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Binding Constraints to Trade and the Role of Aid for Trade

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BINDING CONSTRAINTS TO TRADE AND THE ROLE OF AID FOR TRADE

WTO Hong Kong Ministerial Declaration specifies in paragraph 57 that "*Aid for Trade should aim to help developing countries, particularly LDCs, to build the supply-side capacity and trade-related infrastructure that they need to assist them to implement and benefit from WTO Agreements and more broadly to expand their trade*".

This note addresses some of the challenges and current methods to identify the binding constraints hindering developing countries' capacity to benefit from trade expansion, and highlights some of the considerations that should be taken into account when donor-provided financial assistance - Aid for Trade- is used to tackle them.

Most developing countries have benefited significantly from WTO Agreements and trade expansion. During the period 1990-2005, their total share in world exports of non-oil manufactures almost doubled from 21.5 percent to 40.2 percent, a remarkable achievement considering that world trade has been growing around three times faster than world output. However, some countries are failing to leverage trade for economic growth and poverty reduction. At the risk of oversimplifying, one could distinguish four main groups:

1. **Poor Trade Integration:** Countries that are failing to further their trade integration and to take advantage of the growth of world markets to expand their exports. In some countries this has been mostly due to conflict and/or governance crises which have hampered progress in economic development and integration into world markets. In others, marginalisation is simply due to an inability to overcome supply-side constraints and the various barriers to entry into world markets.

2. **Shallow Trade Expansion With Little Domestic Impact:** Countries that are expanding their trade but are failing to engineer economic growth, and in particular productivity spillovers to the rest of the economy. This might be the case in countries where export-led strategies are very much based on low-value added assembly tasks.

3. **Rent-Creating Trade Expansion With Little Poverty Reduction Effects:** Countries where trade-led growth has not led to poverty reduction. Typically that occurs in non-agricultural resource-based commodity exporters where increases in value-added are easily captured by the elite and not re-invested in the domestic economy.

4. **Poor Adjustment Capacity:** Another type of situation warranting special consideration is when the prospects of future trade integration are poor because of issues related to preference erosion, natural depletion of primary commodities or because of a heavy specialisation in products with low-income elasticities and/or dwindling world demand.

Identifying the binding constraints

Developing countries which are suffering from poor trade integration or unable to capture growth and reduce poverty are likely to suffer from multi-faceted supply-side constraints such as policy barriers, poor infrastructure, limited access to finance and technology, etc. In addition, a large part of the private sector may be informal, further accentuating the difficulties of designing effective assistance measures. It is usually unrealistic to address all their needs and required reforms simultaneously both for political economy and financial reasons. Political capital for reform is at least as scarce as financial assistance and both should be invested where maximum impact can be expected. Good prioritisation is thus an absolute critical step in designing programming aid-for-trade interventions.

Most prioritisation exercises use a mixture of approaches to identify major bottlenecks in an economy's interface with international trade, such as:

- Asking the constrained – i.e. dialogue with the private sector and other stakeholders.
- Cross-country comparisons based on economic literature findings concerning the determinants of trade growth and on benchmarking exercises such as the Costs of Doing Business or other available indicators on competitiveness, investment climate or logistics.
- Analysis of economic fundamentals and sectoral economic expertise.

Asking the constrained can appear to be the most effective way of identifying constraints to trade expansion. Exporters and importers, which fight on a regular basis with red tape, poor infrastructure, corruption and monopolistic transport sectors, are likely to have a very good understanding of the reforms required to increase their competitveneess. In some countries, there may be issues of representativity of the private sector, with one or two companies heavily influencing the positions of chambers of commerce and other private sector organisations. This may be particularly the case in countries with very small private and formal sectors. However, the greatest shortcoming of this approach is that it does not help to identify the constraints that are so high as to stop all exporting or formal economic activity in a given sector, since there are no stakeholders with experience in that field. In other words, it helps to identify what needs to be done to help existing formal businesses, but not to identify what needs to be done to create new formal economic activities.

Cross-country comparisons can also be an interesting and cost efficient tool to identify trade capacity constraints. Gamberoni and Newfarmer (2008), for example, identify five indicators that can be used to gauge trade capacity constraints. Based on trade literature findings that behind-the-border barriers represent important obstacles to the ability to export and import, and that trade-related infrastructure, institutions and trade policy-induced incentives are key determinants to trade performance. With the help of a gravity model, they selected the transport and customs components of the World Bank's Logistics Performance Indicator, the time for export indicator of the World Bank's Cost of Doing Business database, the percentage of tariff lines covered by tariff peaks and the tariff trade restrictiveness index of the World Bank as the best predictors of trade performance. Such an approach offers a quick and inexpensive way to assess which broad policy areas should be first selected for consideration when starting to design a trade development strategy, and that can also be used to validate the conclusions of more in-depth and systemic studies.

The two most systematic frameworks to identify bottlenecks for trade and growth are the **Diagnostic Trade Integration Study** (DTIS) methodology used by the Enhanced Integrated Framework and the growth diagnostic promulgated by Hausmann, Rodrik and Velasco as a tool for diagnosing economic growth in general.

'*The Diagnostic Trade Integration Study (DTIS) assesses the overall competitiveness of a country's economy, identifies sectors of greatest export potential, outlines constraints to trade, and presents an Action Matrix. It provides the analytical foundation for policy recommendations and Trade Related Technical Assistance and Capacity Building formulation for the country's integration into the multilateral trading system. It is also a powerful tool for linking trade strategies and priorities to the overall national development strategy*'. (UNCTAD, 2005)

The DTIS method provides a template for the analysis of country-specific needs, coupled with a consultation process that validates the results of the analysis. The outcome is a report and action plan matrix used, at a later stage, as the basis to develop concrete implementation plans. However, despite the wealth of the analysis and inclusiveness of the process, the priorities emerging from these action matrixes have not always been followed-up either by the governments or by donors.

The failure to follow up can be attributed, at least in part, to the structure of the template and the process that are more conducive to the identification of overall needs rather than the identification of bottlenecks. Despite the country-specific approach, the template encourages a box ticking approach where the consultants examine in turn whether the macroeconomic environment is stable enough, whether the infrastructure to meet SPS standards in key export market is sufficient and whether transport costs are internationally competitive; but the main issue resides in trying to identify the bottlenecks to trade expansion. The result is a long list of priority actions often daunting in scope which is then presented to all the different stakeholders to be reduced to a more manageable size. While consultation and dialogue with national stakeholders is essential, it is also easy to imagine how, in the absence of an approach that ranks priorities in terms of impacts, such consultations can easily result in a collective choice that elects the less threatening interventions to the special interests present in the consultation.

There are no magical recipes to improve this process; however, two avenues might prove promising:

- Involve more government officials and private sector operators in the diagnostic and analytical process that inform the prioritisation exercise. This is probably very difficult without lowering the depth of the analysis. Six months to one year of top expertise is a non-negligible resource for many low-income countries. However, the diagnostic task might be suited to partition with national experts participating in the most critical aspects and/or could be left under the government's control and authorship.

- Change the structure of the analysis so that it is more conducive to identifying and ranking bottlenecks which can then be used to derive policy priorities and avoid the long-list syndrome.

A contingent approach to diagnosing barriers to growth is the **Growth Diagnostics** developed by Hausman, Rodrik and Velasco, which could, in principle, be adapted to trade. Their aim is to develop a unified framework for analysing and formulating growth strategies that are both operational and based on solid economic reasoning.

They argue that because of scarce political capital of reformers, wholesale reform very often fails. The objective should thus be to obtain "the biggest bang for the reform buck." In theory, the most logical approach should be to identify and tackle first the biggest distortions; i.e. to identify where the largest wedges between private and social valuation lie and then assess whether a public intervention could successfully reduce or eliminate the distortions. The main shortcomings of this approach are that it requires extensive knowledge of the economy and that the largest distortions are not always the most relevant to growth.

Instead Hausmann, Rodrik and Velasco suggest starting with the theoretical determinants of economic growth such as investment, education or productivity and analyse which of these factors constrains growth most. Growth diagnostics simply consists of reviewing and analyzing all the main factors determining growth in theoretical economic models in order to ascertain where the most binding constraints on growth lie.

In their model, economic growth depends on the returns to investment (broadly constructed), their private appropriability, and on the cost of financing investment. From these three factors, a decision tree is developed to guide a series of probing questions. For example, is the problem of poor appropriability, due to high taxes, corruption or macro-instability? If the problem is the high costs of finance, is that because of fiscal deficits or poor intermediation? This approach should enable better targeting, and maximing the return from political and financial capital.

Conceptually, the growth diagnostic approach seems very promising for improving the quality of aid-for-trade interventions. However, this would involve adapting the growth model to a trade model, a challenging task when considering the interlinkages between trade and growth itself.

The role of aid for trade

Once there is a clearer understanding of which policies are needed to support trade-related growth and poverty reduction, it should be possible to design the required policy intervention. However, not all interventions are equally suited to be implemented with aid financing and/or donors' involvement. The range of factors to take into account include the impact of donors' behaviour on the recipient country decision-making and ability to implement as well as the impact of aid flows on absorption capacity and exchange rates. These considerations are common to all aid initiatives, but country ownership is particularly relevant to trade.

Indeed, past evaluations of trade-related assistance show that lack of country ownership is an important factor of poor effectiveness (OECD, 2006). This is not surprising given the potential of trade reforms to undermine the economic power of political elites and other vested interests. The issue is of course particularly relevant for aid-financed activities. In the absence of aid, the launch of reforms requires a modicum of political backing, particularly if they are politically and/or financially costly.

With aid, however, the issue of political commitment becomes critical. The incentive of officials in recipient governments is to maximise aid inflows, in order to maximise their budget. Many donor agencies reward meeting commitments and disbursements targets. Unsurprisingly, recipient countries attempt to formulate projects in ways that are compatible with the donor agencies targets, and attract maximum funding, independently of the real objectives. In the case of budget support and to a lesser extent SWAPs, the extra scope for fungibility means that the divergence of objectives does not necessarily reduce the effectiveness as measured by the recipient's set of objectives. For project aid, the result is too often very high transaction costs, with both parties unwilling to relinquish control and thus poor effectiveness.

The Poverty Reduction Strategy approach was meant to solve many of these problems by providing a framework for donors to align their priorities with recipients and anchor their projects in a wider development strategy, thus increasing coherence and harmonisation, and ensuring country-ownership. Consequently, mainstreaming trade into the Poverty Reduction Strategy papers became a key objective of aid-for-trade practitioners.

Indeed, mainstreaming trade into national development plans is essential. The complexity and interdependence of trade with a country's overall development strategy requires a minimum of joined-up government and effective dialogue with stakeholders to formulate and implement an effective trade development strategy. It enables to strengthen synergies and identify potential incoherence between the trade and the domestic growth agendas.

PRSPs were conceived to stimulate the formulation of long-term, comprehensive and results-oriented development strategies that are built on national consensus and to provide a platform to develop a donor-recipient relationship. But, recipient countries have tended to use the PRSP process as a tool to secure more predictable aid and establish a dialogue with all donors. As such, the PRSPs remain very much influenced by the views of recipient governments on donors' preferences and needs.

Is weak country ownership sufficiently important to stop donors working to address key binding constraints to trade and growth? A potential third way in these cases is to develop a longer term and softer approach, akin to the drivers of change approaches, particularly if there is already a sizeable domestic reformers' constituency. Issues such as sequencing reforms, piloting projects to showcase the benefits and accompanying reforms with adjustment support would need to be fully integrated into implementation plans in order to strengthen country ownership and ensure the effectiveness of aid for trade.

Conclusions

Because of the country and time specificity of the constraints faced by developing countries, it is of little use to develop universal best practice guidelines on which policy interventions are most efficient at addressing binding constraints to trade. Instead, research on the determinants of trade performance and evaluation findings on what has worked best in past aid for trade efforts can provide a map to guide diagnosis efforts and to prioritise aid-financed interventions taking into account the binding nature of the constraint as well as the inherent challenges of donor-funded assistance.

Increasing the effectiveness of aid for trade also requires that best practices are developed on (i) how to design trade-capacity building programmes in low-income countries, with poor data, small and unrepresentative private sectors, lack of human capacity and great financial needs, and (ii) implementing the aid effectiveness principles, country ownership in particular. This itself would require developing a better understanding of the political economy of trade reform in low income countries.

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