support and export subsidies in the agriculture sector of developed countries, most notably in the US, the EU and Japan, is tantamount to unilaterally appointed SDT. The double standard goes even further when the governments in the developed countries maintain special programmes for vulnerable producers in their national markets. They operate programmes for small and medium-size firms, family-owned farms and disadvantaged regions. These involve finance at below-market rates, technical assistance and reserving a part of the market in government procurement. The practice of SDT at home does not diminish the virulence of their opposition to SDT for developing countries in the multilateral trading system.

While there is substance to the statement that developing countries have not grown as expected or desired despite SDT, it is also grossly inaccurate because it is based on an incomplete analysis of the international trade environment in which developing countries have operated. The evaluation of the performance of the trade of developing countries must include the harmful policies of developed countries starting with the $311 billion of subsidies lavished on agriculture in the OECD countries in 2001, an amount that exceeds the GDP of Sub-Saharan Africa and is six times total foreign aid.[47] Tariff peaks stymie developing country exports; for example 60 per cent of imports from developing countries entering Canada, the EU, Japan and the US were subject to tariff peaks.[48] There is also tariff escalation, non-tariff barriers, quotas, sanitary and phyto-sanitary measures, and a host of other protectionist policies and trade-distorting practices such as dumping. Ironically, what these policies amount to is special and differential treatment granted unilaterally to themselves by the developed countries. It is very problematic to assess the efficacy of SDT for developing countries because most of the measures are best-endeavour commitments couched in hortatory language but are not specific and definitely not enforceable. Even more disappointing is the new trend for developed countries to offer technical assistance as the answer to demands for SDT. It creates the invidious position that obviously it is a gesture that developing countries cannot refuse but in reality it is more of a placebo than a lasting solution.

47 *Human Development Report 2003* (New York: United Nations Development Programme, 2003) p. 155.

48 *Human Development Report 2003* (New York: United Nations Development Programme, 2003) p. 156.

4. It has frequently been said that SDT in the form of non-reciprocity has produced perverse trade policy choices in developing countries. Specifically, it has encouraged them to be protectionist, delaying trade liberalisation[49] as long as they can get away with it. This is the natural course of action because there is no obligation to reciprocate, prompting some to speak of the 'perversity of preferences'[50] of schemes such as the Generalized System of Preferences (GSP). The existence of SDT is purported to 'discourage effective efforts to integrate into the world economy' and 'merely exacerbates the difficulties of pursuing satisfactory policies' and 'should be phased out as soon as possible'.[51] This kind of attribution is too superficial because it overlooks the motivations for deferring trade liberalisation which are present in every country whether it enjoys SDT or not. The common motivations emanate from the desire to preserve market position by minimising competition from imports and garner economic rents and higher profits.

What has not been definitively established in the debate on the efficacy of SDT is how each measure of SDT is directly related to a specific aspect of developing countries. This is partly due to the wide range of countries covered by the existing outmoded nomenclature of developing country and least developed country. It is extremely difficult to identify a typical developing country or a feature that is common to all developing countries to the same extent. Not all developing countries exhibit all the features and problems ascribed to the category.

Some countries, by virtue of not being classified as developed or industrialised, are still counted among the so-called developing countries. These advanced developing countries have proven themselves to be internationally competitive, industrialised and large enough not to be price-takers in a wide and growing range of goods and services. In this context, the call for SDT for SDEs will not succeed unless (a) these countries can be identified as a separate genre of economy, not developed, nor least developed, but a sub-set of developing countries having characteristics which derive from

[49] Robert E. Hudec, *Developing Countries in the GATT Legal System* (London: Gower, 1987).

[50] Caglar Ozden and Eric Reinhardt, *The Perversity of Preferences: The Generalized System of Preferences and Developing Country Trade Policies, 1976–2000*. Policy Research Working Paper No. 2955 (Washington, D.C.: World Bank, 2003).

[51] J. Michael Finger and L. Alan Winters, 'What can the WTO do for Developing Countries?' in Anne Krueger (ed.), *The WTO as an International Organization* (Chicago: University of Chicago, 1998) p. 390.



being developing and from being small; (b) the need for SDT is established based on the characteristics of SDEs and the implications for their functioning, growth, development and structural transformation; (c) each and every type of measure of SDT proposed for SDEs is shown to be directly related to and addressing a specific characteristic and/or aspect of the functioning of SDEs. The next section is therefore devoted to identifying and describing the characteristics of small developing economies.

## 9.5 Characteristics of small developing economies

Small developing economies have certain characteristics,[52] such as a high degree of openness, limited diversity in economic activity, export-concentration on one to three products, significant dependency on trade taxes, and small size of firms. Some developing countries and least developed countries in general may exhibit some of the characteristics listed as defining small developing economies. This has led some to argue that many of the problems attributed to small developing economies are not unique to them or can be addressed by appropriate policy measures and therefore smallness does not differentiate economies.[53] Careful analysis reveals, however, that the characteristics, which are common to different types of developing countries, differ by degree between the different types of developing countries. Therefore what sets small developing economies apart and defines them as a distinct genre of developing country is the combination of characteristics and the degree or extent of these characteristics.

### *9.5.1 Acute vulnerability*

The high degree of openness and the concentration in a few export products, particularly some primary products and agricultural commodities whose prices and demand are subject to fluctuations in world markets, make small developing economies vulnerable to external economic events. Substantial dependence on external sources of economic growth makes small developing countries acutely vulnerable to exogenous shocks. The

[52] There is a view that small countries are so heterogeneous that they do not exhibit uniform characteristics and do not behave in the same way in similar circumstances. See Peter J. Lloyd, *International Trade Problems of Small Nations* (Durham, N.C.: Duke University Press, 1968).

[53] T. N. Srinivasan, 'The Costs and Benefits of Being a Small, Island, Landlocked, or Ministate Economy', *World Bank Research Observer*, vol. 1, no. 2 (1986).

exposure of small developing economies to real shocks is much greater than in larger economies, which are usually more diversified in structure and exports. Gonzales regards vulnerability as such a critical aspect that he speaks of small vulnerable transitional developing states as a distinct category of economy.[54] The WTO Ministerial Declaration of Doha makes reference to the objective of identifying trade-related issues for the fuller integration of 'small, vulnerable economies' into the multilateral trading system.[55]

Economic vulnerability can be a feature of an economy of any size and level of development, but it is compounded by small size, a high degree of openness, narrow export concentration, susceptibility to natural disasters, remoteness and insularity. Small developing economies have structural features that make them more vulnerable to external shocks.[56] Indeed, acute vulnerability is a feature that is unique to small developing economies, differentiating them from other types of economies that may share characteristics such as openness, weak adjustment capacity and limited institutional capacity.

The characteristic of small developing economies that most differentiates them from other developing countries is acute vulnerability. This is a condition which arises from a high degree of openness compounded by a high degree of export concentration and export market concentration. Export concentration is not unique to small developing economies; it is a feature of several developing countries and is particularly common among the least developed countries. However, concentration on a few exports, concomitant with small size of productive units and a disarticulated adjustment capacity, gives export concentration an importance in small developing economies beyond that of other developing countries.

### 9.5.1.1 High degree of openness

External transactions are large in relation to total economic activity, as indicated by the high ratio of trade to GDP. There is heavy reliance on external trade because of a narrow range of resources and the inability to

54 Anthony Gonzales, 'Policy Implications of Smallness as a Factor in the Lomé, FTAA and WTO Negotiations', Caribbean RNM/IDB Regional Technical Cooperation Project No. ATN/JF/SF-6158-RG, September 2000.

55 WTO Ministerial Declaration, Doha, 9–14 November 2001, WT/MIN (01)/DEC/1, 20 November 2001, paragraph 35, p. 8.

56 'Small and Relatively Less Developed Economies and Western Hemisphere Integration', OAS/Ser.W/XIII.7 (Washington, D.C.: Organization of American States, September 1996).



support certain types of production, given the small scale of the market. Economic openness is measured by imports and exports of goods and services as a percentage of GDP. A high degree of openness is not peculiar to small developing economies, as the growth of interdependence and the increase of international transactions relative to national production have resulted in all economies showing increased levels of openness. For many developed countries, a high degree of openness is typical; however, the implications of this are very different compared to small developing countries. A high level of openness coexists in most small developing economies with extreme export concentration and internationally uncompetitive production, resulting in vulnerability. In contrast, a high degree of openness in developed economies is indicative of their integration in the global economy and their ability to compete in global markets.

### 9.5.1.2 Export concentration

The limited range of economic activity in small developing economies is reflected in concentration on one to three exports accompanied, in the majority of cases, by a relatively high reliance on primary commodities. In extreme cases, one export, often a primary product or tourism, accounts for nearly all exports. Empirical analyses have detected a positive and statistically significant relationship between export concentration and export instability[57] and, through its effects on terms of trade, volatility has a major effect on income volatility.[58] The terms of trade volatility is 30 per cent higher for small developing economies than for other developing countries.[59]

### 9.5.1.3 Export market concentration

In many small developing economies export concentration is accompanied by export market concentration, i.e. dependence on one or two export markets. For example, in the 1990s, Britain absorbed Dominica's bananas when that product accounted for 90 per cent of total exports.

57 J. Love, 'Commodity Concentration and Export Earnings Instability: A Shift from Cross-section to Time Series Analysis', *Journal of Development Economics*, vol. 24 (1986) pp. 239–48.

58 Marion Jansen, 'Income Volatility in Small and Developing Countries', WTO Discussion Paper (December 2004) p. 5.

59 M. Ayhan Kose and Eswar S. Prasad, 'Thinking Big', *Finance and Development*, vol. 39, no. 4 (December 2002).

#### 9.5.1.4 Export marketing monopoly

The effect of export market concentration is particularly detrimental to economic development if the export marketing is controlled by a single multinational corporation.[60] This is frequently the case, in part because of the very small export volume, for example the export of bananas and sugar from the Caribbean. Even where an export is handled by several multinational corporations, the transactions constitute intra-firm trade[61] and not the arm's-length international trade of economics textbooks. For a long time the world bauxite trade was conducted on the basis of intra-firm transfers[62] and there was no genuine world market in operation.

#### 9.5.1.5 Acuteness

The extent of vulnerability of an economy can be measured by a 'vulnerability index': for example the index constructed by Atkins, Mazzi and Easter[63] incorporates economic exposure, susceptibility to environmental events and remoteness and insularity. Gonzales uses income volatility, growth resilience and preference dependence.[64] Different vulnerability indices have been formulated differing in which variables are included and the methodology of weighting. Despite differences, all vulnerability indices reveal a relationship between vulnerability and size, with the smallest countries being the most vulnerable. Atkins et al. found that twenty-eight of the thirty most vulnerable were small developing economies.[65] A Commonwealth Secretariat/World Bank study has shown that of 111 developing countries, twenty-six of the twenty-eight most vulnerable were small countries and

[60] George Beckford, *Persistent Poverty. Underdevelopment in Plantation Economies of the Third World* (Oxford: Oxford University Press, 1972).

[61] Gerald K. Helleiner, *Intra-Firm Trade and the Developing Countries* (London: Macmillan, 1981).

[62] Norman Girvan, *Corporate Imperialism: Conflict and Expropriation: Transnational Corporations and Economic Nationalism in the Third World* (New York: Monthly Review Press, 1976).

[63] Lino Briguglio, 'Small Island Developing States and their Economic Vulnerabilities', *World Development*, vol. 23, no. 9 (1995) pp. 1615–32, and Jonathan P. Atkins, Sonia Mazzi and Christopher D. Easter, 'Small States: A Composite Vulnerability Index' in David Peretz, Rumman Faruqi and Eliawony J. Kisanga (eds.), *Small States in the Global Economy* (London: Commonwealth Secretariat, 2001) pp. 53–92.

[64] Anthony Gonzales, 'Policy Implications of Smallness as a Factor in the Lomé, FTAA and WTO Negotiations', Caribbean RNM/IDB Regional Technical Cooperation Project No. ATN/JF/SF-6158-RG, September 2000.

[65] Jonathan P. Atkins, Sonia Mazzi and Christopher D. Easter, 'Small States: A Composite Vulnerability Index' in David Peretz, Rumman Faruqi and Eliawony J. Kisanga (eds.), *Small States in the Global Economy* (London: Commonwealth Secretariat, 2001) p. 63.



that the least vulnerable economies were all large countries.[66] Argentina, Brazil, Canada and the United States have vulnerability indices of 0.2 or less while the ten smallest countries range from 0.59 to 0.84.[67]

### 9.5.2 *Imperfect markets*

The small size of markets in small developing economies results in market structures which are characterised by substantial imperfections. These derive from the limited number of participants, and in many cases there are monopolies and oligopolies. Even where there are a large number of producers or traders, one or a few firms effectively dominate the operation of markets both in the financial as well as in the real sector. Market imperfections, of one kind or another, are to be found in economies of all types, but in small developing economies these imperfections are particularly perverse. For example, monopolies in small developing economies are especially inefficient because the market is so small that there is little prospect of competition and they suffer from the lack of economies of scale.

### 9.5.3 *Small size of firms*

Firms from small countries are small by comparison with multinational corporations and firms in large economies. Small firms are at a disadvantage in the global marketplace because they cannot realise economies of scale, are not attractive business partners, and cannot spend significant funds on marketing, research and development. The difference in the size of total sales of the largest national firms is a good indicator of the enormous gap between firms competing in the global marketplace. The total sales of General Motors are 328 times larger than those of the largest nationally owned firm in the SDEs of the English-speaking Caribbean. Sales and employment of some multinational corporations are larger than the GDP and population of many small developing economies. Given the minute size of even the largest firms in small developing economies, they in essence constitute micro-enterprises by global standards and this remains the case even when they merge within regional integration schemes among such economies.

[66] 'Small States: Meeting Challenges in the Global Economy', Interim Report of the Commonwealth Secretariat/World Bank Joint Taskforce on Small States, October 1999, p. 13.

[67] Lino Briguglio, 'Small Island Developing States and their Economic Vulnerabilities', *World Development*, vol. 23, no. 9 (1995) pp. 1615–32.

### 9.5.4 *Dependence on trade taxes*

There is a high dependence on trade taxes as a percentage of government revenue in small developing economies. Trade taxes account for more than one-half of government revenue in St Lucia, Belize and the Bahamas, and over one-third of government revenue in Guatemala and the Dominican Republic. The extreme dependence on trade taxes as a source of fiscal revenue accounts for the resolute and persistent resistance of governments in small countries to contemplate tariff reductions. This, rather than protection of local industry, has delayed or blocked trade liberalisation in small developing economies. Ironically, more costly imports due to high tariffs result in high input costs, which reduce the international competitiveness of exports of goods and services. This in many instances, however, is justified by the need to control import demand for balance-of-payments purposes.

### 9.5.5 *Limited institutional capacity*

Small developing economies have very limited institutional capacity and this has a number of implications which increase the cost of goods and services provided by the state, which in turn increase the cost of production in the private sector. In many instances the government cannot sustain specialised services, with the result that they are either not available or have to be imported. Even where the state has the capacity to supply certain goods and services, these tend to be high cost because of the absence of economies of scale and the indivisibility of certain public service functions.

## 9.6 Implications of small size

There is no direct correlation between size and economic growth[68] and level of development. This is evident in the fact that many countries which are small in terms of standard indicators such as population, land area and GDP are ranked favourably according to levels of GDP per capita and the UN's Human Development Index. Nevertheless, small size has

[68] Chris Milner and T. Westaway, 'Country Size and the Medium-Term Growth Process: Some Cross-Country Evidence', *World Development*, vol. 21, no. 2 (1993) pp. 203–11, and H. W. Armstrong and R. Read, 'Trade and Growth in Small States: The Impact of Global Trade Liberalization', *World Economy*, vol. 21, issue 4 (June 1998) pp. 563–85.



implications for the international trade of these countries. These implications include:

### 9.6.1 *Volatility*

Small developing economies have traditionally experienced pronounced economic volatility because:

(a) Acute vulnerability is especially severe when export earnings depend on products which are prone to instability such as primary products[69] or goods whose market access depends on voluntary preferential arrangements in developed countries. This instability is heightened when exports depend on a few external markets, because exports are exposed to fluctuations in demand and price, and changes in market access policy in importing countries. It has been suggested that many small economies can reduce export instability by shifting to services, particularly tourism and financial services. The change in export composition toward the service industry has not always been accompanied by reduced instability in export earnings.[70]

(b) One of the peculiarities of small developing countries, particularly small islands, is the fragility of their ecologies, the prevalence of natural disasters and their susceptibility to environmental damage from natural disasters. Natural disasters have been a recurring factor in the volatility of small developing economies. The World Bank has estimated that the impact of a natural disaster on a small economy and its financial sector can be far more devastating than it is on a large economy, where the damage is relatively localised. For example, the damage to Jamaica from Hurricane Gilbert in 1988 amounted to about 33 per cent of GDP, damage to Antigua from Hurricanes Luis and Marilyn in 1995 amounted to about 66 per cent of GDP, and Montserrat suffered losses totalling 500 per cent of GDP from Hurricane Hugo in 1989. In comparison, the damage to the United States from Hurricane Andrew in 1992, while much larger in absolute financial terms, amounted to only 0.2 per cent of GDP.

[69] On the instability of primary product export earnings see *Global Economic Prospects and the Developing Countries 1994* (Washington, D.C.: World Bank, 1994) chapter 2.

[70] Ransford Palmer, 'Export Earnings, Instability, and Economic Growth, 1957 to 1986' in David L. McKee (ed.), *External Linkages in Small Economies* (Westport: Praeger, 1994) pp. 31–4.

(c) Small developing economies exhibit a very high reliance on foreign capital inflows in the form of private direct foreign investment and development aid. The average of the ratio of the volume of capital flows to GDP is larger in small developing economies than in other developing countries and the ratio of foreign aid to GDP is about 20 per cent, double that of other developing countries.[71] Foreign aid flows are subject to considerable fluctuations from year to year because they are allocated according to the political priorities of donor governments. The evidence for the last twenty years reveals that small developing economies are at a disadvantage in attracting direct foreign investment compared to larger developing countries. This is in part due to the perception that smaller countries are riskier investment environments. Even when they have sound economic policies and the macroeconomic fundamentals are good, small developing countries are rated 29 per cent more risky.[72]

Volatility is a feature of developing countries which export primary products, particularly agricultural commodities and minerals, and which experience fluctuations in capital flows. Volatility is costly because of its adverse impact on financial intermediation, exchange rates, inflation, income distribution, resource allocation, productivity and investment.[73] Income volatility has a strong negative effect on economic growth in developing countries[74] and adversely affects investment.[75]

Small developing economies experience higher levels of volatility than other economies, indicating that small size is related to volatility. Empirical studies have documented greater volatility of output[76] and real

71 M. Ayhan Kose and Eswar Prasad, 'Thinking Big', *Finance and Development*, vol. 39, no. 4 (December 2002).

72 Paul Collier and David Dollar, 'Aid, Risk and the Special Concerns of Small States', Development Research Group, World Bank, February 1999.

73 *Overcoming Volatility: Economic and Social Progress in Latin America, 1995 Report* (Washington, D.C.: Inter-American Development Bank, 1995) pp. 194–5.

74 William Easterly and Aart Kraay, 'Small States, Small Problems? Income, Growth and Volatility in Small States', *World Development*, vol. 28, no. 11 (2000) pp. 2013–27, and Garey Remy and Valerie A. Remy, 'Cross-country Evidence on the Link between Volatility and Growth', *American Economic Review*, vol. 86 (1995) pp. 1138–51.

75 J. Aizenmann and N. Marion, 'Volatility and Investment: Interpreting Evidence from Developing Countries', *Economica*, vol. 66 (1999) pp. 157–81.

76 Garey Ramey and Valery A. Ramey, 'Cross-country Evidence on the Link between Volatility and Growth', *American Economic Review*, vol. 86 (1995) pp. 1138–51.



per capita income[77] in small economies, and income volatility increases the smaller the economy.[78] Estimates by the World Bank and Commonwealth Secretariat show that 'the standard deviation of annual real per capita growth is about 25 per cent higher'.[79] Small developing economies experience difficulty in sustaining economic growth and they may, as Looney argues, be incapable of sustaining economic growth.[80] During the period 1980–98 only twenty-four of fifty-three small island countries achieved growth and the 'average per capita growth rate was negative'.[81]

### *9.6.2 Sub-optimal resource use, allocation and mobilisation*

Small markets are imperfect markets and this has several implications for resource use, allocation and mobilisation:

(a) Small markets are not competitive business environments even with a large number of firms because a very limited number of participants achieve dominance and hence there is an oligopoly or a monopoly. These market situations reduce the efficiency with which firms operate and lead to distortions in resource use. The lack of market-driven competition leads to inefficiency and higher costs, as firms are not driven by the dynamics of competition to optimise efficiency and introduce new technology and improved production systems. A firm's international competitiveness depends on its capacity to innovate continually in production techniques and products. The national market conditions in which the company operates are a significant variable in its drive to develop its competitive advantages.

(b) The small size and skewed structure of the market inhibits the ability of small developing economies to garner resources from external

77 William Easterly and Aart Kraay, 'Small States, Small Problems? Income, Growth and Volatility in Small States', *World Development*, vol. 28, no. 11 (2000) pp. 2013–27.

78 Marion Jansen, 'Income Volatility in Small Developing Economies. Export Concentration Matters', WTO Discussion Paper (December 2004).

79 'Small States, Meeting Challenges in the Global Economy', Interim Report of the Commonwealth Secretariat/World Bank Joint Taskforce on Small States, October 1999, p. 13.

80 Robert E. Looney, 'Economic Characteristics Associated with Size: Development Problems Confronting Smaller Third World States', *Singapore Economic Review*, vol. 37, no. 2 (October 1992) pp. 1–19.

81 *Human Development Report 2003* (New York: United Nations Development Programme, 2003) p. 72.

sources, in particular private foreign investment. Investors often are unaware of opportunities in small developing economies or do not consider them to be worthwhile as investment locations because of the limited size of the national market. Further, investment in export sectors tends to be biased in favour of larger economies, even when these economies are low-income and less developed.

(c) The high import content of production and consumption, undiversified economic structure and the lack of competitive markets in small developing economies mean that there are rigidities in resource allocation. This makes the adjustment process more difficult and, of necessity, slower than the adjustment process in larger, more developed economies.

(d) Small firms and farms are unable to sustain a consistent supply in volume and quality in both the local and export markets, and this results in their elimination from the market even where they are competitive in price and acceptable in quality on most occasions. For example, the tourism sector often imports food products which are produced locally because supply is not consistent.[82]

(e) International competitiveness and efficiency is sub-optimal because labour productivity can never be at its maximum as small developing economies cannot provide opportunities for specialisation. In these circumstances, highly skilled personnel function as generalists, which reduces their productivity. This inherent trend is compounded by the migration of a significant proportion of university-trained persons seeking jobs suited to their type and level of training. In some situations a highly specialist person, e.g. a neurosurgeon, may not be able to find sufficient work in an economy of 500,000 or fewer people. Small developing economies such as Fiji, Haiti, Jamaica and Trinidad and Tobago have more than 60 per cent of their highly skilled population living abroad and the figure reaches 83 per cent in the case of Guyana. The comparable data for large developing economies – Brazil, China, India, Indonesia and Thailand – are less than 3.2 per cent.[83]

82 Rebecca Torres and Janet Henshall Momsen, 'Challenges and Potential for Linking Tourism and Agriculture to Achieve Pro-Poor Tourism Objectives', *Progress in Development Studies*, vol. 4, no. 4 (October 2004) pp. 294–318.

83 Jean-Christophe Dumont and Georges Lemaitre, *Counting Immigrants and Expatriates in OECD Countries: A New Perspective* (Paris: OECD, 2005) p. 14.



### *9.6.3 Constrained international competitiveness*

It is firms not countries that conduct international trade. Firms in small developing economies are small by global standards, although they may be very large by local standards. Such firms are constrained by a business environment which is less conducive to attaining international competitiveness than those of large developing countries or developed countries where economies of scale can be realised without involvement in export activity and firms can benefit from modern infrastructure, large markets and enterprise cluster. Even in developed countries small firms find it more difficult than large firms to overcome the difficulties of breaking into export markets and undertaking foreign investment. The result is that less than 0.2 per cent of small firms have multinational operations.[84] Despite these difficulties, some firms in small developing economies have attained international competitiveness,[85] established worldwide brands and become multinational enterprises.

(a) Small developing economies have severe constraints on their material and labour inputs, both in amount and variety, because of their limited land areas, narrow resource bases and small populations. These constraints prevent the attainment of economies of scale for a wide range of products and lead to high unit costs of production, especially in manufacturing.[86] Small market size also tends to cause high costs because there is often a lack of competition, and in many instances the markets are oligopolistic or controlled by monopolies.

Firms in small economies, especially small developing economies,[87] are at a major disadvantage compared to large firms in the global context. These small firms cannot attain either internal economies of scale[88] (where

84 Zoltan J. Acs, Randall Morck, J. Myles Shaver and Bernard Yeong, 'The Internationalization of Small and Medium-Sized Enterprises' in Zoltan J. Acs and Bernard Yeong (eds.), *Small and Medium-Sized Enterprises in the Global Economy* (Ann Arbor: University of Michigan Press, 1999) p. 52.

85 Ganesh Wignarja, Marlon Lezama and David Joiner, *Small States in Transition: From Vulnerability to Competitiveness* (London: Commonwealth Secretariat, 2004).

86 Donald B. Keesing, 'Population and Industrial Development: Some Evidence from Trade Patterns', *American Economic Review*, vol. 58, no. 3 (1968) pp. 448–55.

87 Firms in small developing economies are discussed in Alvin G. Wint, *Managing Towards International Competitiveness: Cases and Lessons from the Caribbean* (Kingston: Ian Randle Publishers, 1997), and Alvin G. Wint, *Competitiveness in Small Developing Economies: Insights from the Caribbean* (Kingston: University of the West Indies Press, 2003).

88 The cost disadvantages suffered by small firms result from the lack of economies of scale, higher costs of inputs and higher transportation costs. See L. Alan Winters and Pedro M. G. Martins,

unit cost is influenced by the size of firm) or external economies of scale (where unit cost depends on the size of the industry, but not necessarily on the size of any one firm). A small economy and, by extension, small industries (including export sectors) are unlikely to foster the competitive dynamics necessary for firms in small economies to achieve competitive advantage. Competitive advantage in the sense in which Porter[89] uses the term is more likely to occur when the economy is a developed one and is large enough to sustain 'clusters' of firms connected through vertical and horizontal relationships and where there are networks[90] of related and supporting industries. A firm working with world-class local suppliers can benefit from cross-fertilisation opportunities and overcome information asymmetries. Related industries can also be an important source of innovations and can provide strategic alliances and joint ventures.

Firms in small developing countries also have severe difficulties in attaining 'economies of scope', i.e. economies obtained by a firm using its existing resources, skills and technologies to create new products and/or services for export. Exposure to global competition requires small firms to invest heavily just to survive in their national market, and more so in order to export. Larger firms are better able to generate new products and sources from existing organisations and networks. Very large firms, such as multinational corporations, operate internationally in ways that are very different from small firms.

The disabilities constraining small firms increase the smaller the developing economy in which they operate. Firms in micro-developing economies face higher costs than other small developing economies.[91]

(b) A small developing economy is an aggregation of firms which are small in the world market and therefore 'price-takers', i.e. exercising no influence on world market prices for goods, services and assets. Inputs,

'Beautiful but Costly: Business Costs in Small Economies' (a study prepared for the Commonwealth Secretariat and the United Nations Conference on Trade and Development, 2004). For the opposing view see Boris Blazic-Metzner and Helen Hughes, 'Growth Experience of Small Countries' in B. Jalan (ed.), *Problems and Policies in Small Economies* (New York: St Martin's Press, 1982) pp. 85–102.

89 Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990) pp. 71–3.

90 Christopher A. Bartlett and Sumantra Ghoshal, *Managing Across Borders* (Boston: Harvard Business School Press, 1989).

91 Alan L. Winters and Pedro M. G. Martins, 'Beautiful but Costly: Business Costs in Small Economies' (a study prepared for the Commonwealth Secretariat and the United Nations Conference on Trade and Development, 2004).



including imports, cost firms in small economies more than large firms, thereby making firms in small economies relatively less efficient.

Small developing economies pay higher transportation costs[92] because of the relatively small volume of cargo, small cargo units and the need for bulk breaking. Small economies pay an average of 10 per cent of the value of merchandise exports as freight costs, compared to a 4.5 per cent worldwide average and 8.3 per cent for developing countries.[93] Small developing economies spend more on freight costs as a percentage of imports than large countries. The world average is roughly 5.25 per cent whereas the SDEs of the Caribbean pay between 9 and 13 per cent.[94]

The public sector and government expenditure in small developing economies accounts for a larger share of GDP[95] than in larger countries. This is a reflection of the indivisibility of public administration structures, the lack of economies of scale in the provision of public goods and the execution of certain functions which every country, no matter how small, has to carry out, e.g. a head of state, a parliament, a police force, etc. The growth of the public sector has also been due in part to attempts to compensate for the absence of the private sector in certain economic activities, as well as the inability of firms in small developing economies to finance large infrastructure projects either in the narrow local capital market or in international financial markets.

The small size of the market and the prevalence of small firms make it difficult for small economies to attract private foreign investment and joint venture partnerships even when the policy regime and economic fundamentals are better than competing locations. The result is that both the public sector and the private sector composed of small firms pay higher interest rates and other costs, which serve to increase the costs of production. Small firms and farms find it more difficult than larger entities to meet the cost of compliance with international standards. For example, in

92 Dennis Pantin, *The Economics of Sustainable Development in Small Caribbean Islands* (Mona, Jamaica: Centre for Environment and Development, University of the West Indies, 1994) p. 16.

93 *A Future for Small States: Overcoming Vulnerability* (London: Commonwealth Secretariat, 1997) p. 29, and M. Ayhan Kose and Eswar S. Prasad, 'Thinking Big', *Finance and Development*, vol. 39, no. 4 (December 2002).

94 *UNCTAD Review of Maritime Transport, 1997* (Geneva: UNCTAD, 1997).

95 Robert E. Looney, 'Profiles of Small Lesser Developed Economies', *Canadian Journal of Development Studies*, vol. 10, no. 1 (1989) pp. 21–37, Michael Howard, *Public Finance in Small Open Economies. The Caribbean Experience* (Westport: Praeger, 1992), and Alberto Alesina and Enrico Spolaore, *The Size of Nations* (Cambridge, Mass.: MIT Press, 2003) chapter 10.

developing countries enterprise size is the key variable in the ability to comply with sanitary and phyto-sanitary measures in developed country markets.[96]

### *9.6.4 Disarticulated adjustment capacity*

The high import content of production and consumption and the rigidity inherent in the undiversified economic structure of small developing economies severely hamper resource allocation, which makes the adjustment process more difficult and slower than in larger economies. In many situations, adjustment requires resource creation as well as resource allocation. The undiversified economic structure of small developing economies causes the adjustment process to be more difficult, larger relative to GDP and of necessity slower than in larger countries.[97]

There is a high degree of openness in small developing economies, one of the consequences of which is that movements in the price of imports dominate the overall domestic price level. The prices of non-traded goods also tend to adjust rapidly through the impact of foreign prices on wages and other costs. Exchange rate charges do not have the desired effect on the balance of payments because of low import and export price elasticities.

Stabilisation policy must be designed specifically for small developing countries, taking cognisance of the structure of markets and the nature of their operations. The uncompetitive nature of these markets, particularly where monopolies and oligopolies exist, and the limited number and type of institutions make resource utilisation and allocation more problematic than in large developed economies. These types of market situations are characterised by rigidities which make the adjustment process more time-consuming, and which diminish the efficacy of conventional policy measures such as open market operations and recalibration of economy-wide prices such as the exchange rate. Furthermore, structural adjustment, like stabilisation, is a more difficult process in small developing economies because the inherent rigidities in the structure and operation of markets complicate the process of resource reallocation. The nature of these small

[96] 'Food Safety and Agricultural Health Standards. Challenges and Opportunities for Developing Country Exports', World Bank Report No. 31207, 10 January 2005, p. 62.

[97] Gerald K. Helleiner, 'Why Small Countries Worry: Neglected Issues in Current Analyses of the Benefits and Costs of Small Countries of Integrating with Large Ones', *World Economy*, vol. 19, no. 6 (November 1996) pp. 759–63.



markets also restricts the ability of private-sector entities and the government to mobilise additional resources, both within these economies and from external sources.

Small developing economies have structural features that need to be changed (where feasible) if these economies are to cope with the rapid and profound changes associated with globalisation. Adjustment will not suffice to enable these economies to manage the changes in the global economy successfully since adjustment implies marginal and incremental modification to an economic structure which is fundamentally sound and conducive to sustainable economic growth. Economic transformation goes beyond the resource utilisation, reallocation and mobilisation intrinsic in stabilisation and structural adjustment to incorporate resource creation over the medium to long term. Transformation in the current and future global economy will entail the ability of small developing economies to facilitate the rapid and frictionless international mobility of goods, services, finance, capital and technology which is the essence of a seamless global economy.

## 9.7 Special and differential treatment for small developing economies

The design of measures to address the characteristics and interests of small developing economies should not be limited to measures which avoid putting these economies at a disadvantage, nor should it be confined to best-endeavour commitments to promote trade opportunities and safeguard the interests of these economies. For example, Article IV of the GATS specifies measures aimed at increasing the participation of developing countries in the global trade in services, through specific commitments in relation to strengthening the efficiency, capacity and competitiveness of their domestic services. It also requires developed member countries to facilitate the access of developing country service suppliers to information related to market access.

### *9.7.1 Guiding principles*

The overall goal of special and differential treatment applicable to small developing economies is the promotion of economic development, which entails a quantitative dimension, i.e. growth, and a qualitative dimension, i.e. structural transformation, and therefore must be guided by the following principles:

(1) The measures must be precise and enforceable and not merely best-endeavour commitments.
(2) Those provisions dealing with the disabilities in the process of development should be subject to periodic review and renegotiation where appropriate.
(3) The provisions which address the problems arising from small size must be long term and should be renewable.
(4) Sectors or products which are clearly recognised to be internationally competitive should be exempt from SDT.
(5) Where a SDE produces a large enough share of world production of a commodity it should not be entitled to SDT for that commodity.
(6) Provisions must take account of the differences in the size of firms involved in international trade, bearing in mind that firms from small developing economies are micro-enterprises by global standards.
(7) Given the structural and institutional limitations on the capacity for economic management, SDEs must have the maximum degree of freedom to pursue development policies.

### 9.7.2 *Specific measures*

The classification of SDT measures used by the WTO is not as helpful as it could be because the categories are too broad and consequently it does not allow the connection between the provision and the issue it is intended to address to be lucidly established. The categories employed by the WTO are increasing trade opportunities of developing countries, safeguarding the interests of developing countries, flexibility of commitments, transitional time periods and technical assistance. In order to overcome the limitations of the WTO classification and improve the specificity of the measures and elucidate the link with how they help SDEs, nine types of measures are proposed and illustrations are provided where pertinent. The examples provided are not intended to be an exhaustive list of existing SDT measures as such a cataloguing exercise has already been completed by the WTO.

#### 9.7.2.1 Differentiated obligations

Trade between developed countries and small developing economies should be governed by the principle of less than full reciprocity. There would be reciprocity in some subjects and in some sectors and products but SDEs would undertake commitments to the extent consistent with their capacity for adjustment, level of development and their administrative and institutional capabilities for implementation. Developed countries would maintain existing preferential market access for as long as possible and seek to create trade opportunities by more favourable market access for goods and services from SDEs through specific measures on an issue-by-issue basis and, where appropriate, on a product-by-product basis.

Consideration could be given to the inclusion of an 'enabling clause' for small developing economies, which would allow for the differential application of rules in the levels of obligation for small developing economies within the developing country framework.

#### 9.7.2.2 Asymmetrically phased implementation

Given the small size of firms, the small scale of production and limited size of the market, small developing economies will require a longer period of adjustment than developed economies. Hence, there must be asymmetrically phased implementation of rules and disciplines, permitting a longer adjustment period for small developing economies. For example, in agricultural trade, particularly food items, small developing economies should be allowed the flexibility to implement their commitments to reduction of protection and domestic support over a longer period than the implementation period prescribed for larger economies.

Provision for such differentiated phase-in schedules was included in both the Agreement on Textiles and Clothing (ATC) and the TRIPs Agreement. In the ATC, small suppliers were allowed longer phase-out periods for the Multi-Fiber Agreement (MFA) as well as greater flexibility in growth rates, etc. Under the TRIPs Agreement, developing countries and LDCs were allowed the longest phase-in period for implementation of their obligations.

The weakness of the current provisions which allow longer implementation periods is that they are not related to any measure of implementation capacity, the cost of implementation or any evaluation of if and when implementation has been accomplished or to what extent further work is required and how long a period would be needed. These deficiencies have to be remedied in a revision of implementation and adjustment periods.

### 9.7.2.3 Exemptions from commitments in certain areas

Given the vast disparities in size, the extremely small size of some economies and the human, financial and institutional costs involved in implementing the trade agreements, small developing economies should be permitted some exemptions. This would not only address the question of disparities, but also avoid delays which may occur because SDEs, despite their best efforts, are unlikely to meet certain requirements and timetables. For example, if, as is likely, exports subsidies are outlawed, smaller economies should be exempt from this requirement. Exemptions should also be considered for standardising technical requirements through national organisations and participation in international standardisation processes where these have no applicability because of lack of production or importation or exports. Where complete exemptions are not feasible, *de minimis* provisions would be helpful.

An example of this type of measure is the provision which exempts developing countries from the disciplines in some types of export subsidies. This type of provision should be included in other aspects of the WTO agreements. For example, in government procurement agreements the very small developing economies should have their government procurement markets exempt from coverage given their very small size.

### 9.7.2.4 Flexibility in application and adherence of disciplines under prescribed circumstances

Small developing economies are highly open economies and are therefore more susceptible to balance-of-payments problems. This is particularly the case for small developing countries where balance-of-payment deficits tend to be persistent because of their structural origins. The balance-of-payment provisions such as those provided in Articles XII and XVIII:B of the GATT are not confined to any particular type of country but all members may avail themselves of the right to resort to these provisions under the circumstances prescribed. Because of the vulnerability of small developing economies to balance-of-payments problems, these provisions should be made more applicable to them by permitting additional facilities to enable them to (a) maintain sufficient flexibility in their tariff structure to be able to grant the tariff protection required for the establishment of a particular industry, and (b) apply quantitative restrictions for balance-of-payments purposes which take full account of the continued high level of



demand for imports likely to be generated by their programmes of economic development.

### 9.7.2.5 Temporary suspension of obligations in prescribed circumstances

Small developing countries should be allowed to suspend their obligations in certain specified circumstances, for periods of up to one year, starting with six months in the first instance. Situations that would trigger the right to suspend certain obligations could include natural disasters and the sudden and substantial collapse in earnings of one of the principal exports, defined to be over a prescribed percentage of total exports over the previous five years. Small island developing states in particular are prone to natural disasters, causing devastation and necessitating an extended period of national reconstruction, particularly in agriculture. For example, a hurricane that hits Florida does not affect the rest of the United States but when this happens to a small island such as one of those in the Caribbean, the entire country is damaged. The experience of small developing economies dependent on one or two primary products or sensitive services, e.g. tourism, reveals that the devastating impact that the events such as natural disasters have on the fortunes of a single commodity can be both in the short and the long run.

### 9.7.2.6 Development promoting policy

There should be a shift in the focus of SDT from exempting developing countries from having to fulfil certain obligations to measures which proactively promote economic development. The forgoing of obligations has not always been helpful to the adjustment and development of developing countries. It has resulted in the postponement of adjustment to the detriment of economic development, international competitiveness and the diversification of exports. Prolonged adjustment periods can be as harmful to development as adjustment that is too short. Development promoting SDT would furnish governments in small developing economies with the policy flexibility which they need, while not relying on governments in developed countries to honour the hortatory language of 'best-endeavour' clauses. This emphasis on policy space for developing countries rather than developed countries making exceptions may have the advantage of arousing less opposition in developed countries to SDT.

Special and differential measures which stimulate development by stimulating investment, enhancing international competitiveness and promoting export production and diversification can take the form of:

(a) preferential access to the markets of developed countries. Market access is critical to stimulating market forces which can produce trade-led growth. Developed countries can promote this in small developing economies by (i) establishing or maintaining preferential market access arrangements, (ii) reducing protectionism in their markets, (iii) a liberal dispensation on regional trade agreements among small developing economies, (iv) more liberal provisions on Mode 4 of services, the movement of natural persons, and (v) accepting measures for small developing economies for which other economies are not eligible, e.g. geographical indications.
(b) allowing governments in small developing economies the policy space to promote development by means not open to all members of the WTO because these economies are characterised by serious market imperfections or market failures. This could entail the implementation of existing SDT, which allows use of some subsidies, investment incentives, waiving the principle of national treatment for firms which are small by global standards or for exporters whose share of world trade in a particular product is below a certain level.
(c) affording the right to use a 'positive list' approach in deciding which products are to undertake tariff reductions, particularly in agriculture.[98] The principle of non-reciprocity as expressed, for example, in Article XIX(2) of the GATS allows 'appropriate flexibility' for developing countries, including 'opening fewer sectors, liberalizing fewer types of transactions, progressively extending market access in line with their development situation'.
(d) allowing more latitude in rules of origin so that they do not negate preferential market access but serve instead to stimulate development. Relaxation of rules of origin has boosted apparel production in countries benefiting from the Caribbean Basin Economic Recovery Act and the African Growth and Opportunity Act.

[98] Manuela Tortora, 'Special and Differential Treatment and Development Issues in the Multilateral Trade Negotiations: The Skeleton in the Closet' (Geneva: UNCTAD, January 2003), UNCTAD/WEB/CDP/ BKGD/16, p. 14.



(e) permitting a more generous approach to safeguards for small developing economies.

### 9.7.2.7 Technical assistance and training

The need for technical assistance to the small developing economies is widely accepted; however, it is not a panacea nor should it be a placebo. This issue requires some fresh thinking as the institutional capacity is so constrained in most small countries that there is a need for technical assistance to identify technical assistance needs. Technical assistance should focus on:

(a) promoting the development of adequate institutional capacity by training technicians to improve the implementation of the international trade agreements. The costs of implementing the commitments in the Uruguay Round turned out to be enormous relative to the resources of the developing countries;[99]
(b) assisting small developing economies in fulfilling their obligations assumed in international agreements, in particular commitments under the WTO;
(c) supporting the efforts of SDEs to prepare technically for negotiations, attending meetings and maintaining representation at the WTO in Geneva;
(d) contributing to efforts by small developing economies to undertake the structural, institutional and legislative adjustment necessary to stimulate and sustain economic development.

Technical assistance is provided for in the WTO in fourteen provisions across six agreements and one ministerial decision. The major difficulty has been ensuring that these provisions are given practical effect and that the presently inadequate funding is substantially increased.

### 9.7.2.8 Enabling access to mediation

The Understanding on Rules and Procedures governing the Settlement of Disputes (DSU) is currently under review in light of the experiences of the

[99] Michael J. Finger and P. Schuler, *The Implementation of the Uruguay Round Commitments: The Development Challenge*, Policy Research Working Paper No. 2215 (Washington, D.C.: World Bank, 2000).

past few years. The problems which have been identified in the operations of the Dispute Settlement Mechanism (DSM) include:

(a) the limited capability of small developing countries to make use of the mechanism because of their inadequate expertise and institutional capacity to implement panel findings;
(b) the high cost and administrative difficulties of using the dispute settlement mechanism.

There are provisions in the DSU which grant technical assistance to developing countries. These need to be extended to small developing economies and made more effective for these countries. The cost entailed and the difficulties experienced by the countries of the English-speaking Caribbean in the banana dispute between the US and Latin American banana exporting countries and the EU illustrates the problems which small developing countries face in attempting to utilise the DSM.

#### 9.7.2.9 Development funding for implementation and trade capacity-building

The cost of implementation of commitments in the WTO can be very substantial for small developing countries, particularly in the short run, and can amount to a significant share of development assistance.[100]

The current concept of trade capacity-building must be redimensioned to include building trade capacity in both the private and the public sectors. While this may not form part of a trade agreement, the measures of SDT should include not only those expressed in the rules but also financing to ensure that capacity created or enhanced by technical assistance is put on a sustainable basis. Measures of SDT in some cases cannot come to fruition without being complemented by development funding. Development funding for capacity-building should take account of financing for industry and product adjustment, compensation for the loss of preferences, the cost of implementation, improving international competitiveness and strengthening negotiating capacity.

The opportunities created by trade liberalisation can only come to fruition if there is investment, but in the case of small developing economies not all of this will materialise in the form of private investment and hence there is a role for development financing. The financing facility does not have to be part of the WTO; in fact it would be more appropriate to locate it in a multilateral institution specialising in development financing. Hoekman[101] suggests that a levy of 0.25 on imports of OECD countries would generate $10 billion for support to developing countries. The World Bank and the WTO should collaborate on establishing an adequately funded trade capacity-building and adjustment facility to address this issue. Collaboration between multilateral institutions and bilateral agencies must strive for coherence in policies of trade capacity-building and strengthen cooperation to rationalise resource use and avoid duplication in programming.

[100] Sheila Page and Peter Kleen, 'Special and Differential Treatment of Developing Countries in the World Trade Organization', First draft, Overseas Development Institute, August 2004, p. 36.



## 9.8 How SDT addresses the characteristics and problems of SDEs

There has been a failure clearly to identify and articulate the direct link between the structural characteristics and institutional features of developing economies and SDT measures, both actual and proposed. The failure to establish how SDT measures are directly related to specific aspects of developing economies and therefore how they have a beneficial effect on trade and development has led to a critique of the concept of SDT and its efficacy. Indeed, SDT is now widely regarded as an attempt by developing countries to gain an unfair advantage in international trade arrangements and an unjustified ploy to avoid reciprocity.

This section explains the direct link between each measure of SDT and the specific structural characteristics and institutional features of small developing economies. The nine types of special and differential treatment suggested in this chapter are aimed at directly addressing the characteristics and problems of small developing economies. The links between the SDT measures and the characteristics and problems of small developing economies which they are intended to address are set out in table 9.1. In some cases more than one measure may be related to a single characteristic of SDEs.

[101] Bernard Hoekman, 'Operationalizing the Concept of Policy Space in the WTO: Beyond Special and Differential Treatment', Policy Brief No. 4, The William Davidson Institute, University of Michigan, July 2004, p. 13.

Table 9.1 *Relationship between characteristics of small developing economies and special and differential treatment measures*

| Features | Different obligations | Asymmetrically phased implementation | Exemptions | Flexibility | Temporary suspension | Development promotion | Technical Assistance | Mediation | Development fund |
|---|---|---|---|---|---|---|---|---|---|
| | Measures | | | | | | | | |
| Acute vulnerability | | | | X | X | X | | | X |
| Imperfect markets | X | | X | | | X | | | |
| Small size of firms | X | X | X | | | X | X | | X |
| Dependence on trade taxes | X | X | X | | X | X | | | X |
| Limited institutional capacity | X | X | X | | | | X | X | X |
| Volatility | | | | X | X | | | | |
| Sub-optimal use of resources | X | | | | | X | | | X |
| Lack of international competitiveness | X | X | X | | | X | X | | X |
| Disarticulated adjustment capacity | | X | X | | X | X | X | | X |



## 9.9 Identification of small developing economies

Neo-classical trade theory assumes that international trade takes place between countries in an environment of perfect competition, and trade occurs because of differences in comparative advantage, which in turn derive from differences in resource endowment or technology. In this paradigm the effects of size of country and size of firm are not taken into account. However, in reality, size has important implications. Economies of scale, the size of a country and the size of a firm are important considerations because large firms can achieve economies of scale and market dominance (including oligopoly and even monopoly) which put small firms at a disadvantage. While the discipline of economics has not dealt adequately with the question of small size, the effect of small size has however been recognised in national economic policy, as all countries have policies specifically designed to promote the viability of small businesses and small farms. This tenet of conventional national policy needs to be applied to the global economy and be recognised in the rules of international trade agreements, given the disparities in size among firms and countries. More generally, small and/or vulnerable participants (both firms and households) in national economies are afforded appropriate treatment by compensatory policy measures. These compensatory measures are fiscal transfers, technical assistance and enabling programmes, e.g. subsidies or low-cost finance or rules which discriminate in their favour, such as quotas or prevention of market dominance by larger firms. In the world economy there is no multilateral entity which provides fiscal transfers to small and/or vulnerable countries and firms. Therefore measures must be included in the rules governing the multilateral trading system to ensure that the vulnerable survive, adjust and develop.

Small economies as a distinctive genre of economy attracted the interest of academics in the 1960s. Subsequently, several technical studies of a policy-oriented nature have been carried out on small economies and, in particular, small island states by the Commonwealth Secretariat, the World Bank, UNCTAD, the Organisation of American States and the Free Trade Area of the Americas (FTAA) Working Group on Small Economies. There is a general consensus in these studies that small economies have characteristics which distinguish them as a particular genre of economy and that these features are constraints on their capacity for trade and development. The first meaningful attempt to grapple with the concerns of small developing countries in a trade agreement was the Free Trade Area of the Americas process.[102] Since its inception in the mid-1990s the FTAA negotiations have included a Working Group on Small Economies. The issue finally emerged in the World Trade Organisation when the Declaration of the Ministerial meeting in Doha in November 2001 mandated a Work Programme on Small Economies.[103]

While the WTO Agreement does not recognise small developing economies as a distinct category, it explicitly recognises that there are different types of economies and that economies other than developed economies require rules and disciplines which are specifically designed to take account of their relative disabilities and promote their development. The preamble of the WTO Agreement recognises that there is a need for positive efforts designed to ensure that developing countries 'secure a share in the growth in international trade commensurate with the needs of the economic development'. The Uruguay Round Agreements include provisions for developing member countries and there are some concessions to the least developed countries, Net Food Importing Countries, countries 'below $1,000 per capita' and narcotic economies.

There is no single definition of a small developing economy, undoubtedly because size is a relative concept. Definitions based on quantitative criteria vary considerably because they employ different criteria and select different cut-off points. The most frequently used criteria have been size of population, size of land area and value of Gross Domestic Product or some combination of these. As for population, Gutierrez proposed a range of 8–12 million,[104] Kuznets[105] and Streeten[106] selected an upper limit of 10 million, Chenery and Syrquin[107] and Lloyd and Sundram[108] used 5 million.

102 Richard L. Bernal, 'The Integration of Small Economies in the Free Trade Area of the Americas', *Policy Papers on the Americas*, vol. IX, study 1 (Washington, D.C.: Center for Strategic and International Studies, February 1998).

103 The work programme has the caveat 'not to create a sub-category of WTO Members'. WTO Ministerial Declaration, Doha, 9–14 November 2001, WT/MIN (01)/DEC/1, 20 November 2001, paragraph 35.

104 Mario A. Gutierrez, 'Is Small Beautiful for Economic Integration?', *Journal of World Trade Law*, vol. 30, no. 4 (1996).

105 Simon Kuznets, 'Economic Growth of Small Nations' in E. A. G. Robinson (ed.), *Economic Consequences of Size on Nations* (London: Macmillan, 1960) p. 5.

106 Paul Streeten, 'The Special Problems of Small Countries', *World Development*, vol. 21, no. 2 (1993) p. 197.

107 Hollis Chenery and M. Syrquin, *Patterns of Development, 1950–1970* (Oxford: Oxford University Press, 1975).

108 Peter Lloyd and R. M. Sundram, 'Characteristics of Small Economies' in B. Jalan (ed.), *Problems and Policies of Small Economies* (New York: St Martin's Press, 1982).



Armstrong and Read[109] suggested 3 million and a figure of 1.5 million has been employed by the Commonwealth Secretariat/World Bank Joint Task Force,[110] while a report from the United Nations Development Programme (UNDP) speaks of countries with small populations as those with fewer than 40 million.[111] A study by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) opted for GDP and selected a ceiling of $15 billion, while Kennes[112] chose a cut-off point of $10 billion in GNP. The problem with using GDP or population is that small is a relative concept, hence both figures have to be revised over time. This dilemma is illustrated by the Commonwealth Secretariat's research, which used a population of 1 million in 1985 but by 1997 had revised the cut-off point to 1.5 million. Demas[113] combined a population of 5 million or less and less than 20,000 square miles of usable land. Bernal[114] applied three criteria without selecting absolute limits and compared data for the thirty-four countries participating in the negotiations for a Free Trade Area of the Americas. A clear bunching of countries emerged at one end on the continuum, all exhibiting smallness in the three criteria. Davenport[115] has proposed the use of the share of world trade and calculates that at a cut-off point of 0.02 per cent thirty-six countries would be small.

Various international organisations classify countries into categories according to selected indicators for operational and analytical purposes. The classifications used by international organisations mainly relate to per capita income levels, indicators of development status, and some selected concept of 'size'. While the main classification criterion used by

109 H. W. Armstrong and R. Read, 'Western European Micro-States and EU Autonomous Regions: The Advantages of Size and Sovereignty', *World Development*, vol. 23, no. 8 (1998) pp. 1229–45.

110 Commonwealth Secretariat/World Bank Joint Task Force, 'Making Small States: Meeting Challenges in the Global Economy'. Report of the Commonwealth Secretariat – World Bank Joint Task Force on Small States (2000).

111 *Human Development Report 2003* (New York: United Nations Development Programme, 2004) p. 72.

112 Walter Kennes, *Small Developing Countries and Global Markets. Competing in the Big League* (London: Macmillan Press, 2000) p. 7.

113 William Demas, *The Economics of Development of Small Countries with Special Reference to the Caribbean* (Montreal: McGill University, 1965) p. 2.

114 Richard L. Bernal, 'The Integration of Small Economies into the Free Trade Area of the Americas', *Policy Papers on the Americas*, vol. IX, study 1 (Washington, D.C.: Center for Strategic and International Studies, February 1998).

115 Michael Davenport, *A Study of Alternative Special and Differential Arrangements for Small Economies* (London: Commonwealth Secretariat, December 2001).

institutions such as the International Monetary Fund (IMF), the World Bank and the United Nations for establishing country categories is the level of per capita income, these institutions also classify countries by aggregate income levels, the types of goods exported (e.g. fuels, non-fuel primary products, manufactures or services) and fiscal structure.

The definition of what is a small developing economy[116] is an issue which can be resolved technically and should not be allowed to delay substantive discussions. An appropriate definition can be derived, based on one or more criteria – population, land area and GDP – and could be arrived at by consensus. As in any categorisation there will be debate about those countries that are just above or below the line of demarcation. Although the dilemma of where exactly to draw the line can be resolved technically, it does introduce a discretionary element into the exercise, which sceptics and opponents have capitalised on to frustrate the identification of small developing economies. This can be resolved by negotiation or by techniques such as 'self-selection' which has been applied for development status under the GATT system and now under the WTO. Indeed, there is no official definition of 'developing country' in the WTO, as status is by self-definition by member countries but is not automatically granted when negotiating accession to the WTO.

## 9.10 The way forward

The resolution of the deadlock on maintaining and/or strengthening SDT is for the membership of the WTO to accept and to acknowledge that there are differences in size and level of development among countries, and consequently that they have different capabilities which must be addressed by differentiated treatment. This is allowed by and provided for in the WTO, based on two complementary principles, namely the most favoured nation principle and the principle of special and more favoured treatment. Obviously there will be rules that are shared by all and there will be special rules for those disadvantaged by size, level of development or both. The reality is that there are two kinds of SDT in operation: that which is provided by multilateral consent to developing countries, including LDCs,

[116] The absence of a formal definition of small developing economy does not invalidate the justification for SDT. As in the case of developing countries, the lack of a consensus on a formal definition did not prevent the application of SDT to these economies. The design and application of SDT to SDEs does not therefore require a formal definition if the WTO extends the right of self-definition.



and deviations which the developed countries have unilaterally abrogated to themselves. When developed countries violate the rules and spirit of free trade within the multilateral trading system codified in the WTO this is tantamount to unilateral SDT for the more developed.

### 9.10.1 *Differentiated treatment*

Nearly all multilateral institutions when dealing with economic issues have recognised the diversity of economies and the necessity of differentiation in order to calibrate their policies to the specific needs of different types of economies. Rather than adopt the typologies employed by other institutions such as the IMF, World Bank and United Nations, the membership of the WTO must formulate a classification of countries based on trade-related criteria. The use of per capita incomes is fraught with problems, which are well known and need not be rehashed here. It would not make for appropriate SDT to apply the proposal of the International Food and Agriculture Trade Policy Council[117] that there should be three groups of countries that should be eligible for SDT: (a) least developed countries, i.e. with per capita incomes of less than \$900; (b) lower middle-income developing countries, i.e. with income per capita of between \$901 and \$3,035; and (c) upper middle-income developing countries, i.e. with income per capita of between \$3,035 and \$9,385. Such a classification is open to all the disadvantages of using per capita income as a proxy for development and the failure to recognise structural characteristics of developing countries, in particular small size. Size is not the only structural feature which warrants consideration, but it is a factor which affects a significant number of developing countries and is likely to become more significant as globalisation proceeds. However, addressing the concerns of small developing economies is a challenge which can be accommodated by the multilateral trading system because collectively they account for such a minute share of world trade.

The most appropriate classification of members of the WTO involves four types of economies:

(a) developed economies, i.e. OECD member states and by self-definition;
(b) developing economies, i.e. with a per capita income of over \$1,000 and which are outside the range of small developing economies. Some of

[117] 'A New Approach to Special and Differential Treatment', International Food and Agriculture Trade Policy Council, Position Paper no. 13, 15 September 2004, p. 2.

the economies in this category could be reclassified as developed by mutual agreement after review of agreed-upon economic criteria;

(c) small developing economies, i.e. over $1,000 in per capita income and smallness based on a combination of criteria of population, land area, GDP and vulnerability;

(d) least developed economies, i.e. with a per capita income of less than $1,000 and which could graduate to the status of developing economy or small developing economy.

Least developed economies and both types of developing economies would be eligible for Special and Differential Treatment but each of these three types of economies would have a different package of measures designed specifically for that particular type of economy. The packages would have some measures common to all and some unique elements. Some measures common to all eligible economies would be given specificity for each type of economy by variations in degree, duration and implementation schedule.

### *9.10.2 Implementation, adjustment and graduation*

SDT should be subject to periodic reviews, the objectives of which are to (a) permit adjustment to the respective SDT packages, (b) allow for graduation, and (c) evaluate the extent to which the developed countries are adhering to their SDT commitments.

Improved economic development is a realisable possibility for the majority of developing countries if they can overcome some of the structural and institutional features which currently inhibit their development. The existence of these impediments is the basis justifying specific SDT measures and therefore, to the extent that there has been structural and institutional transformation, an economy's need for SDT could change over time. There should be periodic reviews of SDT allowing for the possibility of adjustment to some components in the package for each type of economy. Any adjustment recommended by the periodic reviews would require decision by consensus. Countries as they develop may graduate from one category to another and indeed may even become ineligible for SDT by attaining the status of a developed country. At the same time, developed country implementation of SDT measures should be evaluated, and if they failed to comply with their commitments they should be subject to payment of compensation and retaliation through the Dispute Settlement Mechanism.



SDT designed, implemented, reviewed and adjusted in the manner proposed in this chapter would make developed countries more readily agreeable to SDT provisions because of periodic review of adjustments to SDT as needs change and even of graduation. Developing countries would be assured that enforceable reviews would prevent or at least considerably reduce the incidence of developed countries' repeated postponements of implementation and serial renewals of exemptions. The enforceability of SDT measures would imbue developing countries with a positive disposition towards trade liberalisation, as they would have the assurance that their development was being meaningfully addressed through SDT. This in turn would induce them to engage in the full agenda of issues before the WTO and to contemplate new subjects, confident that their characteristics and concerns would be taken into account in the new SDT provisions.

## 9.11 Conclusions

It is now time to recognise formally that there are four different types of economies, namely developed, developing, small developing and least developed. All economies cannot be treated identically, i.e. there cannot be a single set of rules. There must be differences in the rules and their application to take account of the differences in types of economies. All multilateral economic institutions acknowledge these two facts and specifically the WTO recognises three kinds of economies and provides for special and more favourable treatment, commonly referred to as special and differential treatment (SDT). The three-country typology of the WTO is hopelessly outdated and is now a major obstacle to the negotiations of the Doha Development Agenda. The developed countries have resisted further SDT measures and have even tried to eliminate existing SDT because of their unwillingness to extend this type of treatment to the advanced developing countries. The deadlock can be broken by a four-economy typology in which classification is based on sound economic criteria encompassing the dominant features of reality, differences in size and level of development. Four types of economies should be recognised, namely developed, developing, small developing and least developed. The latter three would be eligible for SDT, with a specific package of measures for each category of economy. The packages would be a mix of measures common to all, unique to one type of economy and different in degree and implementation schedule.

The approach recommended is good politics and even better economics.