

Special and Differential Treatment for Small Developing Economies

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INTRODUCTION

The international community has recognized 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 recognized 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 level of development there are substantial differences in size among economies. Small developing economies (SDEs) are a subset of developing countries. The SDEs are a specific type of developing country whose stability, adjustment and growth are constrained by both level of 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 paper 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 I explains why SDEs should be afforded SDT and how this is beneficial to them and the international community. Having done this section II reviews the evolution and status of SDT and finds that there is an unresolved debate about the efficacy of SDT. Section III then examines the issues in this debate concluding that there is a need to more clearly establish the link between the characteristics of developing countries and the existing SDT measures. The characteristics of SDEs are outlined in section IV 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 VI. 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 10th and final section.

I. 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 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 realized 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 89 countries that have a population of less than 5 million, 49 have fewer than 1.5 million people, and 28 have less than 500,000 people.² Indeed, the number of countries has increased significantly in recent decades. At the time of World War I, there were 62 independent countries, by 1946 that number had risen to 74 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 86 smallest economies, most of which are small developing economies account for only 1.5 percent of world trade and such a minute percentage of world trade could not disrupt the operation of the multilateral trading system.³

II. 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 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 Lome Conventions 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 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 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 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 industrialized countries especially the “Asian Tigers” would be beneficiaries. These countries it was felt were sufficiently competitive to assume stronger disciplines than the rest of 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. E U Trade Commissioner Mandelson has warned that “advanced developing countries must be aware that they can not 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 is when starting with Korea, Argentina and Brazil, several developing countries gave up their rights under Article XVIII:B,⁸ which under certain circumstances permit 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 25 developing countries availed themselves of the opportunity notify to the WTO exemptions under the AOA including investment subsidies, agricultural input subsidies and domestic support to

encourage diversification from cultivation of narcotic crops.¹⁰ The underutilization 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 resource and conditionality of lending and policy advice by multilateral financial institutions.¹¹

(4) 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

(5) 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 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 varied¹⁴ 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 % 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 per year 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 realized by industrial countries.¹⁷ However, by the time of the WTO Ministerial meeting in Seattle the majority of developing countries felt they had not realized 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 88 are being carefully studied. Up to the present time there has not been agreement on even one proposal of economic substance.

Special and differential treatment is embodied in the WTO agreements¹⁹ 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 12

provisions in four agreements and one decision, which are aimed at increasing the trade opportunities of developing country members. There are 49 provisions under which WTO members should safeguard the interest of developing countries. In addition, there are 30 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 endeavors, which are not enforceable and have not been fully implemented.

III. 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 maximize consumer welfare.²⁰ International trade on the basis of comparative advantage as determined by their different factor endowments²¹ 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 Hirschman²³ 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 skepticism and prompted alternative views about the role of trade in economic development employing models, which more accurately reflect the reality of developing countries. The divergence between the assumptions underpinning this theory of international trade and reality has forced even 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 Harberler²⁶ and Craincross²⁷ 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 Italy²⁹ and the U.S.³⁰ in the 19th century cited as evidence. The experience of developing countries was in contrast to the predictions prompting different explanations. Nurske³¹ 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. Prebisch³³ and Singer³⁴ 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 /industrialized countries which form the core export manufactured goods and the developing countries export primary products form 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 organization and the operation of labour markets, which are part of the structure of the core-periphery system. Lewis³⁵ argued that in a dual sector economy with labour surplus, low productivity in the subsistence sector is the critical factor whatever the demand conditions. Myrdal³⁶ also focuses on low productivity which is caused by the the structure of underdeveloped countries that generate a predominance of “backward effects” (growth retarding) over “spread effects” (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 has been deterioration in the relative real prices of non-oil commodities throughout the 20th 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 liberalization 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

2. Based on the neo-classical theory of international trade it is asserted that trade liberalization 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 liberalization and higher rates of economic growth.⁴¹ One of the implications is that inadequate or delayed trade liberalization 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 realization of their growth potential.

The empiricism of most of the studies that support the liberalization 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

governance should be the focus of developing countries seeking enhanced economic growth.⁴³ Even the Asian Tigers⁴⁴ or newly industrialized countries, which are often cited as examples of the success of outward oriented policies on closer examination, reveal that their strategies involved selective import liberalization 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 liberalized their trade regimes with disastrous consequences providing ample material for anti-globalization and anti-free trade advocates.

3. If trade liberalization 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 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 U.S., the E.U. 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 (a) 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 6 times total foreign aid.⁴⁷ Tariff peaks stymie developing country exports e.g. 60 percent of imports from developing countries entering Canada, the E.U., Japan and the U.S. were subject to tariff peaks.⁴⁸ There is also tariff escalation, non-tariffs 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. (b) 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 which 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 is more of a placebo than a lasting solution.

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 liberalization⁴⁹ 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 exacerbate 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 liberalization, which are present in every country whether it enjoys SDT, or not. The common motivations emanate from the desire to preserve market position by minimizing 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 industrialized are still counted among the so-called developing countries. These advanced developing countries have proven themselves to be internationally competitive, industrialized 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, not least developed but a sub-set of developing countries having characteristics, which derive from 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.

IV. CHARACTERISTICS OF SMALL DEVELOPING ECONOMIES

Small developing economies have certain characteristics⁵², 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 that the characteristics, which are common to different types of developing countries however 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.

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 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 it 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 it 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.

(a) 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 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.

(b) 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 of exports. Empirical analyses have detected a positive and statistically significant relationship between export concentration and export instability⁵⁷ and through its effects on terms of trade volatility has a major effect on income volatility.⁵⁸ The terms of trade volatility is 30 percent higher for small developing economies than for other developing countries.⁵⁹

(c) 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 percent of total exports.

(d) 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 trade⁶¹ and not the arms length international trade of economics textbooks. For a long time the world bauxite trade was conducted on the basis of intra-firm transfers⁶² and there was no genuine world market in operation.

(e) Acuteness

The extent of vulnerability of an economy can be measured by a "vulnerability index", for example, the index constructed by Atkins, Mazzi and Easter⁶³, 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 28 of the 30 most vulnerable were small developing economies.⁶⁵ A Commonwealth Secretariat/World Bank study has shown that of 111 developing countries, 26 of the 28 most vulnerable were small countries and 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

2. Imperfect Markets

The small size of markets in small developing economies results in market structures, which are characterized by substantial imperfections. These derive from the limited number of participants and in many cases they 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 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 suffer from the lack of economies of scale.

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 realize 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 enormous gap between firms competing in the global marketplace. The total sales of General Motors is 328 times larger than that 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.

4. Dependence on Trade Taxes

There is a high dependence on trade taxes as a percent 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 liberalization 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.

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 specialized 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.

V. IMPLICATIONS OF SMALL SIZE

There is no direct correlation between size and economic growth⁶⁸ 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 favorably according to levels of GDP per capita and the UN's Human Development Index. Nevertheless, small size has implications for the international trade of these countries. These implications include:

1. Volatility

Small developing economies have traditionally experienced pronounced economic volatility because:

(a) Acute vulnerability which is especially severe when export earnings depend on products which are prone to instability such as primary products⁶⁹ or goods whose market access depend 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 the environmental damage from natural disasters. Natural disasters have been a recurring factor in the volatility of small developing economies. The World Bank has estimated 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 localized. For example, the damage to Jamaica from Hurricane Gilbert in 1988 amounted to about 33 percent of GDP, damage to Antigua from Luis and Marilyn in 1995 amounted to about 66 percent of GDP, and to Montserrat suffered losses totaling 500 percent of GDP from Hugo in 1989. In comparison, the damage to the United States from Hurricane Andrew in 1992, while much larger in an absolute financial terms, amounted to only 0.2 percent of GDP.

(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 percent, double that of other developing countries.⁷¹ Foreign aid flows are subject to considerable fluctuations from year and year because they are allocated according to the political priorities of donor governments. The evidence for the last 20 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 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 countries⁷⁴ 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 output⁷⁶ and real per capita income⁷⁷ 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 1980-1998 only 24 of 53 small island countries achieved growth and the “average per capita growth rate was negative”.⁸¹

2. Sub-Optimal Resource Use, Allocation and Mobilization

Small markets are imperfect markets and this type of market situation has several implications for resource use allocation and mobilization, including:

(a) 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 oligopoly or 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 optimize efficiency and introduce new technology and improved production systems. A firm’s international competitiveness depends on its capacity to continually innovate in production techniques and products. The national market conditions in which the company operates is 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 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 favor 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 means 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 on most occasions and acceptable in quality. For example the tourism sector often imports food products, which are produced locally because supply is not consistent.⁸²

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

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. Firms in small developing economies are constrained by a business environment which is less conducive to attaining international competitiveness, than that of large developing countries or developed countries. In these environments, economies of scale can be realized without involvement in export activity and firms can benefit from modern infrastructure, large markets and enterprise cluster. Small firms even in developed countries 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 percent of small firms have multinational operations.⁸⁴ Despite these difficulties some firms in small developing economies have attained international competitiveness⁸⁵, established worldwide brands and become multi-national enterprises.

(a) Small developing economies have severe constraints on their material and labor inputs both in amount and variety, because of their limited land area, narrow resource base 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 scale⁸⁸ (where 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), is unlikely to foster the competitive dynamic necessary for firms in small economies to achieve competitive advantage. Competitive advantage in the sense in which Porter⁸⁹ 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 networks⁹⁰ of related and supporting industries. A firm working with world-class local suppliers can benefit from cross-fertilization opportunities and overcome information asymmetries. Related industries can also be an important source of innovations and provide strategic alliance 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 organization and networks. Very large firms, such as multinational corporations (MNCs), operate internationally in ways that are very different from small firms.

The disabilities constraining small firms increase as 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 including imports cost firms in small economies more compared to large firms, thereby making firms in small economies relatively less efficient.

Small developing economies pay higher transportation costs⁹² because of the relatively small volume of cargo, small cargo units, and the need for bulk breaking. Small economies pay an average of 10 percent of the value of merchandise exports as freight costs, compared to a 4.5 percent worldwide average and 8.3 percent 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 percent whereas the SDEs of the Caribbean pay between 9 to 13 percent.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 a 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 financing of 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 cost of production. The small of firms and farms find it more difficult than larger entities to meet the cost of compliance with international standards e.g. in developing countries enterprise size is the key variable in the ability of to comply with sanitary and phyto-sanitary measures in developed country markets.⁹⁶

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 hampers resource allocation which make 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 changes do not have the desired effect on the balance of payments because of low import and export price elasticities.

Stabilization policy must be designed specifically for small, developing countries taking cognizance 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 utilization and allocation more problematic than in large developed economies. These types of market situations are characterized 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 stabilization 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 markets also restricts the ability of private sector entities and the government to mobilize 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 globalization. Adjustment will not suffice to enable these economies to successfully manage the changes in the global economy 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 utilization, reallocation and mobilization intrinsic in stabilization 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 friction-less international mobility of goods, services, finance, capital and technology, which is the essence of a seamless global economy.

VI. 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 they be confined to best endeavor commitments to promote trade opportunities and safeguard the interest 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.

A. 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 recognized 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 would 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 degrees of freedom to pursue development policies.

B. 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 cataloging exercise has already been completed by the WTO.

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.

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, in particular, 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) as well as the TRIPs Agreement. In the Agreement on Textiles and Clothing (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 LDC’s 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.

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 cost 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 standardizing technical requirements through national organizations and participation in international standardization 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.

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. They should be made more applicable to small developing economies because of the vulnerability of these economies to balance of payment problems 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.

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 6 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 5 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 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 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 long run.

6. Development Promoting Policy

There should be a shift in the focus of SDT from exempting developing countries from having to fulfill certain obligations to measures, which proactively promote economic development. The foregoing 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 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 do 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 and developed countries can

promote this in small developing economies by (i) establishing or maintaining preferential market access arrangement, (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 characterized 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 on which products to undertake tariff reductions, particularly in agriculture⁹⁸. 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.

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

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) promote 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 countries⁹⁹.

(b) assist small developing economies in fulfilling their obligations assumed in international agreements, in particularly commitments under the WTO.

(c) support the efforts of SDEs to prepare technically for negotiations, attending meetings and maintain representation at the WTO in Geneva.

(d) contribute 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 14 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 be substantially increased.

8. Enabling Access to Mediation

The Understanding on Rules and Procedures governing the Settlement of Disputes is currently under review in light of the experiences of the past few years. The problems, which have been identified in the operations of the dispute settlement mechanism 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. This needs 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 U.S. and Latin American banana exporting countries and the E.U. illustrates the problems, which small developing countries face in attempting to utilize the DSM.

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 re-dimensioned 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 must involve 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 liberalization can only come to fruition if there is investment but in the case of small developing economies not all of this will materialize 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 specializing in development financing. Hoekman¹⁰¹ 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 rationalize resource use and avoid duplication in programming.

VII. HOW SDT ADDRESSES THE CHARACTERISTICS AND PROBLEMS OF SDEs

There has been a failure to clearly 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 paper 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 1. In some cases more than one measure maybe related to a single characteristic of SDEs.

TABLE I. Relationship Between Characteristics of Small Developing Economies and Special and Differential Treatment Measures.

MEASURES FEATURES	Different Obligations	Asymmetrically Phased Implementation	Exemptions	Flexibility	Temporary Suspension	Development Promotion	Technical Assistance	Mediation	Development Fund
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

VIII. 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 of country and size of firm have 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 recognized 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 recognized 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 programs e.g. subsidies or low cost finance or rules which discriminate in their favor, e.g. 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 Organization 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 is the Free Trade Area of the Americas process.¹⁰² Since its inception in the mid-1990s the FTAA negotiations has included a Working Group on Small Economies. The issue has finally emerged in the World Trade Organization 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 recognize small developing economies as a distinct category, it explicitly recognizes 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 recognizes that there is 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. Gutierrez proposed a range of 8-12 million¹⁰⁴ Kuznets¹⁰⁵ and Streeten¹⁰⁶ chose population selecting an upper limit of 10 million, Chenery and Syrquin¹⁰⁷ and Lloyd and Sundram¹⁰⁸ used 5 million. Armstrong and Read¹⁰⁹ suggested 3 million and a figure of 1.5 million has been employed by Commonwealth Secretariat/World Bank Joint Task Force¹¹⁰ while a report from the United Nations Development Programme (UNDP) speaks of countries with small populations as those with less 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 Kennes¹¹² 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 would 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. Demas¹¹³ combined a population of 5 million or less and less than 20,000 sq. miles of usable land. Bernal¹¹⁴ applied three criteria without selecting absolute limits and compared data for the 34 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. Davenport¹¹⁵ has proposed the use of the share of world trade and calculates that at a cut-off point of 0.02 per cent 36 countries would be small.

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

The definition of what is a small developing economy¹¹⁶ 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 of the criteria: population, land area, and GDP, and could be arrived at by consensus. As in any categorization 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 skeptics and opponents have capitalized 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 World Trade Organization (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.

IX. THE WAY FORWARD

The resolution of the deadlock on maintaining and/or strengthening SDT is for the membership of the WTO to accept and acknowledge that there are differences in size and level of development among countries and consequently they have different capabilities and this must be addressed by differentiated treatment. This is allowed by and provided for in the WTO, which are based on two complimentary 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 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.

1. Differentiated Treatment

Nearly all multilateral institutions when dealing with economic issues have recognized 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 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 & Agriculture Trade Policy Council¹⁷ that there should be three groups of countries that should be eligible for SDT. These are (a) least developed countries i.e. with per capita incomes of less than \$900, (b) lower middle-income developing countries i.e. gross national income per capita of between \$901 and \$3,035 and (c) upper middle-income developing countries i.e. gross national income per capita of between \$3,035 and \$9,385. Such a classification is open to all the disadvantage of using per capita income as a proxy for development and the failure to recognize 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 globalization 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 economy. Some of 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 small 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 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.

2. Implementation, Adjustment and Graduation

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

Improved economic development is a realizable possibility for the majority of developing countries if they can overcome some of the structural and institutional features, which currently inhibits 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 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 developed 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 measure would be evaluated and if they failed to comply with there commitments they should be subject to compensation and retaliation through the Dispute Settlement Mechanism.

SDT designed, implemented, reviewed and adjusted in the manner proposed in this papers would make developed countries more readily agreeable to SDT provisions because periodic review of adjustments to SDT as needs change and even of graduation. Developing countries will be assured that they SDT is 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 liberalization, as they would have the assurance that their development was being meaningfully addressed through SDT. This in turn would induce them to engage on the full agenda of issues before the WTO and to contemplate new subjects confident that their characteristics and concerns will be taken account of in the new SDT provisions.

X. CONCLUSIONS

It is now time to formally recognize 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 recognizes 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 recognized, 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

country. 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.

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- 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 DC: 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).
- 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.
- ¹¹⁷ *A New Approach to Special and Differential Treatment*, International Food & Agriculture Trade Policy Council, Position Paper No. 13, September 15, 2004, page 2.