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Size matters

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The two papers address questions related to the role and place of small, developing countries in the global trading system and in multilateral trade negotiations, reflecting the resurgence of interest in recent years in size-related constraints to development and to participation of small economies in international trade.

Organizations and institutions such as the Commonwealth Secretariat, the World Bank, the Organization of American States and the United Nations Conference on Trade and Development (UNCTAD), have produced a significant body of analytical work on the subject. The growth in membership of the World Trade Organization has brought into the fold of multilateral rights and obligations an increasing number of small developing states. The activism of these members led to the Ministerial decision at Doha to establish a work programme to examine issues relating to the trade of small economies and to frame responses thereto.

Both papers reflect in different ways this deepening interest in the constraints and consequences of size for participation in multilateral trade and the multilateral trading system.

Mattoo and Subramanian (M&S) juxtapose the growing influence of 'small, poor economies' in multilateral decision making on trade with the constraint created by their small market size in what are essentially mercantilist-based negotiations, and examine the implications of this. They assert that with limited capacity to engage in and reap benefits from the reciprocal exchange of concessions and with their significant influence in the system, the interests of these small, poor countries need to be accommodated, as a good in itself, but, importantly as well, as an expedient measure to 'ensure smooth and expeditious progress in the Doha Round'. The authors identify and evaluate some of the measures being proposed to accommodate the interests of these countries.

Winters and Martins (W&M), in a paper based on extensive empirical work, and with some interesting theoretical implications, contend that, while Ricardian comparative advantage is applicable and welfare maximizing, it does not necessarily provide a basis for remunerative participation in international trade on the part of many small, remote economies. Clearly if this is demonstrably so, then there are important implications for the WTO, which aims at universal membership, embraces many small developing economies, and seeks inter alia to promote amongst its members trade relations with a view 'to raising standards of living, ensuring full employment and a large and steadily growing volume of real income … .'

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I will address both articles in turn and offer some comments on the analysis they offer and the measures they propose.

A word on methodology. The papers do not cover an identical group of countries. W&M identify small economies on the basis of a ceiling on population size of 1.5 million. They list 82 small economies, many of which are not WTO members, and the list is inclusive of several small, developed countries, such as Iceland, Liechtenstein and Luxembourg. M&S identify 73 'small and poor' countries using ceilings of 0.05% of global imports of goods and services and per capita GDP in PPP terms of US$4630 as relevant indices. Of this group, 49 countries are WTO members, and an additional 12 are acceding members.

W&M state the hypothesis to be investigated as being 'crudely' that very small and remote economies are inherently uncompetitive. They make the further point that, while the paper does not dismiss comparative advantage as a route to maximizing national income and welfare, 'there may be some very small economies that face such great absolute disadvantage that exporting at world prices is either impossible or generates factor incomes that are too low to subsist. In the limit free trade could mean no trade for these economies'.

In many ways, and as pointed out by the authors themselves, an old issue is being revisited. In the past, the solution to the constraints of size and remoteness was considered self evident. Such countries should be export oriented, which would enable them to take advantage of economies of scale and reduce costs of production and of financing for investment. A liberalized open international economic and trading system was particularly beneficial for such countries.

The paper by W&M challenges the assumption that small remote economies will be able to engage in remunerative trade on the basis of their comparative advantage. This may be a sobering and discouraging finding, but it should not be surprising. Perhaps the major contribution of the study by W&M is the value it adds to our understanding of the situation facing small economies by providing, probably for the first time, detailed and relevant supporting empirical evidence and accompanying analysis covering a large number of small economies and a wide range of cost-related variables. This shows that small and remote economies find it difficult to trade in a remunerative manner, even in areas where they may have comparative advantage, because their transaction costs and/or their production costs are too high to permit trade on a commercial basis. Taking world prices as given, minimum transaction costs and the cost of intermediate inputs make it difficult to generate meaningful value added and acceptable incomes from trade.

An interesting aspect of the W&M study is the finding that even in export industries such as tourism, clothing, and electronics assembly – typically favoured by developing countries – micro and small economies face significant cost inflation. The cost inflation factor, which measures 'excess' input costs deriving from small size, is placed at 36% for clothing and electronic assembly in the case of micro-economies. This is indeed staggering. On the positive side, this figure lessens as a 'threshold' population size for small economies of 1.5 million is approached.

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It falls to a cost inflation range of 3–6 %, which the authors find to be within the range of estimation error and 'small enough to be overcome by good management'. This certainly sheds interesting light on the problems and challenges facing these economies.

What of a solution? W&M are persuaded that if 'unviable economies' are to be made 'viable', there will need to be compensating flows that are *continuous* in nature. One potential source is through preferences, but these are being eroded by legal challenge in the World Trade Organization and by multilateral trade liberalization. Another could be through enhanced income transfers, which would, however, require continuity and security. Also cited by W&M as a potentially attractive way of topping up income levels in small economies is facilitating the temporary movement of labour within the global economy – (i.e.) Mode 4.

An interesting aspect of the paper is the argument it makes against small countries protecting their industries, or subsidizing business investment to overcome cost disadvantages. According to the authors, even where local industries could be successfully established behind tariff walls, there is nothing in their analysis to suggest that such an approach would be economically beneficial. Instead, the theoretical discussion shows that following comparative advantage *maximizes* real income – only not sufficiently so as to provide an *adequate* income. In regard to subsidizing business investment, the authors observe that smallness does not introduce marginal distortions that need to be countervailed, but rather 'an overall feasibility constraint'.

It is difficult to follow W&M down this particular road. Comparative advantage is not a static concept, it is a dynamic one, and an industry, once established, could conceivably progressively narrow the gap between the income that is realized and what constitutes an adequate income.

This could then serve to reduce the transfer required to ensure an adequate income, whether that transfer be through trade preferences or the provision of direct income.

Equally, one may need to be more receptive than the authors appear to be regarding the potential value of transitional financing to encourage structural adjustment in the economies under study. Even if transitional financing were to fail to overcome the 'overall feasibility constraint', it must certainly have value in improving performance, advancing competitiveness, and enhancing income. What is important is that such measures – and the IMF's recent Trade Integration Mechanism comes readily to mind as an example – should not be seen as a *sufficient* response to the difficulties faced by small and other developing economies in the context of multilateral trade liberalization, when they clearly are not and cannot be.

The paper by M&S has as its point of departure the perceived anomalous situation of 'small and poor' countries in multilateral negotiations in the WTO based on the mercantilist exchange of concessions, and in which, in the view of the authors, the interests of small, poor countries are 'imperfectly aligned' with

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the goals and objectives being pursued. From the perspective of the writers, the anomaly is deepened by the fact that these countries both have 'significant say' in WTO decision making and, as beneficiaries of privileged market access provided by developed countries, limited interest in the broader Most Favoured Nation (MFN) agenda. The danger this poses is that these members will stand in the way of progress – Seattle and Cancun recalled! – and this is an evident concern and anxiety of the authors.

The paper identifies five potential measures/courses of action to accommodate small and poor countries and provide them with a sense that they are obtaining a 'fair balance of benefits and costs' from the Doha Round. These are listed as:

(i) providing preferential market access benefits in the Doha Round
(ii) sparing/relieving such countries of obligations in the Doha Round (and the Uruguay Round) that are either financially costly or welfare deteriorating
(iii) sparing/relieving them of obligations in the Doha Round (and the Uruguay Round) that are welfare enhancing
(iv) providing non-preferential market access benefits in the Doha Round
(v) providing financial and technical assistance.

M&S suggest that various considerations which determine the feasibility of different options are causing the system to gravitate towards three ways of addressing the concerns of small and poor countries: (i) granting them further preferential access, (ii) relieving them of financially costly and welfare deteriorating obligations, and even (iii) relieving them of obligations that may be in their interest. In the view of the authors the 'more desirable way' to accommodate the small and poor countries would be instead to provide them with further financial and technical assistance and with further non-preferential market access options 'in return for their consenting to the system moving forward with the broader liberalization agenda, as well as a quid pro quo for their own liberalization efforts'.

Firstly, it is regrettable that the paper by M&S appears, so obviously, to find the 'influence' that small poor countries have in the WTO counterproductive and their interests so evidently misaligned in institutional terms. The corollary of that, it might be supposed, is that the influence of large, rich countries is positive and beneficent.

Having said this, the point needs to be made that, while the influence of developing countries has certainly increased, it should not be overstated. The WTO process of building consensus is a complex one, and not simply a 'totting up' of the numbers. Neither should the contribution to systemic inertia and departure from the broader liberalization agenda made over the years by developed countries be underestimated, as played out in various areas from agriculture, to textiles and clothing, to trade remedy measures.

The WTO's claim to universality will be valid only in a context where its membership not only increases numerically but, as an Organization, it accommodates

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and responds to the varying and diverse interests of that membership. It cannot be a universal and viable negotiating forum for rules, and the establishment and administration of rights and obligations, if the interests of all members, as reflected in their negotiating positions, are not captured in broadly acceptable outcomes. Thus the manner in which 'small and poor' members of the Organization are treated and their concerns addressed will be an important indicator of the success, strength, and fairness of the system.

In this context, we find that there may be in fact quite some overstatement in the paper regarding the extent to which the multilateral trading system is gravitating toward the first three options – granting further preferential access, and rescinding or relieving small, poor countries of welfare diminishing (e.g. TRIPS) or welfare enhancing obligations (e.g. reduction commitments in goods and services). Except for the traditional case of the Least Developed Countries (LDCs) and possibly the understanding reached on the implementation of the Doha Ministerial Decision on TRIPS and Public Health, the agitation of the developing countries has yet to yield very much that is definitive and agreed in terms of special and differential treatment or implementation issues in the Doha Round. Missed deadlines have been the norm.

It is quite difficult to foresee that there will be broad-based rescinding of, or exemption from, the Uruguay Round or Doha commitments. Important developing country groupings have certainly proposed this in regard to further agriculture and non-agricultural market access reduction commitments in the context of the Doha negotiations. They clearly consider that this is in their interest and will continue to press their case.

Whatever the outcome of such proposals, the importance of implementation issues raised by developing countries, and the resource and financial burden of some obligations – whether welfare diminishing or enhancing – must be taken full account of and responded to in the WTO. An interesting question, not addressed by the authors, is why, given the perceived influence of developing countries, and the consensus rule, there are any welfare diminishing obligations at all.

The positing of technical and financial assistance and non-preferential market access as the most desirable options for accommodating the interests of small, poor economies needs some comment. The issue of supply capacity is very relevant here. This cannot be developed in the short run. For non-preferential market access to be beneficial, even accompanied by financial and technical assistance, is to assume that the small, poor countries are already, or shortly will be in a position to compete on equal terms with other trading partners. This is definitely not the case, clearly suggesting that a broader mix of solutions will be required, even if this were to be necessary only in the short and medium term. At the extreme, as W&M demonstrate, there may be even some small and poor economies structurally incapable of achieving competitiveness and engaging in remunerative trade.

In concluding, let me suggest that, in an important sense, the authors pose a false challenge when they state 'the challenge therefore for the trading system is to find

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ways of accommodating their interests [that is, of small, poor countries] both for its own sake and also for smoother/and expeditious progress in the Doha Round'.

It needs to be recognized that these countries and their interests are not incidental to the WTO and that these interests should not be counterpoised to 'progress' or to a 'successful' Round. Multilateral trade negotiations are underpinned by the fundamental principles of the WTO, and by the 'broader liberalization' agenda, but the fact is that these negotiations take place, as well, in the context of the political, economic and social realities of member states. The broader liberalization agenda historically has taken account of and indeed has been adjusted to accommodate these realities in *developed* member states. The realities of small, poor countries at this stage of their development are no less valid. Responding to these interests on terms acceptable, first and foremost, to small and poor countries, and as well to the membership as a whole, should be seen as an integral aspect of and a legitimate consideration for 'smoother and expeditious' progress in the Doha Round.

In short, in the WTO, there should be neither second tier members, nor-second tier interests. Unfortunately, the opposite is an underlying premise of the M&S paper.

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