DOCUMENT RESUME

ED 159 104 SO 011 117

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TITLE Trade Policies toward Developing Countries: The Multilateral Trade Negotiations.
INSTITUTION Agency for International Development (Dept. of State), Washington, D.C. Bureau for Intragovernmental and International Affairs.
PUB DATE 78
NOTE 252p.

EDRS PRICE MF-$0.83 HC-$14.05 Plus Postage.
DESCRIPTORS Change Strategies; Conference Reports; Conflict Resolution; Developed Nations; Developing Nations; Economics: *Exports; Foreign Countries; *Foreign Policy; *Global Approach; *International Law; *International Relations; Problem Solving
IDENTIFIERS *International Trade

ABSTRACT

Proceedings are presented of a 1977 conference about aspects of international trade negotiations of importance to developing countries. Participants included staff from Washington-based international organizations, various United States departments, Congressional staff, and students of the Foreign Service Institute. Transcripts of three addresses are presented, including comments by two respondents for each paper. The first paper considers special and differential (S&D) treatment measures for exports of developing countries to provide opportunities for improved market-access in developed countries' sectors where quantitative restrictions constitute an important obstacle to trade. The second paper discusses the international experience with safeguard actions under existing rules of the General Agreement on Tariffs and Trade. It also makes recommendations to improve the functioning of the safeguard system including provisions of S&D treatment for developing countries. The third paper argues that an accepted element of any new agreement on the use of export subsidies and other promotion schemes should be that equity and international relations considerations justify a differential treatment for export promotion schemes adopted by developing countries. (Author/AV)

ED159104

Trade Policies Toward Developing Countries: The Multilateral Trade Negotiations

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1978

Bureau for Intragovernmental and International Affairs
Agency for International Development
Washington, D. C.

SP 011117

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FOREWORD

The Agency for International Development and the State Department sponsored a day-long conference on the Multilateral Trade Negotiations and developing countries at the Foreign Service Institute on February 22, 1977. The purpose of the conference was to stimulate discussion among academic experts, U.S. officials and staff of international organizations on aspects of the trade negotiations of importance to developing countries. Participants included staff from Washington based international organizations and various U.S. departments, Congressional staff and students of the Foreign Service Institute.

This proceedings volume contains the papers, comments and discussion at the conference. All views of the participants are their own and do not necessarily reflect views of their agencies. Lorenzo Perez, with the help of Gerald R. Benedick, has edited the papers and discussion sections and provided an introduction and summary to the volume.

A large number of individuals were instrumental in making the conference a success. Special thanks are due to Bruce Duncombe, Edgar Harrell and Lorenzo Perez for developing the conference idea and organizing the meeting. Thanks are also due to Peter Kenen who as the conference chairman highlighted the main issues for discussion with his introductory remarks and kept the discussion lively and in focus during the day. Angela O'Sullivan, Sharon Triggs, Rebecca Wiley and Brenda Howard provided excellent typing support.

Constantine Michalopoulos
Deputy Assistant Administrator for
Economic Affairs

June 30, 1978
Washington, D.C.

Introduction and Summary

Lorenzo L. Perez*
Agency for International Development

The Tokyo Round of Multilateral Trade Negotiations (MTN) was initiated with a meeting of most participating countries in September of 1973 in Tokyo under the auspices of the General Agreement on Tariffs and Trade (GATT). The Tokyo Round aims to achieve the progressive dismantling of tariff and nontariff obstacles to trade, to improve the framework for the conduct of world trade in general as well as to stimulate international trade of the developing countries in particular.

About 90 countries, including noncontracting parties to the GATT, are participating in this round of negotiations. The Tokyo Round with its consideration of nontariff barriers and its avowed concern with the trade problems of developing countries is a much more comprehensive trade negotiations exercise than its most immediate predecessors, the Kennedy Round (1964-67) and the Dillon Round (1961-62) which were mostly concerned with the reduction of tariff barriers.[1]

* This paper represents solely the views of the author and is not intended as a policy statement of the Agency for International Development.

1 A negotiating structure was originally established consisting of a parent Trade Negotiations Committee and six negotiating groups covering tropical products, tariffs, nontariff measures, safeguards, agriculture and sectoral negotiations. The nontariff measures group was sub-divided into the subgroups of: quantitative restrictions, technical barriers to trade, subsidies and countervailing duties, government procurement and customs matters. A seventh negotiating group to work on the framework for the conduct of international trade was added in November 1976 mostly due to the initiative of developing countries. See the IMF Survey, "Tokyo Round Developments" July 4, 1977, pp. 216-219, for a discussion of the main issues in each of the areas of the negotiations.

According to the Tokyo Declaration, all the negotiating groups are considering procedures and measures for giving "special and more favorable treatment for developing countries in the areas of the negotiations where this is feasible and appropriate." In addition, "the developed countries will expect reciprocity for commitments made by them in the negotiations to reduce or remove tariff and other barriers to the trade of developing countries, i.e., the developed countries do not expect the developing countries, in the course of the trade negotiations, to make contributions which are inconsistent with their individual development, financial and trade needs".[2]

Having obtained this general commitment from developed countries to consider special and differential treatment measures, the developing countries are attempting to extend it to all areas of the negotiations, both with respect to their own commercial policies and to the commercial policies of the developed countries.[3] Examples of the former kind would be greater tolerance on the part of the developed countries for export subsidies and for import restrictions imposed by developed countries for balance of payments and economic development reasons. Examples of the kind of actions—that developed countries could undertake on behalf of developing countries' trade are deeper-than-formula-tariff cuts and accelerated phasing of such cuts, preservation of preferential tariff margins, reductions or elimination of quantitative restrictions, and exemptions from safeguard measures. Although the developed countries sympathize with the concerns of developing countries and supported several of their specific demands, concrete methods

2 The Tokyo Declaration, Paragraph 5, September 14, 1973

3 The terms "special" and "differential" (S&D hereafter) are used interchangeably in the MTN as well as in most of the discussion in this volume. See the Walter and Murray paper and the discussion below for a useful distinction between the two terms.

for differential treatment remain to be worked out in individual areas of the negotiations. By early 1977 possibilities for special and differential treatment in some areas of the negotiations like tariffs and tropical products had been more clearly identified than in others. For example, in the tariff group the possibility of deeper-than-formula cuts for products of interest to developing countries and faster staging had been identified as concrete possibilities. In the tropical products area, some developed countries accepted the position of developing countries that they will only reciprocate with their own trade offers for the concessions received from the developed countries in the tropical products negotiations onlv at the conclusion of the overall negotiations. In other areas, however, such as in quantitative restrictions, subsidies and countervailing duties and safeguards measures, alternatives for special and differential treatment options have not been so clearly identified. The authors of the seminar papers therefore were asked to focus on special and differential treatment measures which developed countries should consider on behalf of developing countries in these latter three areas. Such S&D measures would have to pass the tests of economic, political and administrative feasibility.

The quantitative restrictions (QRs) negotiations are an important area of the MTN given the trade impact of QRs and the Tokyo Round pledge to address nontariff barriers. The form that S&D treatment could take in this area is less clear than in the case of tariffs, particularly since the degree to which countries rely on QRs to achieve their commercial policy objectives varies greatly. Ingo Walter and Tracy Murray explore in their paper possibilities for S&D treatment in this area of the MTN and the implications for policies of developed countries.

A related negotiating area is the safeguard area. As trade barriers are reduced, internationally acceptable safeguard mechanisms become more crucial policy instruments. Gerald Meier in his paper on the safeguard negotiations discusses possible changes in the GATT safeguard articles and how the concerns of developing countries could be taken into account in these negotiations.

Subsidies and countervailing duties raise some of the most difficult problems in the MTN negotiations. There is a long tradition in the GATT against the use of export subsidies, particularly in the case of manufacturing trade, because of the possibility that they would lead to unfair competition. At the same time, most countries of the world subsidize their exports to a certain degree. Developing countries defend their right to use export subsidies as part of their export promotion programs to diversify their production structures and trade compositions. Daniel Schydlowsky presented a paper to the seminar analyzing the rationale for the use of export subsidies and proposing guidelines that developed countries could use in their negotiations with developing countries.

The three seminar papers support the current efforts to liberalize international trade as well as rationalizing the potentially more extensive use of export subsidies and safeguard measures. The S&D proposals made in the three areas are made with these general objectives in mind.

<u>Quantitative Restrictions Negotiations:</u>

The paper by Murray and Walter considers special and differential treatment measures for exports of developing countries to provide opportunities for improved market-access in developed countries' sectors where QRs constitute an important obstacle to trade. They argue that special and differential treatment in the QRs area should be envisioned as part of reducing this type of non-tariff barrier. A useful distinction is made in their paper between the terms special and differential. Special measures are those applied on a most favored nation basis but targeted specifically on products of particular concern to developing countries. Differential measures are those which provide LDC exports more favorable market access than exports of developed countries -- i e.. preferential access.

Murray and Walter discuss the major reasons for instituting QRs:

a. to permanently shield from import competition selected economic sectors which are import sensitive for social or political reasons;

b. to temporarily address balance of payments problems;

c. to provide temporary protection for import competing suppliers under "escape clause" actions to ease problems of adjustment of domestic industries including the so-called voluntary export agreements; and

d. to retaliate against foreign restrictions imposed on national exports. usually where alternative adjudication of disputes has failed.

The implications of QR imposition for the countries imposing them are well known. QRs, like tariffs. serve to raise the price of imported products to domestic buyers thereby reducing the volume of imports. But in the case of quotas, the potential tariff revenues are lost in the form of windfall profits of the importers, price increases of foreign exporters, or a combination of both. As the market for importable products expands efficiency declines, fiscal revenue is foregone, and a redistribution of income from consumers to producers occurs under quotas but remain the same or decline under tariffs. With regard to one of the newest forms of quantitative restrictions, voluntary export restrictions (VERs), Walter and Murray argue that on balance they appear to do more damage to the national economy of the importing country than do import quotas. This is because the foregone revenue under VERs goes solely to foreign exporters worsening the importing countries' terms of trade. It is clear from the paper that countries imposing QRs, whether temporary or permanent, would have to perceive that the reasons for doing so, such as the importance of an import sensitive sector, warrant the costs of these restrictions to their economies.

At the same time, exporting countries facing QRs can have their exports significantly affected. Permanent QR protection of "sensitive" sectors skews trade patterns and industrial structures of exporting countries away from the dictates of international comparative advantage. It also damages the potential of the economies of the exporting countries for growth. Resources might have to be channeled into sectors where their contribution to growth may well be lower. Existing patterns of comparative advantage in developing countries tend to favor labor-intensive industries, which are precisely those frequently subject to QRs in the industrial countries. Restrictions in these industries can force redirections in investment and employment flows which can be quite damaging.

Even the use of QRs for "escape clause" types of action may have short-term effects in developing countries which are rather dramatic. Murray and Walter argue that in developing countries where alternative employment of productive factors may be extremely restricted, both the factor under utilization and factor misallocation costs resulting from QR induced market closures may be far more significant than for advanced countries. Another problem associated with QRs is the uncertainty they may induce among individual suppliers in exporting countries, compounding in some instances the problem of export volatility which many of them face.

The Murray and Walter work is a very good illustration of how difficult it is to assess the quantitative impact of QRs. Analyzing the impact of QRs on developing country exports using existing trade data is very difficult because there is almost no way of identifying the pattern and volume of developing country exports that would exist in the absence of QRs. Murray and Walter approach the issue by comparing the export performance of developing countries in markets controlled by QRs with their performance in markets not subject to QR restraints. Their presumption is that if the developing countries have a smaller share in the restricted markets than they do in open ones, their exports are likely to be competitive in world markets and they would benefit from QR liberalization. If developing countries have significant shares of both restricted and unrestricted markets, this is even stronger evidence that they are competitive and should increase further their share of domestic markets if restrictions are reduced.[4]

Upon analysis of the available data, the authors conclude that, in general those OECD countries which administer QRs on imports of a particular product account for a relatively minor share of total OECD imports. Also the developing countries supply a relatively small share of these restricted markets in comparison with their export performance in unrestricted markets and consequently QRs do seem to discriminate against the developing countries in several products of export interest to them. Special treatment for developing countries' exports, in the sense that the QRs affecting their exports are eliminated, could significantly enhance their export prospects. If this is not possible, a differential elimination of QRs in favor of suppliers from developing countries over the developed third country

4. There is in fact evidence that LDC suppliers are competitive with import competing industries despite their QR protection.

suppliers might be defended on equity grounds. Such a policy could also be defended on efficiency grounds as long as provisions are taken co ensure that such differential treatment does not become an obstacle for a total elimination of the restriction in the future. They recommend, however, that as a general rule, "special" treatment may be preferred to "differential" treatment, since the latter may lead to a permanent misallocation of resources on a global level if the barriers are maintained to preserve the differential treatment.

The special case of textile trade is highlighted in the paper. Existing production technologies in the textile industry have led to a shift in international comparative advantage toward labor abundant developing countries. The resulting trade flows have seriously affected textile producers and workers in the industrial nations. The developed countries have found the adjustment costs to be unacceptably high because of the industry size, its geographical concentration and the age and skill characteristics of textile workers. As a result, they have negotiated voluntary export restraint measures, on a case-by-case basis between the impacted developed country and the major export suppliers. As a result of these agreements, exports of cotton textiles grew more slowly than any other category of manufactured exports during the 1960s. The rate of growth of exports of cotton textiles of developing countries increased dramatically in the early 1970s indicating the emergence of new developing country based suppliers who were not covered by existing restraint agreements. These new suppliers are also likely to be covered in voluntary export agreements negotiated in the future. Murray and Walter recognize the sensitivity of certain sectors of the textile industry and recommend gradual adaptation to the trade flows created by changing comparative advantage conditions. However, they recommend that even for sensitive textile sectors, imports should be permitted to grow at a rate that is consistent with a gradual decline in the level of output of the import-competing industry.

The paper, in covering the range of alternatives for liberalizing QRs, groups them into four categories, ranging from the cases where it is unlikely that the QRs will be lifted to the other extreme where the QR can realistically be eliminated.

(a) for the first category of QRs, consisting of non-negotiable QRs, the only measure which could benefit developing countries would be to reallocate the export-country shares, giving the developing countries larger allocations. But the potential for helping developing countries in this area is quite limited and traditional suppliers would be unnecessarily affected.

(b). a second category involves QRs for which long-run adjustment is indeed desired. It might be possible to choose the QRs of more interest to LDCs first for liberalization and give them special treatment in this sense. Differential treatment in this second case could simply involve allocating larger shares of existing and gradually enlarged QR limits to developing countries.

(c) a third category would be to bring all QRs being used for GATT sanctioned safeguard purposes into a new GATT framework for the purpose of regular review to ensure the temporary nature of these measures. As restrictions are gradually eliminated differential treatment could be arranged by granting developing countries larger increases.

(d) finally, a fourth category might simply call for the abolition of all residual QRs and substitute other forms of protection more closely aligned to the market. Special treatment could involve reducing tariffs on products of export interest to developing countries and differential treatment could be provided by gradually including the products in the generalized system of tariff preferences to provide for reduced-duty market access. Differential treatment might be provided for a particular group of countries like the least developed countries [5] by giving them larger preferential tariff cuts.

These special and differential treatment measures can also be graduated according to how successful the developing countries are in breaking into the import markets. Categories could be set up under which the special and differential measures would be reduced as developing countries pass through different threshold levels of import market penetration.

Murray and Walter believe that these S&D trade liberalizing attempts, aimed at the different QR categories, could be successfully promoted and carried out through a code of conduct for QR use. Such a code of conduct could provide a mechanism for notification, consultation and a justification procedure for the existence and imposition of QRs.

Rachel McCulloch in her comment on the Murray and Walter paper underscores the distinction between "special" and "differential". McCulloch argues that if product categories are appropriately chosen, developing countries can reap benefits without preferential treatment. Special measures are probably more consistent with the long run objective of moving toward a more open economy, since they do not establish a group with a vested interest in retaining existing trade restrictions.

5 The least developed countries were orginally identified by the United Nations as those countries with a GDP per capita below $100 in 1968 prices, literacy below 20% in the post-15 year age group, and the share of manufacturing in GDP of 10% or less. Twenty-eight countries are presently identified as least developed.

McCulloch also believes that to the extent that developing countries are nearer to the starting line in the industrialization process than developed nation competitors, any restrictions which close potential markets are especially harmful to new industries which have not yet reached a minimum efficient scale of operation. In developed countries, new industries often have a relatively large (and usually protected) domestic market which helps them to achieve scale economies. To the extent that QRs perpetuate the market shares as of the date of introduction, they penalize especially the more recent entrants into the field. In addition, McCulloch points out that QRs are highly complex administrative arrangements. Under these circumstances new and small suppliers which are frequently from developing countries are likely to be at a disadvantage in dealing with the attendant red tape.

For these reasons, McCulloch believes that the rationale for special and differential treatment can be established on two grounds. One justification would be the infant industry argument. Another justification would be on the basis that special and differential measures are a form of economic aid. The opportunity to supply a restricted market is worth something (the differential between domestic and foreign costs) and by giving a larger percentage of these rights to LDCs, a transfer of resources is achieved.

In providing special and differential treatment, McCulloch believes that it is better to use a differentiation criterion among LDCs which recognizes their share of the world market rather than their share of a particular import market as proposed by Walter and Murray. Conceptually the world market share criterion is more attractive but in practice it might be difficult to use by an importing developed country if an exporting country which has a small world market share has a large share of its import market.

Findlay is also in basic agreement with the Murray-Walter approach to QR liberalization. He argues that QRs on labor intensive manufactures exported from developing countries can frustrate the widely recommended export oriented development policies. With sluggish growth in world demand for important primary exports, the faster growing markets for labor intensive manufactures can provide the means to significantly increase developing countries export earnings. How successful developing countries are in increasing their export earnings will determine to an important extent how successful they are in increasing their rate of economic growth with obvious implications for the North-South dialogue.

Findlay is supportive of the Murray-Walter proposal that QR-liberalization should be negotiated in a multilateral rather than a bilateral context. This could conceivably eliminate a "free rider" problem of having some industrial countries trying to avoid eliminating some controls on sensitive sectors while hoping that others behave in such ways as to preserve the open trading system which is in the interest of all. The problem with the multilateral approach is, of course, that the countries which want to avoid liberalization will resist it. It is also difficult to completely bypass bilateral rounds of negotiations due to the difficulties of assessing the trade impact of individual QRs which might principally affect one or a few trading partners.

It is clear that more international discipline is needed on the use of quantitative restrictions. The frequency in the use of these restrictions has increased in recent years and the multilateral trade negotiations present an opportunity to restrict, if not reverse, this trend. The Murray and Walter recommendation that is most attractive, from a trade liberalization point of view, is the one promoting special treatment to the developing countries by eliminating the QRs of interest to them. Proposals for differential treatment to give developing countries larger shares of restricted markets are bound to be violently opposed by the other suppliers of restricted markets.

Their proposal of a code of conduct on the use of QRs is also an attractive one. Such a code of conduct could not only envision conditions under which escape clause types of action might be taken but, more ambitiously, could try to establish a negotiating mechanism by which QRs would be progressively eliminated in the future. Such a mechanism would contribute to guaranteeing the supposedly temporary nature of such actions. It should be added that one would expect the developing countries to eventually agree to such a code of conduct and given their frequent use of QRs, such a move on their part will go a long way toward liberalizing trade.

SAFEGUARD NEGOTIATIONS

Gerald Meier's paper discusses the international experience with safeguard actions under existing GATT rules and makes a number of recommendations to improve the functioning of the safeguard system including provisions of S&D treatment for developing countries. Article XIX of the GATT allows emergency action on certain imports if, as a result of unforeseen developments and trade concessions granted, imports increase in such quantities which cause or threaten to cause serious injury to domestic producers.[6]

Meier believes that the resort to Article XIX has, however, been rather limited in comparison with the invocation of domestic escape clauses, voluntary export restrictions (VERs) and restrictions in the textile trade

6 The GATT contains several different safeguard clauses (Articles XI:2(c), XII, XVII: 2, XIX - XXI, XXV, XXVIII, but Article XIX is the most relevant here).

such as the Multifiber World Textile Agreement. Countries have been reluctant to invoke Article XIX in order to avoid the article restrictions that emergency actions are supposed to be taken only in cases where "serious injury" is due to prior tariff concessions, to avoid the MFN rule and to avoid the need to give compensation to the affected trading partners. Under these circumstances the concept of "market disruption" has gained increasing acceptance particularly with regard to international trade in textile products. In the case of the 1974 Multifiber World Textile Agreement, market disruption was designated as: (i) a sharp and substantial increase or imminent increase of imports of particular products from particular sources with the import increase being measurable and (ii) these products are offered at prices which are substantially below those prevailing for similar goods of comparable quality in the market of the importing country.

Meier agrees with Tumlir that a revision of Article XIX is in order in view of the departures from GATT principles in recent years.[7] Meier argues that safeguard actions should be evaluated with the objective of reducing the sum of the dislocation costs due to sudden increases in imports and the costs of avoiding dislocation. The latter costs are those sustained by a country through redu   in the gains from trade (static benefits) and in the dynamic gains from import competition.

The paper notes that there are a number of policy instruments available to reduce imports to a desired level and that a hierarchy of desirable policies is widely recognized.[8] Coupled with the reduction of imports, a

7 Jan Tumlir, "Emergency Protection against Sharp Increases in Imports", in H. Corbet and R. Jackson (eds.) In Search of a New World Order (Halsted Press, 1974, Chapter 15).

8 See W. M. Corden Trade Policy and Economic Welfare (Oxford: Clarendon Press, 1974) for a discussion of alternative policies.

country may also wish to resort to adjustment assistance measures to compensate those affected by the rise in imports.

With the objective of minimizing both dislocation costs and the cost of avoiding dislocation from imports, Meier suggests a number of proposals to reform Article XIX. His proposals range from (a) requiring an actual increase in imports before invoking an escape clause, (b) having an international commission or panel of experts review national procedures for determining injury and compensation if any is warranted to (c) international agreements on different degrees of injury which would be useful in triggering an early warning system for providing adjustment assistance.

Meier also argues strongly against forcing a country which invokes an escape clause, to offer compensation, in the form of a most-favored-nation concession, on selected products exported by countries adversely affected by the invocation of Article XIX. Although implementation of this proposal would weaken one of the most important GATT underpinnings, in practice this has already occurred with the recourse to VERs and the like by many countries. It can be argued that the impossibility of reaching a mutually satisfactory settlement on the basis of reciprocity might lead a country, confronted with an emergency, to avoid using Article XIX and take recourse in some other measures. The nondiscriminatory basis of Article XIX may appear particularly inequitable to developing countries which are small suppliers or new entrants but are denied access to the safeguard-invoking country's market even though the safeguard was initially invoked because of injury from another large supplier.

The paper also recommends that a reformed Article XIX should involve some commitments and procedures, giving other countries an effective assurance of a continually growing access to the protected market and of a foreseeable removal of the market safeguard. This is especially important for developing countries that are entering new export markets. Meier agrees with Murray and Walter on the importance of adjustment assistance policies in helping to increase the speed with which change can be absorbed, while safeguards should be designed to slow down the speed of the change that has to be absorbed and digested.

With regard to procedural matters the paper emphasizes that (i) the determination of conditions on which the executive branch of government is called to take action be entrusted to a statutory body whose term of office not be coextensive with that of the executive and (ii) that, after a preliminary investigation, this body should hold public hearings in which all interested parties, including foreign firms, could be represented and argue their case. In addition, it would seem logical that the burden of proof should fall on the invoking party.

Meier's final general recommendation, and probably his most important, is that the MTN should adopt a comprehensive view of safeguards and focus on all measures instead of only on Article XIX. Such an approach might discourage the increasing proliferation of VERs and QRs. It is, however, a most difficult objective to achieve since large trading countries would probably prefer to maximize their policy flexibility free from international surveillance.

With regard to safeguard actions as they affect developing countries, the paper defends special and differential treatment for developing countries based on the principal of redistributive justice. This principle holds that the poorer party should not be made to stand a loss which the richer party could stand better. This rule of conduct is, of course, at the heart of argumentation on behalf of any special and differential treatment. In the case of quantitative restrictions the argument can also be made on efficiency grounds as Walter and Murray have done ...[9]

The Meier paper has difficulty in coming up with novel proposals for S&D. Such difficulties are due to the inherent conflict which exists between preserving exporting countries' interests while at the same time protecting import sensitive industries. Meier proposes that in the case where developing countries' suppliers are not the major "offenders" they should be exempted from escape clause actions. When some LDCs are the major offenders only those which are disrupting the domestic industry should be affected by an escape clause action. Meier would also supplement these measures with a general guideline originally proposed by Tumlir: emergency protection measures would not be applied to imports from countries whose exports of that product to the country invoking the clause have been growing at less than the average rate of growth of imports from all sources.[10]

Meier's approach is one of selectivity in invoking escape clause actions. One could argue that this method could turn out to be a two-edge sword for implementing S&D treatment for developing countries. It could very well be that semi-industrialized countries like Brazil and Korea might be singled out for action under a selective approach. The very fact that a country has to invoke an escape clause action on a MFN basis and might have to give compensation under Article XIX serves as a deterrent for such actions. Unfortunately, these deterrents have worked too well and the use

9 Meier gives as another reason for S&D treatment for developing countries that in return for improved access to advanced country markets, the developing countries might commit themselves to refrain from organizing commodity markets with price-raising objectives and might guarantee stable supplies of primary commodities. Given the politics of the negotiations it is very unlikely that this is a reasonable negotiating avenue.

10 Tumlir, op. cit.

of other instruments have proliferated affecting significantly developing countries' exports. If S&D treatment for developing countries' exports is going to be achieved in new rules for safeguards on the basis of selectivity, safeguard actions should be applied in a way which ensures that developing countries' exports will not be subject to more actions as a result of this selective application, and the proliferation of new trade barriers is avoided.

Irving Kravis, while agreeing with Meier in many respects, believes that potential trade gains for the developing countries from minimizing the use of safeguards are greater than those from a differential administration of safeguards. He argues that some kinds of safeguard actions are probably unavoidable since developing and developed countries place their domestic interests ahead of any international commitments with respect to trade. Kravis supports Meier's proposal of more specific criteria for safeguard invocation and the provision of multilateral controls over such invocations. He warns, however, that there is a limit to how much can be done along these lines before countries decide to ignore international commitments and safeguards lose their useful role of encouraging countries to enter into trade commitments which they otherwise would eschew.

Kravis argues that an effective way of inhibiting the use of safeguards is to raise the perception of these costs in each developed country. One way would be through auctioning import quotas if safeguard actions take this form. The proceeds could be placed in a multilaterally administered aid fund. The revenues produced by the auction of quotas would make explicit at least one part of the cost of restrictions and thereby strengthen the hands of those favoring freer trade.

Lawrence Krause is very skeptical of the possibility or desirability of having domestic safeguard actions monitored by an international body as proposed by Meier to reform Article XIX. He believes that such a panel is unlikely to be an objective one and that countries would simply not submit themselves to such an international discipline.

Krause argues that rather than making Article XIX provisions sharper they should be left the way they are or even made fuzzier so that "ad hoc" accommodations can be made between litigating parties, and Article XIX used more frequently. He criticizes Meier for believing that trading countries would be willing to give S&D treatment to developing countries on the basis of need when taking a safeguard action. Krause is afraid that a selective approach to safeguard invocation could very easily lead into countries invoking Artice XIX for a greater variety of trade restraining actions.

Peter Kenen in his concluding remarks made an interesting proposal for the use of a tariff-quota to deal with market disruption cases. Under his scheme temporary relief from import competition would be given by imposing quotas on the exports of the current exporting countries at the original tariff rate. A tariff surcharge would apply to imports coming from an exporting country in excess of what is allowed under its quota. A share of the import market would be unallocated to allow new comers to enter the market at the original tariff rate. Under this arrangement countries experiencing improvements in their competitive positions would thus still be able to increase their exports if their increases in productivity are large enough to offset the higher duty rate created by the surcharge. The tariff surcharge on imports coming from a country in excess of its original quota could go to zero gradually according to a predetermined schedule. Differential treatment could be provided on behalf of developing countries by having reductions in the tariff surcharge take place faster in the case of developing countries' exports.

Meier's recommendations are similar to those made by Walter and Murray in the sense that they all argue for more international discipline in the use of quantitative restrictions and for clearer rules to regulate the imposition of new restrictions. Meier believes that Article XIX should be reformed to make it more comprehensive. In this way, hopefully, the proliferation of new trade restricting mechanisms would be avoided. Meier is also in favor of tightening the definition of injury in escape clause cases and having an international commission review national procedures for determining injury.

Although there is implicit merit in clarifying the procedures of injury determination, trading countries will probably be unwilling to give an international panel the power to review their injury determination procedures. A GATT panel might be more useful in providing the means for a country invoking an escape clause action and the exporting countries affected by such action to negotiate a mutually satisfactory settlement and guarantee the temporariness of trade restrictions.

Empirical analysis is probably needed to determine to what extent S&D can be provided to developing countries by selective invocation of escape clause actions in the near future. If a selective approach were to be more generally accepted internationally and developing countries increase their shares of developed countries' sensitive import markets in the future, developing countries could indeed be selected out for escape clause actions. This could facilitate a negative form of S&D treatment. The experience in the textile trade seems to indicate that this is a real possibility. Because of such a danger proposals for S&D treatment based on a selective approach should be evaluated carefully.

SUBSIDIES AND COUNTERVAILING DUTIES NEGOTIATIONS

Daniel Schydlowsky argues in his paper that an accepted element of any new agreement on the use of export subsidies and other promotion schemes should be that equity and international relations considerations justify a differential treatment for export promotion schemes adopted by developing countries. Schydlowsky believes that export subsidization can be defended for developing countries essentially on two grounds: (a) On the grounds of the long recognized principle that exporters should not be placed at a competitive disadvantage as a result of taxation levied on the inputs of the exported products. This principle leads to a refund of the duties paid on the imported raw materials of the exporting countries. Schydlowsky goes one step further and proposes a generalized drawback mechanism which would cover all the repercussions of import protection which have the effect of increasing export costs and (b) on the grounds that export subsidies are needed to correct for distortions existing in factor and product markets which make market prices inappropriate guides to the real competitiveness of developing countries' industries. Unless corrections are made for these distortions, world trading arrangements will not maximize world welfare. For these reasons Schydlowsky argues for a generalized compensatory subsidy to offset the effects of the existing distortions.

Schydlowsky makes his case for a generalized drawback subsidy on the basis that a drawback of import duties allows an exporter to compete on the basis of his own productivity only in cases where he exclusively uses imported inputs as soon as domestic production of inputs exists behind a tariff wall, that is no longer so. When some inputs are sourced domestically behind tariff protection, costs are not less than when the competing imports are used. When the refund is only made available on that part of the increased costs corresponding to imported inputs, the general principle that the exporter should compete on his own productivity is lost. The author concludes that the export subsidy should refund the full increase in cost due to the import protection.[11] Schydlowsky also generalizes the argument from material inputs to all cost increases arising from taxation of inputs. Some of the other costs that Schydlowsky proposes to consider are increases in labor, capital and inventory costs due to the existing protection on finished goods in the exporting country.

The application of a generalized drawback requires three elements of information for its application to a product or a sector: the cost structure, the level of taxation of inputs, and the repercussions of taxes on the nominal wage level. The information on taxation of inputs is public knowledge and cost structures could supposedly be obtained from industrial surveys or by petitioning the data from individual exporters. Schydlowsky takes for granted that the estimation of the impact of input taxation on the nominal wage is not too difficult.

The second part of the author's subsidization proposal, his proposal for a generalized compensatory subsidy, is based on world welfare maximization grounds. When product and factor markets are distorted (e.g overvalued exchange rates, import and labor market restrictions) market competitiveness no longer provides a correct guide to comparative advantage. The paper proposes to calculate marginal social cost in lieu of marginal private costs and compare the former with world prices.

Due to the well-known distortions of factor and product markets in developing countries, the observed prices for labor and capital and the

[11] Schydlowsky uses the term subsidy in this instance different from GATT terminology which does not consider a drawback to be an export subsidy.

existing exchange rate do not adequately reflect the marginal social costs of using these factors of production.[12] To maximize world income, factor costs would have to be valued at their marginal social costs which would then be translated from local currency into foreign exchange values by use of the shadow price of the exchange rate. The developing countries with the smallest costs will have comparative advantage in such industries. In the cases where the estimated marginal social costs are different from the observed private costs, there would exist legitimate grounds for export subsidization.

In this framework, one would have to consider the distortions created by the tariffs in the importing country. World prices do not reflect consumer utility whenever import duties exist in the major consuming countries. Import taxation in this case drives a wedge between world marginal social cost and consumer marginal utility. Export subsidies offsetting such import duties are welfare increasing and thus are fully justified on world welfare grounds.

The application of the generalized compensatory subsidy requires the same cost structure information as the application of the generalized drawback, and requires in addition the availability of a set of shadow prices for the inputs and the outputs. Schydlowsky proposes that the shadow prices be periodically calculated by governments and publicly announced. He suggests that there might be a need to have an international body supervise the calculation of shadow prices in order to avoid having them tilted in a way which generates unnecessary export subsidization.

12 See the Schydlowsky paper, p. 185 for a discussion of these distortions.

Schydlowsky is aware of the opposition that might exist to his proposal and for this reason recommends the adoption of a compensated devaluation as a "baseline" export promotion tool for developing countries. A compensated devaluation would entail a change in the financial exchange rate accompanied by offsetting changes in export taxes and import duties. Such a compensated devaluation would partly eliminate the need for drawbacks and subsidies to correct distortions.[13]

Bela Balassa, although agreeing with the spirit of Schydlowsky's paper, raises objections to his proposals on theoretical and practical grounds. With regard to the implementation of a generalized compensatory subsidy to correct for market distortions, Balassa refers to the problems involved in shadow price estimation and the lack of a generalized use of them in investment planning in developing countries. Since the use of shadow prices is not widespread for other purposes, countries might have difficulties in using them to assess the need for export subsidies. In addition Balassa points out that a more appropriate solution is to remedy distortions directly in those factor markets where there are differences between shadow and market prices. Balassa's suggestion is strengthened once it is realized that many of these distortions are policy induced.[14]

Balassa is also skeptical of the justification for export subsidization on the basis of offsetting the price effects of tariffs of importing countries in order to increase consumer welfare. The price paid by the domestic consumer will not necessarily decline by the full amount of the export subsidy, especially if developing countries' producers have a small share

13 See Schydlowsky, p. 191-192, for a discussion of the limitations of a compensated devaluation in performing the roles of subsidies as envisioned in his proposal.

14 Jagdish H. Bhagwati: "The General Theory of Distortions and Welfare", in Jagdish N. Bhagwati, (ed.), Trade, Balance of Payments and Growth, Amsterdam, North Holland Publishing Co., 1971.

in the world market and export supply elasticities as well as substitution elasticities are low. One might also add that importing countries would not agree to permit subsidies on these grounds since they would tend to undermine their protectionistic objectives.

Balassa is also doubtful of the necessity of including in a generalized drawback such costs as import duties paid on capital goods and increases in labor costs resulting from the imposition of tariffs on wage goods. Many capital goods are imported duty free and there are problems in estimating the increased interest costs and wages due to protection. Balassa shows in his comment that under reasonable assumptions the value of such increased costs is not likely to be that significant.

On the other hand, Balassa reminds us of the well known proposition that efficient industrialization policy requires the provision of equal incentives for export production and import substitution activities. He argues that promotion of manufacturing activities should be pursued to the extent they provide social benefits in the form of the training of skilled labor and technological change that are not fully captured in the entrepreneur's profit calculation.[15] He believes that export subsidization should be limited so as to assure that developing countries do not employ excessive subsidies which distort competition and result in economic costs to them. As a possible application of this approach, he suggests that international rules be adopted to limit the acceptable rate of export subsidy to the average tariff on manufactured imports in the exporting country.

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[15] For an expansion of this argument see: Lorenzo L. Perez: "Export Subsidies in Developing Countries and the GATT", Journal of World Trade Law, Vol. 10, No. 6, November/December 1976.

Matthew J. Marks in his comments on Professor Schydlowsky's paper makes the point that importing countries will be prepared to take measures to further the welfare of the world only to the extent that these measures are not inconsistent with what these importing countries deem to be their own welfare. Marks believes that proposals for the use of export subsidies based on the principle of the maximization of world welfare will have limited receptivity. He is also concerned that the granting of export subsidies to correct for the effect of existing distortions in the product and factor markets will only encourage and permit the continuation of bad economic policies which originally caused many of the distortions.

Marks also points out that subsidies have a revenue cost and that richer developing countries are likely to be in a better position to take advantage of generous subsidy rules with the possible result being that poorer developing countries may be driven out of importing markets. For this reason he suggests that there should be a graduation mechanism for the use of export subsidies with developing countries becoming more subject to the GATT discipline on the use of export subsidies as they become more successful in their export sales.

There was a lack of consensus in the Conference with regard to the subsidy issue. Schydlowsky argues for the extension of the currently accepted drawback principle to a generalized drawback subsidy. His other proposal for a generalized compensatory subsidy is on weaker grounds if the distortions whose effects a subsidy is supposed to cancel are policy induced and could be eliminated or reduced by a change in the policies which originally created them. In defense of this criticism Schydlowsky argued that first-best solutions are not likely to be practical and the generalized compensatory subsidy proposal could be viewed as a compromise solution.

This second proposal would have a better chance of being accepted internationally if the use of a generalized compensatory subsidy would be accompanied by a commitment on the part of the exporting country to change some of the policies which originally created the distortions. This approach would amount to accepting a second best solution while moving to a first best one.

It is surprising that Schydlowsky does not emphasize more the existence of economic externalities, e.g., the infant industry case, as a justification for export subsidies. He believes that these cases are less important empirically than the instances where subsidies are justified on distortion grounds. Balassa acknowledges the importance of externalities but his proposal, of allowing an export sbusidy equal to the average tariff protection in the exporting country, although very easy to implement, has the problem that it gives the same amount of promotion to industries which might need different degrees of promotion. Nevertheless, it appears clear in principle that a general proposal for special and differential treatment on the use of export subsidies could be based on a combination of a generalized drawback subsidy, a generalized compensatory subsidy with commitments to policy changes, and some provisions to take into account infant industry situations.

The question of the political acceptability of such a program is still a very real one and, in this connection the comments of Matthew Marks and other participants of the seminar should be taken into account. With regard to the implementation of such a program it is reasonable to expect that some of the internal consistency of the Schydlowsky proposal would have to be given up on behalf of simpler rules which would facilitate the implementation of an export subsidy program. The implementation of such a proposal would be difficult to sell politically and the chances for its approval would improve if they are tied to a mechanism by which countries as they develop further are required to use subsidies in the same manner as developed countries. But a major educational and political effort would be required to reach agreement on such an approach.

CONCLUSIONS

Quite a number of issues were touched on by the authors of the seminar papers and other participants of the seminar in analyzing the possibilities for special and differential treatment in the multilateral trade negotiations. The highlights of the papers and comments were discussed above. Although there was no clear consensus on many of the issues discussed a number of underlying themes kept reappearing in the different sessions which should be identified in this concluding section. One recurring theme was that special and differential treatment measures should be implemented within a process of trade liberalization. In a trade liberalization process special and differential treatment measures can and should be provided without creating new trade restrictions. In such a process it would make sense to liberalize first or faster international trade in the products of interest to developing countries (special treatment in the Murray-Walter sense). The seminar participants were generally in agreement that permanent preferences on behalf of developing countries should be avoided since such measures would be to the detriment of a more competitive international trading system and eventually harm the trade interests of developing countries.

Another recurring theme in the discussions was that the international economy is undergoing structural changes through which developing countries are gaining an increasing comparative advantage in labor intensive products. This development will cause serious frictions in North-South trade relations as labor intensive industries in developed countries feel the increased competition from developing country exports. Although acknowledging the seriousness of the problem, there was a consensus by the participants of the panel that industrialized countries should follow policies that would adjust their economies and allow an increasing amount of developing country exports into their markets. These policies would tend to maximize world welfare but involve economic costs to the affected industries in the short run. Such a process of international adjustment would produce obvious consumer benefits to developed countries and it is probably indispensable if developing countries are going to continue to meet their financial commitments in international money markets by increasing their export earnings.[16] This approach is most obvious in Schydlowsky's recommendation but it is also implicit in the other two main papers.

Special and differential treatment measures were proposed in the seminar on both equity and efficiency grounds. Murray, Walter and McCulloch implicitly and explicitly employ an infant industry argument in arguing for differential treatment in those cases where QRs should be used at all. However, they prefer a process by which QRs are gradually eliminated for efficiency reasons. On equity grounds they argue for special treatment in the QRs area by having the trade in goods of interest to developing countries liberalized faster. Meier argues on equity grounds in favor of S&D treatment in the safeguard area while Schydlowsky makes the case for S&D treatment in the subsidies' area on both efficiency and equity grounds.

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[16] A case in point is South Korea which has been able to service increasing debt levels with improved export performance.

A final issue discussed was that of the political acceptability of the proposed S&D treatment measures. One cannot ignore how difficult it would be to obtain parliamentarian approval in developed countries for some of these programs. It was felt that in order to increase the political acceptability of these programs developing countries would have to reciprocate with their own trade liberalization measures and that as they develop they would have to make commitments to adopt trade practices closer to those of the GATT. With the proper policy mix these trade liberalization measures and increased commitments to GATT rules should help the growth performance of developing countries and increase the benefits of international trade to all participants.

Chairman's Opening Remarks

Peter Kenen

Princeton University

MR. BRUCE DUNCOMBE - Foreign Service Institute: Ladies and gentlemen, good morning. On behalf of the Foreign Service Institute and the Agency for International Development, I would like to welcome you to the trade seminar that we are holding today on special and differential treatment for the developing countries in the Multilateral Trade Negotiations.

Dr. Kenen is the Chairman for the seminar. Dr. Kenen is a graduate of Columbia and Harvard University. From 1964 to 1971, he was a Professor of Economics at Columbia. Since 1971, he has been the Walter Professor of Economics, and the Director of the International Finance Section at Princeton University.

DR. KENEN: Thank you very much Mr. Duncombe. The program calls for me to make some welcoming statements. I will try to be brief.

The three papers before us today deal with a range of issues having to do with special and differential treatment for developing countries, with each focusing on one dimension of the trade negotiations -- the matter of QRs, the matter of safeguard procedures and the matter of subsides and countervailing duties.

The papers differ in the emphasis they give to particular aspects of the problem. Some of the most important issues can perhaps be introduced by these questions: Firstly, what is the rationale in each dimension for giving special or differential treatment to the developing countries? Secondly, what sorts of differential or special treatment might be afforded from an administrative and political point of view? Thirdly, what degree of reciprocity, if any, ought to be required in each area, or perhaps in other areas, in return for special or differential treatment? Fourthly, what difficulties are we likely to encounter in negotiating differential or special treatment?

I hope that the authors will try to focus on these questions in their presentations today, regardless of the degree to which they may have discussed them in their prepared papers. In the initial presentations and later in the general discussion, we might also try to cover some broader questions defining the context for analyses and negotiations of these particular issues. There is, for example, the question that has been troublesome in all North-South negotiations, which is the problem of differentiating among developing countries for the purpose of graduating countries from one class of eligibility to another. What are the implications of doing so in each of these special areas?

It is worth asking, moreover, whether these particular areas within the Multilateral Trade Negotiations are indeed the ones that afford the most promising opportunities for special and differential treatment. Should we be focusing on these or other aspects of commercial policy as the most fruitful ones, in which to differentiate the treatment of developing and developed countries?

Another question has been mentioned in at least one of the papers, addressing the extent to which some quid pro quo should be requested outside the trade negotiations - something other than a measure of reciprocity. There may be trade-offs between concessions in these areas and concessions in other areas of concern.

The broadest question has to do with the context of the current negotiations, a matter on which all of us make implicit judgments when we deal with trade policy. Are we dealing today with a holding operation, trying to resist a retrograde tendency in trade policy, or are we on the eve of an opportunity for further substantial liberalization?

Finally, Professor Meier's paper raises a vital question. To what extent are we dealing with the particulars of national trade policies, and to what extent are we -- or should we be -- talking about the rewriting of the international commercial constitution?

All of these questions are relevant to the particulars of the suggestions we may be able to make today. But let me turn without further delay to the co-authors of the first paper, which deals with the liberalization of quantitative restrictions on imports from developing countries.

Special and Differential Liberalization of Quantitative Restrictions on Imports from Developing Countries

Tracy Murray and Ingo Walter*

This paper considers special and differential treatment of exports from developing countries in providing opportunities for improved market-access in sectors where quantitative import restrictions (QRs) constitute an important obstacle to trade. The term "special and differential" has been only vaguely defined so far. It is generally taken to mean paying special attention to the trade interests of less developed countries (LDCs). This definition embodies strong connotations of vertical equity, or more precisely, inequity. That is, the basic justification of "special and differential" treatment rests on inequalities in the ability of countries at different stages of development to compete in the real world of international commercial diplomacy. We shall add to this argument the further proposition that QRs--even when initially applied on a nondiscriminatory basis, tend for various reasons to be disproportionately restrictive for the products of existing or prospective export interest to the developing countries.

We shall thus define "differential" measures as those which provide LDC exports more favorable market access than non-LDC exports--i.e., preferential access. And we shall define "special" measures as those which are applied on an MFN (non-discriminatory) basis but targeted specifically on products of

*Respectively, Associate Professor of Economics and International Business, and Professor of Economics and Finance, Graduate School of Business Administration, New York University. The authors are indebted to Mr. William Beasom for statistical assistance: Mr. John Evans and Professors Ronald Findlay, Peter B. Kenen and Rachel McCulloch provided helpful comments on an earlier draft, presented at an FSI/AID joint seminar on "The Multilateral Trade Negotiations and the Developing Countries," Washington, D.C., 22 February 1977.

particular concern to the developing countries. This may or may not correspond to the terms of reference of the GATT Framework Improvement Group, formed in November 1976, charged with examining the developing countries' stake in the Multilateral Trade Negotiations and possible changes in GATT rules in their interests.[1]

We shall begin by reviewing briefly the nature and economic effects of quantitative trade restrictions, focusing particularly on an empirical assessment of their overall importance for the trade of developing countries. We proceed to discuss the special case of textiles, alternative approaches to QR liberalization embodying special and differential characteristics, and possible new features in the rules of international commercial policy to facilitate implementing special and differential treatment within an overall framework of trade liberalization.

I. Introduction

As a component of the protective structures of developed market-economy countries, quantitative import restrictions (QRs) have been assigned a number of specific functions.

First, QRs have been employed to provide permanent shielding from import competition to selected economic sectors, such as agriculture and textiles, that are considered "sensitive" for social or political reasons--sensitivity ascribed to such factors as national self-sufficiency as a policy objective, the need to protect low-skill workers, regional economic balance, intersectoral income parity, and the like. In affording permanent protection, quotas have the advantage of being "positive" in the sense of not allowing shifts in domestic or foreign market conditions to influence the volume of imports.

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[1] Multilateral Trade Negotiations News, U.S. Department of Commerce, Office of International Trade Policy, No. 22, January 1977.

Second, QRs are frequently used for balance of payments purposes as temporary expedients. Although this practice has fallen into disrepute, quantitative import limits may be placed on all merchandise transactions, or on certain product categories where domestic production can more or less readily substitute for imports, with the intent of cutting down on expenditures abroad as reflected in the current account of the balance of payments. This use of QRs is usually crisis-oriented, and tends to be replaced by measures in other sectors--such as deflationary macroeconomic policy, exchange-rate alteration, or exchange control--within relatively short periods of time. At least among the developed market-economy countries, the existing system of floating exchange rates and a general commitment to refrain from begger-thy-neighbor policies lowers the threat of QR-related trade disruptions arising from this particular source.

Third, QRs may be used to provide temporary protection for import-competing suppliers under "escape clause" or similar arrangements designed to ease problems of adjustment by domestic industries to rapid shifts in trade flows. The economic rationale here is that the associated adjustment costs depend in part on the speed of the adaptation required, and that slowing down the pace of import growth can significantly reduce these burdens for the sectors most directly affected. Economists have relatively few objections in principle to such measures applied to promote "orderly" and low-cost adjustment processes.[2] They do, however, emphasize the inevitable development of vested interests intent on retaining "temporary" QRs for periods longer than can reasonably be justified on adjustment grounds.

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[2]The evidence to date is not very clear that slower, more orderly, adjustment over longer periods of time is in fact cheaper than rapid and disruptive adjustment which is completed in a relatively short time period. The political costs, however, may be viewed rather differently.

A related "anti-disruption" use of QRs is to prevent foreign suppliers from taking advantage of market-access for predatory purposes, to inflict permanent injury on domestic suppliers that is unjustified by underlying economic factors, in order to take advantage later on of a less competitive market structure. Similarly, QRs may sometimes be used to counter foreign government subsidization of exports, as well as the trade-deflecting effects of closure of third-country markets which lead to a sudden import surge. Again, the use of QRs is intended as a temporary expedient, in this case to deal with foreign-source departures from the free interplay of market forces. Their subsequent removal in response to alleviation of the offending private or public policy measures may be somewhat easier than in the aforementioned cases. But the use of countervailing duties or import surcharges may still be preferable to the imposition of QRs as a temporary expedient to achieve the same ends.

Finally, QRs may be used to retaliate against foreign restrictions imposed on national exports, usually where alternative adjudication of disputes has failed. Moreover, special forms of QRs can be employed to regulate trade with individual nations under bilateral agreements, and embargoes may prevent imports from specific countries for political reasons.

QRs continue to play a prominent role as a tool of trade policy, certainly as reflected in current legislative mandates and GATT rules. The U.S. Trade Act of 1974, for example, empowers the President to use quantitative restrictions as a way of providing relief from injury caused by import competition. One U.S. objective in the current Multilateral Trade Negotiations (MTN) is to "...obtain international safeguard procedures designed to permit the use of temporary measures to ease the adjustment to change brought about by the effect of such negotiations upon the growth of international trade."[3] In its attempts to seek reform of the GATT negotiating machinery, the U.S. has pressed for expansion of the safeguard provisions to cover all types of restraints used by countries in response to import related injury of domestic industry, including QRs.

The 1974 U.S. Trade Act also provides for the use of QRs, alone or in combination with import surcharges, to deal with serious balance of payments and/or exchange rate pressures.[4] Moreover, QRs may be used to counter unfair trade practices on the part of foreign suppliers to exclude the goods in question from the U.S. market, or to retaliate against foreign import restrictions and withholding of supplie: The President may negotiate the removal of existing QRs, although the resulting agreements must be submitted to the Congress for approval.

Within the framework of the GATT, Article '' explicitly prohibits the application of QRs to imports from other contracting parties. However, the list of exceptions includes provisions to alleviate critical shortages of foodstuffs; administration of classification and grading standards; enforce t of domestic restraints of particular products; removal of temporary agricultural surpluses (all Article XI); balance of payments adjustment (Article XII); infant industry protection (Article XVIII) only for LDCs; temporary escape-clause protection (Article XIX); enforcement of domestic health and social welfare standards (Article XX); and assurance of national security (Article XXI), in addition to effectively permitting pre-GATT national QR legislation to remain in force. Despite these wide-ranging exceptions, it is clear that the U.S. and

[3] Trade Reform Act of 1974, Report of the Committee on Finance, U.S. Senate on H.R 1710 (Washington, D.C.: U.S. Government Printing Office, 1974), p. 23.

[4] Indeed, Article XII of the GATT authorizes for balance of payments purposes only the use of QRs, instead of tariffs, apparently because they could be more easily dismantled when the need for import restrictions has been overcome.

other countries have applied QRs in violation of the spirit of the GATT Articles and are continuing to do so--especially in providing essentially permanent protection to specific economic sectors.[5]

There are several different types of quantitative trade controls. First, quotas are either "global" or "selective." Global quotas fix the total amount of a particular product that can be imported from any source during a particular time period. Selective or discriminatory quotas do the same thing with respect to a specific foreign supplier. Global quotas are sometimes subdivided into a number of supplier-country quotas, thereby defining the relative shares of overall allowable imports allocated to each one. Unused country quotas may or may not be reallocated to other suppliers, and there is the possibility of reassignments of country quotas from one time period to the next. Alternatively, global quotas are often administered on a first-come-first-served basis to the benefit of the more competitive and sophisticated suppliers. Such an administration introduces an element of uncertainty regarding the date on which the quota becomes filled and, therefore, imports are no longer permitted.

A number of triggering mechanisms are available for use in quota administration. Import calendars (or seasonal quotas) are sometimes used in the agricultural sector, limiting imports to periods when there is no domestic harvest or when it is inadequate to meet domestic demand at acceptable prices. Conditional imports may be permitted in case of domestic agricultural supply

[5]This includes restrictions imposed under Section 22 of the U.S. Agricultural Adjustment Act; the European Community's Common Agricultural Program; the various textile agreements negotiated under GATT auspices (see below); provisions in trade legislation that do not limit the use of QRs in escape-clause actions; the increasing use of "voluntary" export restraints, and the like.

shortfalls. Discretionary licensing may be used for much the same purpose in the nonagricultural sector, and may not be associated with any explicit, published quota but rather leaves decisions on permissible imports to public authorities' assessments of the state of the domestic market.

Other quantitative restrictions to trade include "voluntary" export restraints (VERs), under which individual supplier countries are convinced to cut back their exports to a particular market where they are viewed as disruptive. Such restraints are normally imposed under the explicit threat of quantitative or other import restrictions in case of failure to act. A critical element of coercion thus underlies VERs, involving QRs or other restrictive measures that may themselves be in violation of GATT commitments. They are often justified as "orderly marketing" techniques applied bilaterally, and may be made multilateral, extended and institutionalized for particular sectors in a form such as the 1974 International Multifiber Arrangement (MFA) in the textiles sector or its predecessor, the Long Term Arrangement Regarding International Trade in Cotton Textile (LTA), established under the auspices of the GATT in 1962. Despite the likelihood that VERs will lead to collusion among foreign suppliers (see below), the 1974 Trade Act encourages the President to negotiate such restraints under "orderly marketing agreements."

Whether global or selective, bilateral or multilateral, QRs (a) may be fixed in terms of the amount of trade permitted, (b) may provide for growth of imports but often limit them to a particular proportion of the market, or (c) may be fixed from time to time according to prevailing conditions in the market.

Explicit quantitative import controls are generally administered by the issuance of licenses--permits to import. Licenses may be allocated to importers according to historical transactions or some other basis more or less arbitrary, or they may be auctioned off by the government. Resale of licenses may or may not be permitted. Allocation of licenses to domestic manufacturers of like or competitive products may lead to underutilization of quotas. Countries subject to "voluntary" export restraints may likewise allocate export permits to various suppliers and, if resale is permitted, markets for such licenses may develop as well.[6]

Several other non-tariff barriers to trade may be considered to be forms of QRs in the sense that they quantitatively restrict imports. One is discriminatory government procurement, which promotes public purchases of goods and services from domestic sources even when competitive import supplies--all things considered--are less costly. Another is domestic-content restrictions imposed upon government contractors and subcontractors. The general pursuit of "buy domestic" practices by firms under the influence of government or subject to governmental campaigns also falls under this general heading--as do "mixing and milling" regulations that specify the maximum imported content of products permitted to be offered for sale. The effects on trade are similar to those associated with more explicit quantitative restrictions. Still another type of QR is foreign aid tied to procurement by the aid recipient in the donor country, a practice followed by most

[6] From time to time, active markets for "export licenses" have developed in several Asian nations as a result of U.S. "voluntary export restraint" agreements under the LTA.

industrial nations. Finally, a number of countries insist on licensing imports for "statistical" purposes, which may at times serve to restrict trade--either directly or as a result of delays and uncertainties involved in the issuance of licenses.

It should perhaps also be noted that the variable levy system, adopted in the agricultural sector by the European Economic Community as a critical part of its Common Agricultural Policy, has effects very similar to QRs even though it is not classified as such. By assuring that the import levy always equals 5% more than the difference between world market prices and internal target prices, variable levies make sure that imports are confined to the role of filling any temporary gaps that may emerge between internal production and demand at those prices.

A much less restrictive approach is the so-called "tariff quota," under which a predetermined volume of imports is admitted under a baseline tariff rate (i.e., MFN or GSP) with imports beyond that limit being assessed a higher rate of duty. Such a provision is embodied in the GSP preferential tariff systems of the EEC and Japan. The U.S. International Trade Commission has recently suggested a similar approach for providing temporary protection to the U.S. shoe industry--the 10% MFN tariff to apply on imports up to 265 million pairs annually with additional imports paying a 40% duty which will gradually decline once again to the 10% MFN rate over a five-year period.

Lastly, "state trading" government monopolies which are given control over all imports of particular products may also be considered QRs under certain conditions. Under such arrangements a government can administratively tailor the volume of imports to accord the desired degree of protection to import-competing suppliers.

II. Implications for Countries Applying QRs

In terms of their impact on the domestic economy, quantitative import controls have a great deal in common with tariffs.[7] Both serve to raise prices of imported products to domestic buyers. Both cut the volume of imports. Both tend to stimulate domestic import-competing production and reduce levels of consumption. Both generate efficiency losses in the domestic economy and bring about the redistribution of income from consumers to producers. But while tariffs bring about these effects by taxing the customs value of imports, QRs do so by physically limiting the quantity of imports allowed, thus setting effective supply to the market equal to domestic supply plus quota imports--with the latter remaining the same regardless of domestic or foreign market developments.

In a static world, one important difference between tariffs and quotas is the revenue effect. With tariffs, the government collects an amount equal to the tariff rate times the amount of imports. With quotas, the same revenue is collected only if import permits are auctioned off in a competitive market. Otherwise there are windfall profits for the importers, for noncompetitive foreign exporters increasing their prices, or both. In the latter case, the application of quotas may lead to worse terms of trade than do tariffs. Selective or discriminatory quotas have the additional disadvantage that they generally fail to concentrate imports on least-cost foreign suppliers, unlike tariffs, thus leading to a wasteful use of world resources.

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[7]There has been extensive discussion among economists concerning the conditions under which tariffs and quotas are "equivalent" in both general equilibrium and partial equilibrium trade models, with and without the assumption of competitive markets. One important qualification in comparing quotas and tariffs is the assumption of perfect competition; when monopoly elements are present the "equivalency" of the two instruments tends to break down. See Jagdish Bhagwati, "On the Equivalence of Tariffs and Quotas," in R. E. Baldwin et al. (eds.) Trade, Tariffs and Growth (Chicago: Rand McNally, 1965) See also M. E. Kreinin, "The Equivalence of Tariffs and Quotas Once Again," Kyklos, March 1970; and Ingo Walter, "On the Equivalence of Tariffs and Quotas: Comment," Kyklos, March 1971.

In a dynamic world, marginal supplies in response to growing domestic demand come from imports under tariffs and from domestic producers under quotas. Efficiency losses, fiscal revenues foregone, and income redistribution from consumers to producers increase under quotas but remain the same or decline under tariffs. Effective protection of import-competing suppliers also increases under quotas but remains the same under tariffs as a result of domestic demand growth. Domestic and foreign market shocks remain independent of one another--an insulation that tends to aggravate inflationary pressures in the importing country by holding down the growth of productivity for a given rate of monetary expansion.

From a perspective of economic growth, quotas may cause more damage than tariffs. One important function of imports in mature economies is to "scavenge"--to put pressure on declining industries and force out high-cost producers so that the factors of production employed by them can be reabsorbed in other industries where their marginal productivity is higher. In spite of the adjustment costs involved, the "churning" of productive factors from lower to higher efficiency activities is an important part of the growth process, and in open economies imports provide significant stimulus in this area. When this function is impeded, particularly as a result of cutting the link between national and international markets by the imposition of QRs, growth of the national economy suffers.

Another element that is often overlooked when considering import controls is the fact that the resulting import reduction tends to lead to an artificially overvalued currency which reduces exports. Thus, the question is not whether to adjust to import competition (i.e., protect jobs) but how to adjust. The decision to impose import controls is implicitly a decision to encourage employment and production where domestic productivity is low and discourage these activities in export sectors where domestic productivity is high.

Still another problem with quantitative import restrictions that does not arise in the case of equivalent tariffs involves the transactions and interfirm efficiency costs of allocating import privileges. These allocations may be random and create inflexibilities, potential corruption, and inefficiencies among firms using them--all costs which are hard to measure but nonetheless real. In addition there is the possibility of quota underutilization mentioned earlier. Such effects often hit hardest those firms which use intermediate inputs that are imported and subject to quotas.

"Voluntary" export restrictions on balance appear to do more damage to the national economy of the importing country than do import quotas. This is because the foregone revenue that would have gone to the government under a static-equivalent tariff, or to domestic importers under an import quota (at least in part), definitely goes to foreign exporters under VERs. They may encourage these exporters to collude, and thus create a monopoly element in import supply. Both factors serve to worsen the importing nation's terms of trade and render VERs the worst possible option for the importing nation, from a static welfare point of view, in achieving a given level of protection.

QRs also turn out to be an inferior policy instrument when used for balance of payments purposes, in spite of their "positive" ability to restrict imports. Tariffs or import surcharges have the dual balance of payments effect of switching purchases from imports to home-produced goods and simultaneously draining spending power from the income stream through the revenue effect. Import quotas accomplish only the former and, if exporters abroad raise their prices, may lead to increased foreign exchange disbursements for those imports allowed. Even if this is not the case, QRs hardly cut domestic spending as those who reap the windfall gains re-inject the resulting purchasing power into the income stream, thus inducing further negative balance of payments effects.

In addition to these aggregate effects, there are micro elements which reduce the attractiveness of QRs. Exporters interested in maximizing their total export earnings will change the composition of exports from low unit-value items to high unit-value items within a given QR or VER product definition. The reduced availability of the low unit-value items will disproportionately affect consumers of such items--i.e., the QR can be expected to be a regressive tax on importing-country consumers--although domestic producers switching output the other way may moderate this effect. Moreover, any such switching of output within product categories will noticeably reduce the negative impact of QRs on import expenditures. Both of these disadvantages of QRs or VERs are absent when *ad valorem* tariffs are used to provide equivalent protection though not when specific tariffs are used.

A number of studies have attempted to measure the effects of QRs on the national economies imposing them.[8] Some have taken a very aggregate view,

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[8]See for example Stephen P. Magee, "The Welfare Effects of Restrictions on U.S. Trade," *Brookings Papers on Economic Activity*, 1972; C. Fred Bergsten, *The Cost of Import Restrictions to American Consumers* (New York: American Importers Associat 1972); Ilse Mintz, *U.S. Import Quotas: Costs and Consequences* (Washington, D.C.: American Enterprise Institute, 1973); Harry H. Bell, "Some Domestic Price Implications of U.S. Protective Measures," in *United States International Economic Policy in an Interdependent World*, Vol. I (Washington, D.C.: U.S. Government Printing Office, 1971); and Andrew F. Brimmer, "Import Controls and Domestic Inflation," Federal Reserve Board (*mimeo.*), November, 1970.

while a number of other studies have attempted to assess their implications for specific industries and sectors. One recent study of voluntary export restraints involves steel. In 1969, the EEC and Japan agreed to limit their exports to the U.S.. Each was assigned 41% of an overall limit of 14 million tons, 4 million tons below 1968 import levels, the remainder being assigned to other (non-signatory) countries. The self-limiting quota was gradually increased in later years, and in some years was non-binding. It was coupled to a 7% tariff rate, which declined gradually as a result of the Kennedy Round, although the VER presumably was the operative trade barrier. Over the 1969-73 period, actual steel imports were about 8.5 million tons, compared with an estimated 108.3 million tons in the absence of trade restrictions. Domestic shipments during the period were 475 million tons, compared with about 458 million tons estimated in the absence of trade controls. The import market share, which averaged 15% over the period, would have been slightly over 20%. Absence of the trade barriers would have led to a gradual increase in the market penetration by imports, inducing 3% layoffs in the steel industry work force and corresponding profit losses of domestic steel firms, but these would have been more than offset by gains to steel-using industries and consumers as a result of lower prices.[9]

III. Implications for Exporting Countries

Just as QRs have a variety of effects on the countries using them as tools of commercial policy, so too do they influence countries exporting the products being restricted. Such damage, of course, cannot be wholly ascribed

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[9]James M. Jondrow, "Effects of Trade Restrictions on Imports of Steel", Conference on the Impact of International Trade and Investment on Employment: The Department of Labor Research Results, December 2-3, 1976 (mimeo.)

to QRs. It may often result from tariffs and other types of trade restriction as well as with unfavorable market changes such as recessions in importing countries, development of substitutes, and the like. Such market-related shifts may be either transitory and can be "ridden out" with some degree of assurance that they will pass, or more permanent but sufficiently gradual as to be assimilated by the economy in a reasonably orderly way.

Limitations of market-access by means of import quotas reduce export demand, export earnings and output and employment in the affected industries. Permanent QR protection of "sensitive" sectors skews trade patterns and industrial structures of exporting countries away from the dictates of international comparative advantage. Exports may flow to third countries at lower prices than would have been obtained in the absence of QRs. Hence the terms of trade deteriorate, unless the exporting country is able to collude with other suppliers under a global QR to raise prices or can itself raise prices under a selective QR--in which case its terms of trade may improve. In the absence of this sort of monopolization, however, the exporting country's gains from international trade and specialization will be smaller. Domestic resource-use will in any case be less efficient.

Permanent QR protection also damages the economies of the exporting countries in a growth context. Instead of permitting exports to reflect domestic shifts in the labor force, capital formation and technological change, these agents of growth have to be channeled into alternative sectors where their contribution to growth may well be less. Since existing patterns of comparative advantage in developing countries tend to favor labor-intensive industries, precisely those frequently subject to QRs in the industrial countries, the resultant redirection of the sources of economic growth in such a setting can be damaging indeed. On a long-term basis, then, QRs prevent exporting countries from using their productive resources to fullest advantage and stunt their economic growth. This is something the developing countries can ill afford.

There are other costs as well. Some LDCs are so heavily export-oriented and import-dependent that negative developments in the export sector such as those engendered by QRs make themselves felt quickly in the level of aggregate economic activity. And often export earnings are heavily concentrated in a single product group which, if impacted by QRs, may bring economic hardship to a particular developing country out of all proportion to the importance of protecting the industry in question to the importing country. Many developing countries also carry a heavy burden of externally-held debt, which they must service in large measure out of export receipts. In attempts to secure further loans abroad or refinance existing debt, QR-induced problems in export performance may elevate the degree of country-risk in the eyes of foreign lenders, thus increasing the cost of borrowing and/or reducing the country's access to international credit markets. Not least important, most developing countries maintain exchange control regimes of one kind or another, whereby foreign exchange earnings are rationed out to meet import needs according to established priorities. Weakness in exports induced by QRs may thus lead to reduced imports and even more unfilled needs than would otherwise exist.

The use of QRs for "escape clause" type action, under whatever trigger mechanisms are used, may have short-term effects in developing countries that are rather dramatic. Sudden imposition of QRs and its effects on export and production volumes releases productive factors which may remain unemployed for some time before being reabsorbed in other sectors where their productivity is lower. In developing countries, where alternative employment of productive factors may be extremely restricted, both the factor-underutilization and factor-misallocation costs resulting from QR-induced market closures may be far more significant than for advanced countries subject to the same sort of restriction.[10] One element that may soften these effects is the possibility of trade-deflection from the closed markets to those remaining free of QRs. Yet the rapid growth of exports to such open markets via trade deflection may generate adjustment problems in those countries and raise the probability of additional QRs or other protection there as well.

Another problem associated with QRs is the uncertainty they may induce among individual suppliers in exporting countries. Published global quotas with permits issued to prominent importers may place them in a dominant bargaining position if there are numerous potential suppliers available in various countries. Even if this is not the case, efforts to collude with other suppliers may lead to indeterminate prices and market shares. Country quotas may have fewer such problems associated with them, but there is always the question: Which domestic suppliers will be chosen to serve the restricted foreign market? This is even more true of "voluntary" export quotas, where the allocation problems of rights to export are similar to

[10]There is an issue of who should bear the risk of instability. See Jagdish N. Bhagwati, "Export Market Disruption, Compensation and GATT Reform," UNCTAD, March 1976 (mimeo.), and G. M. Meier, "The Safeguard Negotiations and the GATT Reform," U.S. Department of State (mimeo.), February 1977.

those related to the issuance of licenses in the QR-imposing country, described earlier. But perhaps the greatest degree of uncertainty results from discretionary licensing, unpublished quotas, seasonal quotas and similar measures which prevent export suppliers from assuming stable and orderly foreign markets. Lastly, developing countries in particular often run the risk of inadequate information about the characteristics of foreign QPs, in part because their trade-information networks may be pocrly developed and staffed.

The instability and risk that may thus be associated with QRs affecting an LDC's exports may compound the problem of export volatility which many of them already face. Countries often count on diversification of exports into manufactures and semi-manufactures as a way of mitigating the export instability that tends to characterize primary commodities markets. QRs impede this diversification through their negative impact on investment incentives, thus making the prospects for the developing country worse.

The aforementioned growth-retarding impacts of QRs on developing countries are not eliminated when "escalator" provisions are built into the QRs, as under the Multifiber Arrangement in textiles. A six percent growth factor may reduce the damage to a mature exporter such as Japan, Taiwan or South Korea--although even here the ceiling on growth rates can still lead to distortive effects. However, for an LDC only just beginning to develop its industry in a restricted product line, where minimally viable scale economies require initial export growth rates as high as 50-100 percent, the damage may be severe indeed and may preclude certain new sectors from developing at all. QRs may thus "lock in" miniscule market shares for many developing countries and preclude what might otherwise represent some of the most promising long-range options in national growth strategies.

To summarize, just as QRs may be judged more damaging than tariffs to the economic welfare of countries applying them, so their ability to effectively sever the interplay of market forces among countries may make them more damaging to exporting countries as well. Their effects reach into the fabric of national economies, both as short-term shocks and as permanent barriers to export growth and they may be particularly damaging to developing countries as a result of limited transformation possibilities, structural rigidities, and poorly develop infrastructures. If it is true that LDC exports are particularly susceptible by their very nature to the imposition of QRs, such arguments should provide a relatively firm foundation for "special and differential" measures to achieve their liberalization.

IV. Incidence of QRs on Developing-Country Exports

There are serious problems in measuring the incidence of QRs, which essentially involves estimating how much trade might occur in their absence. This, in turn, requires estimating the effect of QRs on domestic prices, on quantities demanded by domestic consumers or users, and quantities supplied by import-competing producers. Both domestic demand and supply elasticities are needed as well as the foreign supply elasticities. Since the estimation of these parameters is notoriously difficult, assessments of the "restrictive effects" of QRs based on this technique are usually little more than educated guesses. Alternatives are available if one can project pre-QR import growth rates and compare the resulting hypothetical imports with QR-restricted import values, or if cross-sectional comparisons can be made between countries applying QRs and those that do not.

Still another alternative is to determine the "coverage" of trade by QRs--that is, the proportion of a country's exported product-groups or export volumes subject to QRs abroad. The problem here is that the QRs themselves distort the export-volume figures.[11] And even if undistorted weights are used, "coverage" estimates do not pretend to measure what would have happened in the absence of QRs, i.e., their restrictiveness. On the other hand, such estimates do give at least some indication whether QRs represent a trivial or an important problem for LDCs, individually or as a group.

Apart from the textiles sector, discussed below, U.S. quantitative restrictions at present cover imported meat, specialty steel, petroleum products, printed books and periodicals, aircraft, ships and boats, dairy products, oil seeds and fruits, margarine and other edible fats, sugar, chocolate and other food products containing cocoa, certain preparations of flour and starch containing cocoa, sweetened forage and certain other food preparations. Imports of wild bird feathers are controlled, as are narcotics and firearms. In terms of their import-restrictive effect, with the possible exception of sugar and meat, the majority of American QRs would not appear to have major trade-restrictive effects on LDC exports at the present time, given LDC supply capabilities. QRs on periodicals, ships and boats and perhaps several of the other products may affect exports from individual developing countries. Hence it appears that the principal LDC impact of U.S. non-agricultural QRs resides in the textiles sector, assuming that oil import QRs are today redundant.

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[11]This problem is equally as distortive when post-QR data are used to estimate various demand and supply elasticities, since the observations on price do not necessarily lie on either the demand or supply function. See Ingo Walter, "Nontariff Barriers and the Export Performance of Developing Countries," American Economic Review, May 1971. See also, R. G. Hawkins and I. Walter (eds.) The United States and International Markets (Lexington, Mass.: D.C. Heath, 1972), chapters 4 and 5.

This is less true of other developed market economy countries. France, Italy, Japan, Portugal and to a lesser extent Switzerland, Norway and the Benelux countries maintain more extensive QRs on industrial products, including such important items as footwear, ceramic tableware, cutlery, and tools--although a certain amount of liberalization has occurred over the past decade or so. In the agricultural sector, leaving aside the European Community's variable levy scheme, Switzerland, Norway, Austria, Japan, France and Canada are among those maintaining long lists of commodities that are subject to QRs at the national level.

As noted, analyzing the impact of QRs on LDC exports using existing trade data is very difficult because there is almost no way of identifying the pattern and volume of LDC exports that would exist in the absence of QRs. We shall therefore attempt to shed some light on the question by simply comparing LDC export performance in markets controlled by QRs with their performance in "open" markets--those having no QR restraints. The presumption is that if LDCs have a larger share in "open" markets than they do in restricted markets, their exports would tend to be competitive in world markets. Liberalization of QRs, even on a non-preferential basis, would thus benefit LDC trade interests. Hence, policy initiatives could well be limited to "special" measures to liberalize QRs--i.e., choosing products of export interest to LDCs first. If, on the other hand, LDCs dominate both markets they are obviously competitive, and if they supply neither they are not competitive at all.

Table 1 presents LDC exports to the OECD countries of those products which are controlled by QRs in at least one OECD country. The trade flows are then subdivided into QR and "open" markets. The former category covers imports into countries that actually apply QRs to the products in question, while the latter do not apply QRs to these same product-groups. Textiles are excluded, but will be treated separately in the following section.

LDC suppliers are inconsequential for half of the[7] QR-product groups, 23 of the 45 BTN two-digit categories subject to any reported QR among the OECD countries. It seems clear that these are not instrumental in restraining imports from developing countries, and their liberalization would not appreciably stimulate LDC exports.

The data for the remaining product groups sometimes seem to hide more than they reveal. For example, consider coffee and tea, where the LDCs supply over 90% of both QR and "open" markets, and sugar, where the U.S. quota preference for the Philippines and proximity to the Dominican Republic might have explained the high LDC market penetration into this QR market. It might be that these are simply cases in which the developing countries were competitive when the QRs were first introduced and consequently received a relatively large quota allotment that has been maintained administratively over the years. In fact, it might be argued that the QR has "protected" the LDCs' share of the QR markets--a share that has eroded somewhat over time in the "open" markets. It might also be that LDC marketing channels were better established in those markets which happen to be controlled by QRs than in "open" markets.

One way to assess the extent to which QRs affect LDC exports is to ask how heavily LDC exports are concentrated in QR markets. If the large markets are controlled by QRs, what is the relevance of competitiveness in "open" markets? Liberalization of QRs would be a prerequisite for any significant increase in LDC export performance. Three products--petroleum, coffee and tea, and mineral ores--account for 71% of LDC exports of products subject to reported QR controls in any OECD country. Few would argue that LDC export prospects for these products are dim, yet only one-third of the OECD import market (by value) is subject to QRs--only 2% for coffee and tea. In fact, there is only one product for which LDC exports are heavily concentrated (92%) in a QR market--edible fruits and nuts (BTN 08) and for this product group only 38% of OECD imports from the world actually enter QR markets. Apparently LDC exports in this category are heavily concentrated--the largest single trade flow is Sri Lanka's exports of fresh and dried fruit to France, Italy and the U.K. And there are only three other products for which the QR markets even approach half of the OECD market--sugar (BTN 17), fish (BTN 03) and meat (BTN 02).

The implications of such a cursory examination of trade flows seem clear. In the main, those OECD countries which administer QRs on imports of a particular product account for a relatively minor share of total OECD imports--they account for only 18% of the trade in agricultural and fishery items (BTN 1-24), 22% of industrial items in BTN 25-99, and only 10% of the latter if petroleum and mineral ores are excluded. On the other hand, the LDCs supply a relatively small share of these QR markets in comparision with their export performance in open markets. Consequently, QRs do seem to

Table 1

OECD Imports of Products Subject to QRs by At Least One OECD Country*
(1973 in $ Million)

BTN	Description	Imports into QR Markets: From World	From LDC	LDC Share (%)	Imports into Open Markets: From World	From LDC	LDC Share (%)
1	Live animals	110	6	5	2,179	151	7
2	Meat and edible offals	3,479	650	19	2,746	730	27
3	Fish, crustaceans, molluscs	983	583	59	2,531	610	24
4	Dairy products, eggs, honey	514	10	2	2,733	6	--
6	Live trees, plants, flowers	56	1	2	354	8	2
7	Edible vegetables, roots	711	172	24	852	239	28
8	Edible fruits and nuts	710	369	52	1,143	30	3
9	Coffee, tea, etc.	89	87	98	3,897	3,742	96
10	Cereals	1,179	63	5	5,329	508	10
11	Products of milling industry	18	--	--	745	1	--
12	Oil seeds, etc.	1,167	237	20	2,790	815	29
15	Oils and fats, animal and vegetable	82	20	24	2,037	1,015	50
16	Preps. of meats, fish, etc.	165	46	28	2,050	135	7
17	Sugar, confectionary	1,111	901	81	1,745	728	42
19	Cocoa preparation	76	20	26	1,552	935	60
20	Preps. of vegetables, etc.	253	82	32	1,009	99	10
22	Beverages, spirits, vinegar	313	40	13	11,280	49	--
23	Residues, wastes	94	34	36	3,081	1,192	39
24	Tobacco	212	28	13	1,797	466	26
1-24	Agricultural products (Subtotal)	11,322	3,349	30	49,850	11,459	23
25	Salt, sulphur, etc.	65	--	--	86	--	--
26	Mineral ores, concentrates	1,760	758	43	3,447	1,212	35
27	Mineral fuels, etc.	17,382	10,019	58	18,967	17,924	95
28	Inorganic chemicals	11	--	--	293	--	--
29	Organic chemicals	305	4	1	2,634	54	2
30	Pharmaceuticals	68	--	--	1,356	9	1
31	Fertilizers	3	--	--	15	--	--
33	Essential oils, cosmetics	132	1	--	899	7	1
37	Photographic goods	107	--	--	1,023	2	--
38	Misc. chemical products	61	--	--	250	--	--
39	Artificial resins and plastics	171	--	--	4,984	26	1

Table 1 - OECD Imports of Products Subject to QRs by At Least One OECD Country*

BTN	Description	Imports into QR Markets: From World	From LDC	LDC Share (%)	Imports into Open Markets: From World	From LDC	LDC Share (%)
40	Rubber, etc.	2	--	--	63	--	--
41	Raw hides, skins, leather	16	14	88	339	90	27
48	Paper and paperboard	58	--	--	1,744	--	--
49	Printed books, papers, etc.	94	--	--	390	8	2
64	Footwear, etc.	420	42	10	2,389	518	22
67	Prepared feathers, down	13	--	--	42	--	--
69	Ceramic products	233	3	1	244	5	2
73	Iron and steel	43	1	2	989	24	2
84	Machinery	939	33	4	15,199	283	2
85	Electrical machinery	1,117	40	4	9,395	1,258	13
87	Vehicles	3,554	4	--	32,571	167	1
88	Aircraft	720	21	3	1,207	12	1
90	Optical equipment	424	1	--	1,662	8	--
92	Musical instruments	53	--	--	1,532	--	--
97	Toys, games, sporting goods	116	10	9	1,997	334	17
25-99	Industrial products & raw materials (Sub-total)	27,866	10,951	39	103,717	21,941	21
	(Less Petroleum #27)	10,484	932	9	84,750	4,017	5
	(Less Petroleum & Ores #26,27)	8,724	174	2	81,303	2,805	3
1-99	Total	39,188	14,300	36	153,567	33,400	22
	(Less Extractive #26, 27)	20,046	3,523	18	131,153	14,264	11

Source: "QRs Applied by DCs to Imports of Industrial Products from Market Economy Countries," etc., U.S. Department of State (mimeo.) 1976 and UNCTAD NTB Inventory, updated (mimeo.) 1976. Trade Data are from OECD, Trade by Commodities, Series C and U.N., Commodity Trade Statistics, Series D. The BTN-SITC concordance is from U.N., "Standard Industrial Trade Classification, Revised" (1961), Statistical Papers, Series M, No. 34.

*Note: The data were collected for each BTN 4-digit product category for which a QR has been reported as being applied by at least one OECD country (excluding textiles and apparel); the data presented are 2-digit aggregations of the 4-digit categories. These data underestimate the incidence of QRs for two reasons: (1) not all QRs have been reported, and (2) some reported QRs cover narrow subcategories of a particular BTN 4-digit product category and, consequently, data are not [illegible]. The product categories subject to QRs covered in this table represent 55% of total developing country exports [illegible] countries in 1973--about 25% excluding the extractive sector and about 35% if textiles are included.

discriminate against the LDCs in several products of export interest to them. The complete elimination of QRs, therefore, could significantly enhance LDC export prospects. If, however, the complete elimination of QRs is not feasible, differential treatment (as contrasted with special treatment) in favor of the LDCs might be defended as a way of increasing their shares of QR markets--at least to the level indicated by their apparent ability to supply "open" markets. Such differential treatment could be justified on equity grounds. More importantly, it can also be justified on efficiency grounds in the sense that it at least partially removes a distortion of trade.

V. The Special Case of Textiles

During the late 1950s, the U.S. and European countries became concerned about the degree to which imports of cotton textiles were making inroads into their national markets. The source of this fear was continuing and increasing displacement of domestic textile production and employment by imports from low wage countries--mainly Japan, but increasingly the developing countries as well.

To counter this threat, the Western nations at the instigation of the U.S. negotiated a "Short-Term Arrangement on Cotton" under the auspices of the GATT. The arrangement was to remain in force for one year--1 October 1961 to 30 September 1962. The arrangement permitted bilateral agreements to limit trade in cotton textiles--a step which previously would have violated most-favored-nation treatment as contained in the first article of the GATT. This short-term arrangement was followed by the GATT-negotiated Long-Term Arrangement

Regarding International Trade in Cotton Textiles, the so-called LTA, which ran from 1 October 1962 to 30 September 1967. The LTA was renewed upon its expiration, and subsequently a new Arrangement Regarding International Trade in Textiles was negotiated in 1974. This arrangement was expanded to include wool and man-made textiles--the so-called Multifiber Arrangement (MFA) referred to earlier.

The main focus of all of these arrangements was to provide the major importing countries with a safeguard measure to protect their domestic producers and workers from sudden and sizeable increases in import competition. The rationale is that, instead of banning imports from all sources under such conditions, bilateral arrangements could be reached (without violating the GATT) between pairs of importing and exporting countries on the level of trade that would consider the interests of both countries. The aim is to provide time for the affected domestic producers and workers to adjust to the increased import competition.

The interests of the exporting countries were introduced into the Arrangements in calling for the following: (1) Periodic GATT reviews of all "voluntary" export restraint agreements; (2) The restraint levels were not to be less than the volume of trade occurring during a 12 month period just prior to the bilateral agreement; (3) If the bilateral agreement were to run beyond a 12 month period (or be renewed annually), the subsequent restraint level was to be increased by 5% under the LTA and 6% under the MFA; (4) The importing countries agree to sponsor adjustment programs to move workers to other industrial activities in order to provide long-term expansion of imports; and (5) Under the MFA, the trade interests of developing countries are explicitly cited. The Arrangement calls for no restraints against minor developing country suppliers and larger growth rates for new or recent developing country suppliers.[12]

As with virtually all international agreements, there are loopholes. And in this case the loopholes are decidedly in favor of the importing countries. Smaller growth rates in restraint levels are explicitly permitted "in exceptional cases," and undoubtedly the importing countries will prove to be less than vigorous in honoring their commitments to industrial adjustment in order to facilitate increased imports from developing countries.

Regardless of what one thinks about the advisability of an LTA-type scheme, it is nevertheless true that trade in textiles does constitute a special and important case. The textile and apparel industries currently provide more jobs in the U.S. and the EEC than any other single manufacturing industry--roughly 2.3 million workers or 12% of the 1970 industrial labor force was employed in textiles and apparel in the U.S.. For the EEC the 1970 figures were 3.3 million workers and 15%, respectively. And Japan was also heavily committed to textile and clothing production with 1.8 million workers accounting for 15% of total employment in manufacturing.[13] A more recent study by the International Committee for Rayon and Synthetic Fibres (RIRFS) estimates that if imports into Western Europe grow at an annual average rate of 8% until 1985 and exports stagnate, with overall consumption growing from 4.4 million tons in 1974 to 6 million tons in 1985, imports will attain a market share of 29%. This could lead to dismissal of 1.6 million of Western Europe's current 4.5

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[12]GATT, Arrangement Regarding International Trade in Textiles (Geneva: GATT, 1974).

[13]These data are taken from the GATT, Study on Textiles, Report of the Working Party on Trade in Textiles, document L/3797, 29 December 1972.

million workers in the textile industry. On the other hand, if the rate of import growth is held to 6% under the MFA and exports grow at 3% per annum, the estimated 1985 import market share is only 9.2%, with commensurately lower displacements of jobs.[14]

But industry size and aggregate employment is not the only issue of concern. The many firms in the U.S. textile industry are quite competitive and geographically dispersed. At the same time, textile firms are often located in rural areas, or a few firms are tightly bunched and provide the major source of employment for an isolated city or region. Hence import competition ~~that~~ severely affects a few firms producing a particular (seemingly unimportant) textile or apparel item may cause extreme local economic hardship.

Furthermore, textile workers on average tend to be older and less skilled than other manufacturing employees. Textile workers' skills are often not transferable to other occupations, and the job search problems of middle-aged unemployed workers can be severe. They may face discrimination by employers who would benefit from too few years of active service to justify establishing a new pension program, to justify the investment in retraining, and the like. And the individual hardships facing such middle-age textile workers are compounded by their loss of existing retirement benefits, seniority, and level of pay--their marginal revenue product in the protected textile industry may indeed be significantly above their value to alternative employers. For all of these reasons, pressure for protectionist trade policies that would effectively insulate them from import competition is understandable.

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[14] Dow Jones-Associated Press dispatch, The London Times, 20 January 1977.

For the developing countries, the special case of textiles is equally important. Textile production is an activity with low skill requirements that provides a good match with LDC labor force capabilities. In many lines of production, it tends to be a labor-intensive activity with relatively low capital requirements. Textile production lends itself to a wide spectrum of scale requirements with efficient low-cost production frequently attainable using rather small scales of operation. It is hardly surprising that international comparative advantage for many textile products has shifted to the labor abundant, low wage, capital scarce areas of the world.

The textile industry could make important contributions to the development aspirations of many LDCs, including especially the highly populated resource-poor countries. Access to world markets would generate a relatively large number of jobs per unit increase in exports. The net contribution to foreign exchange earnings is also likely to be significant, due to the high value-added nature of the textile production process. Moreover, due to the low skill requirements, the textile industry provides an attractive initial entry into industrial-type production for previously unemployed or underemployed non-industrial workers. This last point should not be underrated, since with few exceptions industrialization is a prerequisite for economic development. Prospects for increasing labor productivity in the agricultural sector are dim unless there is a commensurate increase in farm size and reduction in farm population--and hence more unemployment and poverty if the released workers are not absorbed by labor-intensive industrial employment.

In short, existing production technologies in the textile industry have led to a shift in international comparative advantage toward labor-abundant developing countries. The resulting trade flows have seriously affected textile producers and workers in the industrial nations. Because of the size and geographical distribution of these import-competing textile industries, and the age and skill characteristics of textile workers, the developed countries have found the adjustment costs to be unacceptably high. As a consequence, they have pursued measures to alleviate the need for adjustment--i.e., they have restricted the flow of imports through "voluntary" export restraints and similar measures, negotiated case-by-case between the impacted developed country and the major export suppliers.

The impact of the LTA and the respective bilateral voluntary export restraint agreements can be seen from the data presented in Table 2. During the 1960s, LDC exports of cotton textiles grew slower than any other manufactured exports. The only products which grew anywhere near as slowly are nondescript textiles--some of which contain cotton and are likely to have been subject to an LTA restraint, as well--and wool textiles. During this same period, LDC exports of synthetic textiles, which were not covered by the LTA, grew at a rate triple that of cotton textiles.

More recently, the rate of growth in LDC exports of cotton textiles has increased dramatically. But this should not be taken to represent a new liberalism toward textile trade on the part of the industrial countries. Instead, it probably indicates the emergence of new LDC suppliers which were not covered by existing restraint agreements. As these new emerging suppliers

Table 2

OECD Imports of Textiles from Developing Countries
($ million)*

Product	1961 1/	1970	1973	Annual Growth Rate 1961-70	Annual Growth Rate 1970-73
Textiles	336	982	2,437	13	36
Cotton	121	313	872	11	41
Wool	4	14	51	14	56
Synthetic	3	46	250	37	76
Nondescript 2/	208	609	1,264	13	28
Apparel 3/	35	1,315	3,730	50	42
Footwear	22	165	570	25	51
Other Manufactures	1,450	7,624	14,577	20	24

Data: OECD, Trade by Commodities, Series C.

1/ Excludes Japan.

2/ Includes repenetrated yarn, thread and fabric; textiles of Jute and other fibers; and other textiles which were not identified by material.

3/ Products are subdivided by type of garment instead of by material.

*Note: The figures are in value terms in contrast to the LTA agreements which specify quantity restraint levels. Thus, value growth rates in excess of the 5% LTA limit are possible under the restraint agreements.

themselves become subject to negotiated export restraints, the growth in LDC exports of cotton textiles can be expected to slow. We must also anticipate that, as a result of the extension of the LTA to man-made fibers and apparel under the MFA, the growth in LDC exports of synthetic textiles will be substantially retarded.

Table 3 presents import data relating to the bilateral agreements entered into by the U.S. as of end-1976 under the Multifiber Arrangement. Note that virtually all of the suppliers of man-made fibers affected by U.S. bilateral quotas under the MFA are developing countries. The only exception is Japan, which is also the largest single supplier followed by Taiwan, Korea, and Hong Kong. MFA countries supplied about 73% of total imports during the first eight months of 1976 and 79% in the same period a year earlier, reflecting the more rapid growth of imports from uncontrolled countries--45% versus 34%. Thus, the aggregate effects have been serious for the controlled suppliers and are certain to become serious for the new emerging suppliers as the scope of the MFA is expanded.

In addition, as noted earlier the exporting country government allocates export licenses for particular volumes of trade and particular products. The exporting firm that receives an assigned quota obtains a valuable license. In many cases, these quotas are exchanged between exporting firms--i.e., there is a market for quotas.[15] During 1974 a number of U.S. importing firms were interviewed regarding the operation of the export quota system under "voluntary" textile restraints. We learned that, on average, the quota price increased the cost of textile products to U.S. importers by roughly 15%.

[15]The textile export quotas are generally allocated on the basis of historical export performance. In many cases, a firm which is allocated a quota chooses to divert exports to a non-restricted market and sell its quota permits.

Table 3

U.S. Imports of Man-Made Fiber Textiles
(millions of square yard equivalents)

Source	1975	Eight-month data 1975	Eight-month data 1976	% Change
Bilateral agreement countries	1859.4	1176.7	1575.3	34%
Colombia	17.1	11.8	6.0	-49
Hong Kong	169.4	97.7	150.6	54
Japan	576.9	367.8	488.9	33
Korea	380.2	233.5	352.9	51
Macao	9.4	5.6	7.8	39
Malaysia	1.6	1.3	0.4	-69
Mexico	90.2	53.6	66.9	25
Philippines	91.8	59.0	61.8	5
Singapore	58.6	43.0	49.3	15
Taiwan	426.5	277.4	360.3	30
Thailand	37.7	26.0	30.4	17
Uncontrolled countries	607.4	307.0	573.0	87

Data: Textile Manufacturers Institute.

Second, developing countries that "consent" to the export restraints normally attempt to maximize their foreign exchange earnings subject to the quantity limits imposed by the bilateral agreements. This is accomplished by maximizing the number of high unit-value items exported within each quota category. For example, U.S. Textile and Apparel Category 43 includes women's, girls' and infants' knit shirts. The exporting government, to maximize export value, thus may allocate 100% of the export permits to firms that export women's knit shirts--none at all may be allocated for girls' and infants' knit shirts. The impact of such a shift in the product composition of trade on the U.S. consumer is quite predictable--domestic prices of children's knit shirts will increase more than if imports, even restricted, continued to flow.

Thus, in addition to the aggregate effects of reduced developing-country exports and increased consumer costs in developed countries to protect domestic producers and workers, we see LDC producers receiving in effect a monopoly profit and developed country consumers facing significantly different price increases from item to item within particular textile product categories. Given these disadvantages of the existing MFA bilateral export restraint program, it seems advisable to seek an alternative textile policy. But to be realistic, it seems inevitable that some type of control over import competition will be maintained. The textile industry is simply too large for the developed countries (DCs) as a whole and too important in particular economic localities to propose the complete freeing of international trade. The adjustment costs to be borne by the nation, or imposed on the textile workers, are much too high to ignore.

We end up with a traditional sort of economic policy conflict. We disapprove of the present system and worry about its costs, but cannot realistically see its elimination. A compromise approach seems the only way out. Over the long term, the interests of both the textile-exporting developing countries and the importing developed countries would be best served by a gradual process of adjustment to import competition. This would progressively exploit the gains from international trade and international comparative advantage. And it is rather likely that even under completely unrestricted international trade conditions a major textile and apparel industry would continue to thrive in the advanced countries--albeit in somewhat different form than exists today. We might expect that they can maintain a competitive position in capital-intensive, high-technology development and production of various natural and synthetic fabrics. Also, capital-intensive large-volume cutting of materials--e.g., for offshore sewing--might well prosper. Textile retail/wholesale and importing activities would certainly expand. And one would also expect that much of the fashion design would be done there--especially fashions that concord with special customs, tradition or activities such as western or casual wear, sportswear, haute couture and the like. Substantial manufacturing in these and in high-fashion sectors of the industry are also likely to do well.

But no matter what a future textile industry or employment might look like in the advanced countries, the critical question remains: What policies should they pursue to facilitate adjustment in the economy without imposing excessive burdens on those who have to do the adjusting? Since the adjustment problem essentially boils down to concern for particular producers and workers who would have extreme difficulty in obtaining alternative employment, the issue requires rather detailed microeconomic information on the textile industry itself. Information is needed about which workers must find new jobs, what are the localized labor market impacts, and the like. Such detailed information would probably identify numerous textile items for which adjustment would be relatively easy and costless. In such cases, the "voluntary" export restraint agreements should be terminated unilaterally. In those cases where the identified adjustment costs are deemed excessive, more gradual adaptation seems appropriate. But gradual adjustment does not mean that the growth should be limited, as at present, to a 6% annual rate--one that in particular import sectors is often far below the rate of growth in the domestic market. Imports should be permitted to grow at a rate that is consistent with a gradual decline in the level of import-competing production.

To operationalize such a modified restraint program, forecasts of DC demand for various textile items would have to be made and restraint levels decided upon. Imports should be allowed to grow each year by 100% of the increase in the DC market plus enough to displace, say, 2%, 5% or 10% of existing domestic production. The specific rate of import displacement decided upon would depend upon the particular adjustment problems incurred on a product-by-product basis.

The problem with the existing MFA program is that the interest of the domestic industry is protected permanently for those items having a growth in U.S. demand in excess of the 6%. In such cases DC production indeed grows, which makes a potential future adjustment problem even more serious. And advocates of the status quo gain greater political influence as adjustment costs mount.[16] A second concern about the LTA/MFA approach is that it may be extended to other products. Recall that an important set of new "import relief measures" was introduced in the 1974 U.S. Trade Act--namely, that the President is empowered to "negotiate orderly marketing agreements with foreign countries limiting the export from foreign countries and the import into the U.S." The Purpose is to "prevent or remedy serious injury or threat thereof ...and to facilitate the orderly adjustment to new competitive conditions." But, as the textile example shows, in practice such programs often lead to measures that prevent adjustment rather than facilitate it.

VI. Possible Approaches to Special and Differential QR Liberalization

The Tokyo Declaration initiating the MTN calls for "special and Differential treatment" for the benefit of LDCs as an integral part of the negotiations. As noted at the outset, the term "special treatment" seems to imply that the QR related trade problems of the LDCs should be given particular consideration with a view to liberalizing those quantitative restrictions that bear most heavily on LDC exports. But any such relaxation of QRs would apply to the exports of all GATT Contracting Parties under most-favored-nation conditions. In essence, "special treatment" would thus involve a ranking of the QRs to be liberalized, with efforts in the GATT tackling those most important to the LDCs first.

[16] With respect to the MFA, the U.S. synthetic fiber industry views a 6% growth factor in allowable imports under bilateral agreements as excessive at a time when estimated market growth is only 2% per year. Moreover, it would like a global quota established based on end-use markets to afford greater protection to specific product lines where import penetration is already high. The industry has in addition proposed a "recession clause," in effect an automatic quota trigger that would reduce allowable imports in the event of an economic slump. See Chemical and Engineering News, November 29, 1976, pp. 12-13.

"Differential treatment," on the other hand, implies that once a particular QR is liberalized, the eased market-access that results would not be equal for all Contracting Parties. Instead, the LDCs would get "preferential access." A precedent is already well established under the Generalized System of Preferences (GSP), favoring the exports of manufactured products from developing countries in tariff treatment. The GSP was initiated in 1971 with the implementation of the EEC program, and was completed when the U.S. followed suit in January 1976--19 OECD countries currently grant tariff preferences on manufactured exports of developing countries. Such "preferential treatment" is in direct contradiction to the most-favored-nation principle of GATT--indeed, Article I of the GATT was waived in June 1971 as a necessary prerequisite for the introduction of the GSP.[17]

Preferential market-access can make a significant contribution to developing countries in cases where they compete for export markets with developed economy countries and/or with the socialist countries. Whenever the developing countries are already the major suppliers, however, the scope for preference-induced displacement of developed country exports is rather limited. In such cases, the relaxation of QRs on an MFN basis alone may be every bit as beneficia[l] as their relaxation on a preferential basis. Hence in the important textile sector "special treatment" would appear to be sufficient to substantially benefit the LDCs. "Preferential treatment," on the other hand, would be more appropriate for a variety of competitive agricultural products and many manufactured items. As a general rule, "special" treatment may be preferred to "differential" treatment, since the latter may lead to permanent misallocation of resources on a global level.

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[17]See Tracy Murray, Trade Preferences for Developing Countries (London: Macmillan, and New York: Halsted-Wiley, 1977).

There is, however, a major problem with any type of preferential treatment because it provides easier access to markets for products coming from the "preferred" sources. To insure that the eligible products are actually produced in the preferred country, special "rules of origin" must be introduced. Without such origin requirements, one developed country might divert its exports to another by first shipping the goods involved into a "preferred" developing country for reexport to the destination country. Thus, "preferred" trading would stimulate the creation of "trading houses" in LDCs rather than industrial production.

"Rules of origin" have to specify minimum processing requirements necessary to qualify for preferential access, and their complexity often makes them pseudo nontariff barriers. They also become controversial and subject to criticism because of their double-edge nature. Rules that are too liberal tend to stimulate "trading house" activity with only minor LDC value-added--e.g., major repackaging. Rules that are too restrictive make it impossible for LDCs to qualify for preferential market-access. For example, under the European Community's GSP scheme transistor radios qualify for duty-free entry only if they are produced with transistors that are made in the developing country concerned. Very few developing countries have the technical capability to produce transistors, however. Thus, establishing origin requirements becomes a very technical and tedious problem that has to weigh the incentive to stimulate "trading house" activity against the possibility of imposing origin criteria beyond the production capabilities of the developing countries involved. Such rules must also take into consideration the fact that developing countries are indeed very different from each other--rules that are appropriate for Brazil, Mexico or Singapore may well be totally inappropriate for Paraguay, Ethiopia or Bangladesh.

The QR problem lends itself to solutions through preferential treatment more readily than other commercial policy instruments. Normally, QRs are not administered on a first-come-first-served basis. Instead the QR import limit is allocated among the exporting countries according to some "rule," which in turn is generally linked to the historical pattern of trade--i.e., the major historical exporters are allocated a larger share of the applicable QR limit. During a relaxation process where the overall QR limit is being increased, the increase could be allocated "preferentially" to LDCs, possibly with the poorest LDCs getting the largest share of the increase.

In covering the range of alternatives for liberalizing QRs, we shall group them into four categories, ranging from a case where it is deemed mandatory that the QR level of protection be maintained to the other extreme where the QR can realistically be eliminated.

Recalling that QRs are fundamentally inconsistent with adjustment and trade according to shifts in international comparative advantage, we recognize that it might be important in some isolated cases to maintain permanent domestic production of an internationally non-competitive product. We would argue that the number of such cases that are justifiable is rather small, but not necessarily zero. This first category would involve products for which the QR limit cannot be increased because it is fundamentally in the national interest to foster domestic production and, therefore, to prevent adjustment. The QR itself is non-negotiable. Since the overall level of imports will not in fact be increased, the only measure which could benefit LDCs would be to reallocate the export-country shares, giving LDCs larger allocations. One would also have to decide which particular LDCs are to benefit--the existing suppliers or new suppliers. In cases where several developed countries maintain permanent QRs, a coordinated approach in differential liberalization in favor of LDCs might be feasible. In a growth setting, periodic increases in QR levels, with the increments allocated to LDCs, present still another possibility. But the potential for helping LDCs in this area are quite limited, and the LDCs should be informed accordingly.[18]

The second category involves QRs applied to those products for which long run adjustment is indeed desired. However, it may be that the country is unwilling to bear the cost of adjusting in all industries at the same time, in part because the same factors of production may be involved in several of these industries. We thus decide to adjust sequentially.

The liberalization of QRs would occur first on some products and later on others, and this could involve selecting products of major export interest to the LDCs for liberalization first. Simultaneously, adjustment assistance could be concentrated in these same industries.[19] If international trade in these products were already dominated by LDCs, QR liberalization on a non-preferential basis would be adequate. The only remaining question would involve

[18] But again the number of justifiable cases which fall into this category will be very small indeed.

[19] Sequential liberalization, however, could increase the cost of adjustment unless the displaced factors are somehow prevented from entering the industries further down the list.

deciding the allocation of benefits among the LDCs. No matter which products were selected first, it is likely that a number of LDCs would not benefit because of restricted supply capabilities. Hence the choice of products for first-stage QR liberalization would depend upon which particular LDCs were to be among the initial beneficiaries.

"Differential treatment" in this adjustment-oriented scenario would simply involve allocating larger shares of existing and gradually enlarged QR limits to LDCs. Implicit in such treatment would be decisions concerning the allocation of enlarged shares among LDCs and providing for new LDC suppliers. It would also be feasible in certain cases to simply state that imports of some products subject to QRs from particular LDCs (especially newly-emerging or marginal suppliers) would not be administered--i.e., provide for open-end imports. For example, the U.N. has designated 29 LDCs as "least developed among the developing countries," and these countries might be exempted from QRs altogether. For such treatment to be beneficial, it may also be necessary to provide more liberal origin requirements for the least developed countries.

The third category would be to bring all QRs being used for GATT sanctioned safeguard purposes into a new GATT framework for the purpose of regular review to ensure the temporary nature of these measures. Such a mechanism should be founded on a basic rule that trade ought to ultimately flow according to international comparative advantage. In introducing any such safeguards, the restricting country should communicate its justification, a time-frame for phasing out the QRs, and the nature of the adjustment measures it is taking simultaneously to facilitate increased imports. Such a framework could include differential treatment in favor of the LDCs by incorporating either exemptions or relatively large quota allocations for all or particular LDCs whenever a new QR is introduced and relatively large increases in LDC allocations as the safeguard is being phased out.

The fourth category might simply call for the abolition of all residual QRs and the substitution of other forms of protection more closely aligned to the market. Generally, equivalent protection in a static sense could be provided by converting particular QRs into tariffs, as noted earlier. "Special" treatment would then take the form of renewed emphasis on reducing tariffs on products of export interest to the LDCs, and "differential" treatment could be provided by gradually including the products in the GSP to provide for reduced-duty market access. Within this option there might develop special justification for discriminating among the LDCs in order to assure a certain "sharing of benefits." Such discrimination could take the form of larger preferential cuts in the QR-replacement tariffs for the least developed countries.

Whereas this last category would fully eliminate the QR problem, it would not necessarily improve export market access for developing countries since one type of protection is being exchanged for another. On the other hand, we have seen that tariffs are clearly preferable to QRs for the exporting countries when the market is growing, so there is a benefit in a dynamic sense. The major impact would nevertheless depend on future tariff reductions and/or the extent to which such products would come under the GSP in a meaningful way.[20] However, given the recent history of GATT negotiations, we might expect the developed countries to be very reluctant to reduce tariffs on import-sensitive products.

The principal argument in favor of QR-conversion into tariffs is to get the remaining trade barriers out into the open and onto the GATT negotiating table. A possible drawback to such a plan is that some developed countries which lose QR protection and face the prospect of declining tariff protection in sensitive areas would turn to more subtle nontariff barriers to trade such as government "moral suasion" aimed at importers of particular products, special health, labelling and standards requirements, and the like.

VII. Possible Approaches to QR Negotiations

As an attempt to synthesize the issues raised in the foregoing discussion, we shall offer as a point of departure a negotiating position whose main objective is to bring the disparate group of QRs currently in effect in many countries within a single general framework. The alternatives for "special and differential treatment" can then be explored within this general framework.

We first suggest that GATT Contracting Parties agree on a "code of conduct" for QRs which includes, as a minimum, the "above board" notification of QRs on all products, including textiles and agricultural products, to an appropriate GATT body set up for that purpose. Such a code would provide for trade-policy sanctions against any country that fails to communicate a complete set of information regarding QRs which it applies. Such information should include

[20] The GSP schemes of the U.S., the EEC and Japan have come under severe criticism because they (a) exclude many products of export interest to the LDCs, (2) impose very restrictive ceiling-type limits on the volume of trade that qualifies for preferential tariff treatment, and (3) embody unrealistically restrictive rules of origin. See Tracy Murray, op. cit. supra.

restraint levels of consumption, production and employment in the protected industry. The QR-imposing country should also be required to notify its reasons for imposing the QR. Notification of QRs under a code of conduct is in no way meant to condone the use of QRs or repeal the restraints against their use contained in the GATT provisions, which limit them to exceptional applications.

Second, such a code of conduct should include procedures for consultation between the importer and concerned exporting countries. In addition, there should be periodic (e.g., semi-annual) GATT reviews of each QR in force. These reviews should be conducted with a view to liberalizing, eliminating or replacing all existing QRs, consistent with the spirit of Article XI of the GATT. The QR-imposing country should be charged with announcing such liberalizations as they occur, or justifying why the QR restraint levels cannot in fact be increased. Also included should be a complaint procedure whereby countries injured by new or tightened QRs imposed by others could seek redress for the damage involved.

Third, a code of conduct should include an explicit recognition that QRs are only justified as temporary measures to allow time for less costly adjustment to import competition. They should no longer be used to provide permanent protection for a noncompetitive sector or be used for balance of payments adjustment purposes.[21] Consequently, QR-imposing countries should be required to announce at the date of introduction a time-frame for phasing-out each quantitative restriction in force. Success in meeting such a phase-out plan would undoubtedly play a major role in the periodic GATT reviews suggested above.

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[21] Short term balance of payments problems could more appropriately be treated by uniform import tariff surcharges, currency depreciation and the like.

Fourth, resort to QR protection should obligate the country concerned to introduce _specific domestic measures_ to facilitate affirmative adjustment on the part of its import-competing industry. Ideally, such measures should be designed to shift resources from non-competitive import-impacted industries and into internationally competitive industries. In some cases, however, an industry may be non-competitive because of domestic programs or institutional constraints including regulatory inefficiencies. In such cases, modernizing assistance and removal of the distortive policies would be warranted. To guard against symptom-alleviating rather than problem-correcting policies, the code should contain a provision that prevents the reestablishment of a QR on a product that had previously been protected without a minimum intervening period of say 5 to 10 years, i.e., a QR moratorium should be established in each case. In conducting the periodic GATT reviews, the rate of decline of domestic production and employment in the QR-protected industry should be of major concern in judging whether the country concerned is living up to its international obligations under the code of conduct.

An important component of such a code of conduct on QRs should be _advance_ consultation on the unilateral imposition of QRs and on the use of pressure to obtain "voluntary" export restraints. While advance consultation under GATT auspices does not guarantee that QRs will not in fact be used, it does provide an opportunity for all sides to be heard. Hence it may lead to the use of alternative protective devices or a reduction in the severity of QRs to be imposed. It might also lead to opportunities for exempting non-offending LDCs if consultation procedures are pursued with an eye toward "differential" treatment.

General rules for "special and differential" treatment should be made part of any such GATT code of conduct on QRs. These might include (a) the general intention to supply larger shares of QRs for developing countries, (b) segmenting LDCs by level of development in order to allow different levels of preferential treatment, and (c) automatic non-administration of QRs for the least developed among the developing countries.

Because QRs in the agricultural sector are in large part merely the trade-policy component of domestic farm policies, any change in the trade-policy aspect can only be an accompaniment of a change in domestic agricultural policies. And the chances for fundamental alterations in domestic farm programs for the sake of more efficient international allocation of production are practically nil. This does not mean, however, that whatever imports are indeed permitted cannot be directed towards developing countries, or that marginal suppliers among the developing countries cannot be exempted from QRs for specific periods of time. Substantially more liberal treatment should be possible for processed agricultural products. However, protected domestic commodity markets may create situations where certain domestic processors face negative effective protection. In the main, this problem could be corrected by appropriate offsetting tariffs on the respective processed agricultural products. Moreover, large shares of the growth in domestic markets for both primary and processed agricultural products could be allocated to the developing countries under differential measures. Hence some dimensions of a QR code of conduct could be applied to the agricultural sector as well.

VIII. Administrative Aspects of QR Liberalization

The administration of QR liberalization essentially involves two elements: (a) an appropriate division of the domestic market between national, LDC and third-country suppliers at the time a new QR is introduced, and (b) appropriate changes in the respective suppliers' access to the market over time. The basic rules and criteria for administering these two elements depend in the first instance, on the justification for initially introducing the QR. If this involves national defense-type considerations--where permanent protection is necessary to maintain a viable domestic industry--then the primary concern is to assure dependable supplies of the particular product over time. In such cases, the choice of foreign suppliers will be based primarily on political grounds rather than on "equity" or "aid to LDC" considerations, and neither administrative element is relevant.

In general, however, the justification for introducing a QR will be to minimize domestic adjustment costs by providing temporary and declining protection from excessive import competition. In such cases both administrative elements are very important. First, the QR-imposing country must allocate permissible imports among various suppliers or permit imports up to the QR limit under first-come-first-served conditions. This latter alternative would benefit the LDCs only minimally when there is strong competition from third country suppliers, and would hardly benefit the least developed LDCs at all when there are more advanced LDC suppliers. When the entire spectrum of prospective suppliers is present, a hierarchy of differential treatment would be to the advantage of the LDCs and especially to the least developed.

It seems quite possible that the LDCs could be subdivided into two or three groups based on the capacity to export, such that exports from the lowest group of LDCs could be admitted without regard to QR limits. It would be expected that the hierarchy will vary from product to product, depending upon national export capabilities.

The problem of assigning LDCs to the respective supplier groups under QRs would become politically sensitive unless some measurable criteria were used. The most obvious justification for classifyir the LDCs is to permit open-access to markets for those LDCs whose export capacity is so limited that injury to domestic import-competing producers and workers is likely to be nil. Under such conditions a simple, effective and justifiable objective criterion would be the share of the import market. For example, three classes of LDCs might be defined as follows: Class I (most preferred or least competitive)--LDCs whose share of the import market for a particular QR product is less than 1%; Class II (intermediate)--LDCs whose share of the import market for a particul r QR prod t is greater than 1% but less than 5%; and Class III (least preferred or most competitive)--LDCs whose share of the import market for a particular QR product is 5% or greater. A fourth class could be defined to designate developed countries--all non-LDCs or nonpreferred--which would not be eligible for special or differential treatment for the particular product.

Initially, the QR level might be allocated among suppliers according to historical market shares with some incremental allocation to LDCs. Imports from Class I LDCs would be permitted without limit. Imports from each Class II

LDC would be monitored, but imports in excess of the allotted QR limit would be permitted unless these excessive imports resulted in substantial injury to domestic import-competing producers or workers. Imports from Class III LDCs would be permitted up to the QR limit. In the event that total imports in a given period were expected to fall short of the aggregate quota level for the year (the "reference level"), the anticipated shortfall could be reallocated to Class III LDCs for the current period.

Over time, both the export performance of the LDCs and the capacity of the domestic market to absorb imports can be expected to change significantly especially since QR protection has to be coupled with active adjustment measures to facilitate increased imports. Hence administrative rules must be established to alter restraint levels periodically. The total quota level or annual reference level could be increased by 100% of the increase in domestic consumption plus a certain percentage, say 5%, of the residual domestic production. The allocation of this enlarged annual reference level among potential suppliers would have to be negotiated, taking into consideration both non-LDC suppliers and emerging LDC suppliers. The increase in exporting country quotas to be allocated to Class I and Class III countries could be limited to actual exports during the previous year--i.e., provide no growth or a very small growth in quota allocations.

The list of LDCs belonging to the respective classes could be updated each year on the basis of past year export performance. For example, those Class I LDCs that develop an export capability will, over time, move into

[22] This 5% figure would depend on the extent to which the U.S. industry would be contracted; even after adjustment is complete we can expect certain elements of the industry to remain competitive.

Class II and on to Class III. This automatically provides for a gradual phase out of differential treatment, since Class III LDC exports are treated essentially like non-LDC suppliers. The only exceptions are that the growth in Class III LDC quota allocations might be larger than non-LDC suppliers, and Class III LDCs would be the major recipients of unused quotas resulting in import shortfalls. A final phaseout for special and differential treatment could be incorporated in the form of a reclassification of certain Class III LDCs--those that supply, say 15%, of the import market--to the non-LDC class for the particular QR product.

One crucial aspect of the administration of QRs still missing is the definition of the QR product itself. From the import-competing industry's point of view, a definition that is precisely aligned with the import-impacted product is most suitable. If the product is quite broadly (i.e., heterogeneously) defined, imports of an import-sensitive sub-category might increase substantially, causing import injury even when imports of the broadly-defined product are maintained within the quota level. However, if the product is narrowly defined, only a very few LDCs are likely to be active suppliers, and these LDCs could very possibly be the major world export suppliers in need of little or no special or differential treatment. In such cases, special treatment is as beneficial to the exporters as differential treatment, since only one or two Class III LDCs participate in the import market and they would actually be phased-out into the non-LDC class.

To appreciate this problem, one need only recall that the U.S. tariff schedules define some ~~10,000~~ mutually exclusive 5-digit TSUS products, to say nothing of the hundreds of 7-digit TSUS subitems defined for administering textile trade under the various LTA and MFA trade agreements. For many of these products the total value of U.S. imports is quite small. To illustrate, under the U.S. GSP any LDC which supplies at least 50% of total U.S. imports of a particular product will lose preferential tariff treatment on the product, defined as 5-digit TSUS items. When the U.S. GSP was introduced in 1976, over 100 such GSP-withdrawal cases occurred in which the affected trade flow amounted to less than $1 million annually. Certainly trade flows of such small magnitudes will not cause much of an import displacement problem. Any code of conduct on QRs should thus contain criteria for defining a minimum bound for QR protection, for example in terms of minimum domestic output, employment and import levels. Any legitimate import injury inflicted on domestic industries involving output, employment or input levels below the minimum thresholds should be treated using purely domestic adjustment assistance measures or programs.

In administering such a program, there are a number of areas where disputes can arise between the QR imposing country and one or more exporting countries. Disputes could involve (a) whether the initial introduction of a QR is justified under the GATT code of conduct on QRs; (b) the definition of the QR product, the initial QR reference level, and the announced phase-out time period; (c) the effectiveness of complementary domestic adjustment programs to facilitate increased imports; (d) the class designation of LDCs in establishing the degree of differential treatment to be accorded: (e) the annual growth in the reference level, and success in meeting the phase-out schedules and (f) the annual allocation of incremental quota levels among the exporters, both non-LDC and LDC.

Under traditional GATT procedures, the responsibility for resolving disputes is first assigned to the countries directly involved for bilateral discussions, under the presumption that most disputes--and certainly all minor disputes--will be resolved at this level and not be brought formally to the GATT. We would argue that this is precisely what should not occur under any GATT safeguard measure on QRs. Such a procedure lends itself to under-the-table solutions which either (a) are in direct violation of the GATT code, or (b) would tend to be disproportionately in favor of the QR-imposing country. Furthermore, resolution of conflicts under such negotiations may be to the disadvantage of other concerned exporters who will not know the details of the bilateral agreement.

Instead, all disputes should be brought before an appropriate GATT body for resolution. All members of GATT should receive prior notification and details of the dispute hearings and the opportunity to express their views. Most disputes would presumably be resolved by agreement among the QR-imposing country and the concerned and interested exporting countries. In other cases, the dispute could be placed before the GATT body for decision, or submitted to a professional arbitration board. In all cases, the final resolution should be published and made part of the public record.

This call for formalizing all disputes within the GATT is stimulated by a concern that the bilateral "selective" approach removes an important deterrent to the excessive use of safeguard exceptions to GATT principles. If every exception to normal GATT rules must be applied on a nondiscriminatory basis, thereby affecting all Contracting Parties, countries would tend to be reluctant to resort to such restrictions, since every country has special concern for the reactions of at least some of its trading partners. This deterrent is lost when bilateral exceptions are permitted.

But again there is a tradeoff. The MFN deterrent may explain why so many countries have avoided the introduction of Article XIX escape clause exceptions in preference to bilateral agreements which are in violation of GATT. What is needed is a compromise that is sufficiently liberal to induce countries to resort to the GATT-authorized safeguard while being sufficiently all-encompassing to provide the requisite deterrent to excessive use. In this spirit, one could argue that a GATT code of conduct on QRs might specify that no new QRs be introduced for any reason--that the code is simply there to govern the phasing-out of existing QRs. In their place, new temporary and declining protection might be provided in the form of tariff quotas, where the quota levels simply specify the tariff rate that would apply. Imports within the quota level pay MFN duties; imports in excess of the quota levels pay a higher tariff that might decline to the MFN level over perhaps a five year period.

A Comment on Tracy Murray and Ingo Walter's "Special and Differential Liberalization of Quantitative Restrictions on Imports from Developing Countries"

Rachel McCulloch

Harvard University

The Murray-Walter paper brings together a wealth of theoretical, empirical, and institutional material on quantitative restrictions and other nontariff barriers. This information provides a useful overview of the current policy environment, but may, by its very profusion, obscure the basic issues now facing U.S. negotiators in the MTN. While it is true that QRs have been advocated for a wide range of purposes, the major question now under discussion is the appropriate use of QRs as a means of delaying adjustment to changes in international comparative advantage. By far the most important of existing QRs, in terms of any measure--whether potentially affected employment at home or losses to current and potential LDC suppliers--are the restrictions on trade in textiles. It is this set of restrictions, along with the threat of similar agreements controlling trade in other labor-intensive manufactures, that is probably of greatest interest to the LDCs today and for the foreseeable future.

Recognizing that adjustment and trade restriction are to some extent alternative ways of accommodating changes in the international economic environment, we can raise four questions with respect to the issue under discussion:

1 How do QRs differ in their effects from other types of trade restrictions?

2. Do the industrialized countries need to use QRs, and if so, under what circumstances?

3. What is the case for special or differential treatment of LDCs in the case of QRs?

4. How should special and differential liberalization of QRs proceed?

In contrast to tariffs, which restrict imports indirectly by raising their effective cost to the potential buyer, QRs limit directly the amount imported, leaving prices and costs to adjust. It is the direct setting of quantity which is the hallmark of a QR. This has two immediate consequences for trading patterns. First, the amount imported cannot respond directly to changes in international cost or demand conditions, no matter how great. (This leaves aside smuggling, which may be a non-negligible consideration for some high value items.) With tariffs and most types of nontariff barriers, an increase in the cost advantage of foreign suppliers will induce some new imports. This will be true whether the restriction is in the form of a tax or tariff, a Buy American policy, or health and safety regulations. Of course, if tariff rates are adjusted frequently, quantity targets can be maintained effectively even though the quantity of imports is never explicitly limited. The variable levy used as part of the EC's Common Agricultural Policy is of this type. The second consequence of using a direct quantity restriction is that suppliers need not represent the lowest-cost sources of imports. Whether this will be true depends upon the way in which the QR is administered. If rights to supply the protected market are auctioned (in small amounts) by the importing government, or if they are widely distributed but can be bought and sold freely, the lowest cost suppliers will place the highest value on these rights and hence outbid higher-cost competitors. However, if quotas are allocated by country, as in the case of textiles, imports need not come from the lowest-cost suppliers. This problem does not arise with most other types of nontariff barriers.

The absolute limit on imports also gives rise to potential departures from competition which would not occur in the presence of tariff protection. On one hand, a domestic monopolist will have greater latitude to raise prices at home. Consumers are not protected by an induced flood of competing imports, which would keep the domestic industry in check under tariff protection. Potential monopolists among foreign suppliers may also benefit from QRs. If imports are strictly limited, and especially if each country is allocated a fixed share of the total, foreign suppliers may raise their asking price quite close to the prevailing domestic price in the protected market. In effect, the foreign suppliers may be able to "collect" the implicit tariff revenue which would go to the importing country's treasury in the case of a tariff or import licenses auctioned to the highest bidder. The use of QRs to delay adjustment rests precisely on the insensitivity of import levels to changes in the relative cost advantage of foreign suppliers. For permanent protection of an industry, as for national defense considerations, tariff protection (or better still from the trade theorist's sometimes unworldly perspective, a subsidy to domestic producers) is adequate. But in situations characterized by rapid fluctuations in world supply conditions, the objective of reducing the shocks to which the domestic economy must adjust over a given period may be better served by a temporary direct limitation on the amount of "disruptive" imports. However, the concept of temporary protection is a potentially dangerous one. As Murray and Walter (as well as Meier) indicate, QRs intended to slow down the adjustment process have a way of becoming permanent fixtures. I would certainly endorse measures to insure that temporary protection is just that, and that the GATT procedure for implementing new QRs requires a timetable for phase out as well as positive measures for promoting adjustment in the importing country.

How are the LDCs in particular affected by QRs? To the extent that the LDCs on the whole are nearer to the starting line in the industrialization process than their developed nation competitors, any restrictions which close potential markets are especially harmful to new industries which have not yet reached a minimum efficient scale of operation. In developed countries, new industries often have a relatively large (and usually protected) domestic market which helps to achieve scale economies. And to the extent that QRs perpetuate the market shares as of the date of introduction, they especially penalize the more recent entrants into the field. In this connection it should be noted that QRs often preserve the market share of domestic producers. This means permanent protection and even growth in absolute size of the import-competing industry--an outcome which cannot be justified on grounds of reducing costs of adjustment. Meier correctly condemns this contradictory interpretation of the temporary protection concept.

In the special case of VERS, there are benefits to suppliers relative to what they would receive if the same level of imports were maintained by a tariff. The exporting government must allocate the national quota among suppliers. This can be done by a tax or licensing arrangement, or by a government export monopoly. In any event, the exporting nation has a gain in economic or political power through its control over exports to the lucrative protected market. In this case, our own domestic industry and foreign suppliers are both better off than with a tariff. [illegible]estic consumers and taxpayers are worse off. It is unlikely that thi[illegible] [illegible]aring of the benefits of protection is a mere accident arising from ignorance of international trade theory, as Murray and Walter seem to suggest.

There is a further reason why QRs may weigh more heavily on LDC suppliers than others. Because QRs are highly complex administrative arrangements, new and small suppliers in developing countries (and elsewhere, for that matter) are likely to be at a disadvantage in dealing with the attendant red tape. It is worth mentioning the effect on domestic relative prices of substitution, within licensed import categories, of higher-cost for lower-cost items. This is unlikely to have the dramatic effects predicted by Murray and Walters the very discrepancies in relative prices which they predict should induce compensatory production shifts in the domestic import-competing industry in favor of domestically producing additional lower cost items. To the extent that goods within a given category are fairly close substitutes in production, the skewing of price differentials resulting from substitution is likely to be a minor concern.

The distinction made by Murray and Walter between "special" and "differential" treatment measures is worth underscoring. It is important to remember that if product categories are appropriately chosen, LDCs can reap benefits without preferential--i.e., discriminatory--treatment. Special measures are probably more consistent with the long run objective of moving toward a more open world economy, since they do not establish a group with a vested interest in retaining existing trade restrictions. (This is an issue which has, of course, come up in the relationship of the GSP arrangements to the MTN.)

We can view the rationale for preferential or special treatment for LDCs in light of two separate arguments. First, there is an infant industry justification, as was used in the case of GSP also. A second rationale is that the opportunity to supply a restricted market is worth something--the value of the rights reflecting the differential between domestic and foreign costs. By giving a larger percentage of these rights to LDCs, we are making some transfers of resources--in effect, we are giving a form of aid--to the LDCs. This is clearest in the case in which the rights can be bought and sold. One problem with this rationale is that if the rights are <u>not</u> transferable between countries, the poorest or least developed nations have the least to gain in the short run.

Meier brings in a third possible motivation which I feel is somewhat difficult to sustain. That is the linking of preferential treatment for LDCs' exports to markets for primary commodities. Unless we can count upon the

Group of 77 to enforce compliance with such a deal, this kind of agreement is unlikely to be very effective. Indeed, it is precisely the countries which have the least to sell in the way of raw materials which are most concerned about promoting manufactures.

Now, looking at the case for special treatment, we might adopt the Murray-Walter suggestion of a sliding scale for preferences, according to how large a supplier is relative to the market served, with those below a certain minimum to be exempted entirely. This would reflect the infant industry justification. Two problems arise, however, in implementing this suggestion. The first is that we would like ideally to give the most encouragement to new producers, not merely new entrants into a particular market. Thus, a more relevant criterion might be a share of the world market. Furthermore, the criterion does discriminate against the larger LDCs. (The same criticism applies to the competitive need exclusions in the U.S. GSP system.)

If the justification for special treatment is to give aid to poor nations, perhaps a per capita income criterion should be included as well. There is, however, a tradeoff between generating efficient resource transfers and promoting development of infant industries. A new entrant into a particular market may do better by selling its rights to an established LDC producer with lower costs, but by foregoing current production, the new entrant will fail to achieve the dynamic gains envisioned in the infant industry justification.

A remaining issue is which domestic industries will remain protected by QRs, and how these QRs can be relaxed. Presumably the justification for QRs must rest upon a comparison of adjustment costs to the domestic industry and benefits to domestic consumers and foreign suppliers. These costs and benefits depend on a number of factors, some mentioned by Murray and Walter, others not. The most notable omission is the difference between foreign and domestic costs, a key parameter in determining the cost of protection to domestic consumers. Interestingly, as Meier notes but does not comment upon, the Multifiber Agreement includes a large difference between domestic and foreign cost as one consideration in applying restrictions. Murray and Walter seem to find a justification for protection in the absolute size of the domestic import-competing industry. Surely this influences the political power within the industry but not necessarily the economic adjustment costs incurred as a result of increased competition from imports. Two smaller industries might together account for the same total impact on employment, for example. The way in which products are classified ought not in itself determine whether a product should be on the list of those protected by a QR.

As Murray and Walter point out, the idea of reducing adjustment costs by slowing down adjustment seems well established but has not been grounded in any hard evidence. We need to know more about adjustment, and we need to design more effective policies to promote adjustment. Our experience so far with so-called Trade Adjustment Assistance has been far from reassuring to workers employed in those industries now subject to accelerated foreign competition. With regard to facilitating the adjustment process, I would dissent from the Murray-Walter suggestion of a sequential approach to liberalization. This could actually compound adjustment difficulties if workers displaced from one industry, say, textiles, move on into other labor-intensive industries, only to be displaced again as trade is liberalized in the next industry on the list. It would seem preferable to gradually relax protective barriers across the board while helping displaced factors to find new employment in expanding parts of the economy through improved adjustment assistance procedures.

A Comment on Tracy Murray and Ingo Walter's "Special and Differential Liberalization of Quantitative Restrictions on Imports from Developing Countries"

Ronald Findlay

Columbia University

Tracy Murray and Ingo Walter have written an excellent paper. I am in basic agreement with the general thrust of their argument so my comments will be mainly concerned with emphasizing certain broader aspects of the issues involved in quantitative restrictions on imports from the developing countries. Appraisal of this question requires some conception of the general objectives of U.S. foreign economic policy and the direction in which it appears to be evolving. As Charles Kindleberger has recently observed, the U.S. spent the first 170 years of its existence pursuing a narrowly nationalist trade policy followed by about 25 years of attempting a more global perspective. It was during this period that the chairman of this conference authored a study of U.S. international economic policy titled, Giant Among Nations. The last few years have seen Atlas attempting to lighten this burden, welcomed by some as a decline in "hegemony," bewailed by others, including Kindleberger, as an abdication of an essential "leadership" role in the world economy.

My own view is that the enlightened self-interest of the U.S. calls for a total rejection of quantitative import restrictions, especially against imports of those labor-intensive manufactured goods in which the developing countries have a present and increasing comparative advantage.

It is important to realize that QRs are a form of protection which freezes the domestic market. This is in contrast with tariffs where, although the demand in the importing countries is reduced at each point in time as the importing country's income grows the exporting countries can expect some expansion in the nature of its market. Requests for protection are particularly tenacious in that once the quota is imposed, the size of the importing country's market is fixed. In this context, exporting countries do not have too much to look forward to even in a growing world.

In terms of resource allocation, a fixed QR implies that the share of imports gets smaller over time, as the importing country market grows. Under these circumstances, the costs of inefficient resource allocation keep increasing to domestic consumers.

Quantitative restrictions on labor intensive manufactures exported from LDCs can frustrate the widely recommended LDC - export-oriented development policies. Research by economists like Professor Kravis and Sisler for the period of the nineteen fifties and sixties have concluded that any sluggishness in the LDCs' export growth is more related to the supply side than to the demand side.[1/] The experience of Hong Kong, Singapore, Taiwan and Korea, in the late sixties show that, although world demand for various primary exports may be sluggish, the market for labor intensive manufactures can provide the means to significantly increase export earnings. And so long as the developing countries follow the right policies, they

1/ See Irving Kravis, "External Demand and Internal Supply Factors in LDC Export Performance," Banca Nazionale de Lavoro Quarterly Review," June 1969, Vol. XXIII and Benjamin Cohen and Daniel Sisler, "Exports of Developing Countries in the 1960's," Economic Growth Center, Yale University, Center Discussion Paper No. 173, November, 1977.

can take advantage of their relative abundant labor. With the transfer of technology from advanced countries through multinational corporations, or whatever other form, they can look forward to rapidly expanding manufactured exports.

But this scenario of export led growth can be very much jeopardized if as soon as the less developed countries make substantial progress in penetrating the advanced countries' markets, quantitative restrictions start to go up. QRs simply eliminate the entire prospect of this outward-looking development strategy.

The United States, in its general international economic policy, has a stake in promoting market-oriented, outward-looking policies in the LDCs. The U.S. is a substantial creditor of the developing countries. It is an exercise in self-contradiction to expect the principal and interest of this debt to be paid while markets in this country for the potentially most dynamic exports from the developing countries are shut off. While the case for free trade may be so obvious to economists that they tire of repeating it, they should not cease to do so, especially when the same mercantilist and protectionist fallacies are cited on the other side, under various euphemistic disguises such as "adjustment assistance" and words such as "disruption" of domestic markets by imports. The same old conflict between the large gain to the few, concentrated in an industry or region so that they can lobby effectively, and the smaller but nevertheless real loss to the many, who are widely dispersed and therefore not organized, is what is involved here. Economists should be true to their heritage and point this out as loudly and as often as they can.

Murray and Walter, while generally on the side of the angels in their paper, show some signs of weakness when it comes to textile imports. They say that the magnitude of the import-competing sector means that the displacement will be large and therefore one has to realistically acquiesce in some protection. We must not forget, however, that the same size argument can be made for liberalization as well and that there are large permanent gains to consumers to offset the temporary losses of the displaced workers. While the "theory of the second best" is a major intellectual advance, it should not have the effect of preventing the profession from fighting for the first best with all the weight of its authority. So far, this session of the conference has devoted too much time discussing how to minimize the damage from quantitative restrictions instead of denouncing them for the abomination that they are.

As the authors point out, fixed quotas imply that all the growth of the market is supplied from domestic production whereas a fixed tariff rate restricts the market at any point in time but permits imports to increase in response to the expansion of the size of the market. For most developing countries, exports constitute the major source of financing capital for their goods purchases and it is only through foreign exchange earnings that they can ultimately pay for imports of sophisticated machinery essential for their development. With the well-known sluggishness in the growth of demand for most primary exports other than petroleum, it is imperative that the developing countries have access to the growing market for labor-intensive manufactures in the large industrial countries. Quotas therefore have a particularly pernicious impact on developing countries since they directly affect their growth prospects through a constriction of capital goods imports. Quotas applied to Japanese TV sets for example, while also deplorable, would not have such drastic consequences for the Japanese economy with its extensive domestic capital goods sector and highly skilled labor force which makes it less dependent on any one particular line of export trade.

It is true that rising tariff levels can have effects similar to a fixed quota, and falling quota levels similar to a fixed tariff. However, a tariff would seem to be much the lesser of the two evils since there is always a political bias in favor of inertia and the status quo. The proposal of a quota combined with supplementary imports at a higher tariff rate, favored by Peter Kenen in his closing remarks, would have the same effect on import volume as a tariff at the higher rate without the quota, which would be redundant.[2/] Its effect would simply be to redistribute revenue on the imports up to the quota level from the government to the importers. Since it is effectively equivalent to a tariff the "tariff quota" would certainly be preferable to a pure quota. The advocates of protection, however, will notice this too.

I find attractive, at the present juncture, the recommendation by the authors for multilateral rather than bilateral negotiations of the issues regarding quantitative restrictions. The danger with bilateral negotiations is that each industrial country might be tempted to act as a

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[2/] Editorial note: Discussants were allowed to revise their comments after the seminar and to make references to comments of other participants of the seminar.

"free rider," trying to placate its domestic protectionist lobbies while hoping that others behave in such ways as to preserve the open trading system which is in the interest of all. Multilateral negotiations would at least have the effect of squarely confronting the industrial nations as a whole with a stark choice between the alternatives. It is essential that the issues, involving specific quotas on particular commodities exported into particular countries, be looked at as a whole in terms of the links between the prospects for the growth of exports from the developing countries and their growing deficits for food and petroleum imports and the service of the mounting volume of debt.

With regard to the empirical work of Walter and Murray, let me just say that I found it very difficult to interpret the message of Table 1. It looks as though QRs are a good thing for the LDCs. The LDCs share of the QR market is 30 percent while it is only 23 percent of the open markets for agricultural imports in Table 1. But on the other hand, Walter and Murray are probably right in concluding that QRs discriminate against the LDCs in several products of interest to them. Presumably in over half of the individual items the LDCs have a larger share in the open markets and if shares are weighted by trade value the result would be even stronger in showing that LDCs have a larger share in open markets.

A more comprehensive quantitative analysis than the one that Murray and Walter were able to do within the limits of their paper, could be conducted by attempting the following three calculations.

1. Estimate the cost to the U.S. consumer in terms of higher prices and restricted supplies of quotas on various items on which they are now in force and on which new quotas, such as the impending one on shoes, or reductions in existing quota levels, such as sugar, are contemplated. The authors summarize some previous research by Baldwin, Magee and others but a wider study using a single consistent framework would be very desirable.

2. Estimate the reduction in export earning for the developing countries generated by such restrictions.

3. Estimate the reduction in demand that this would imply for U.S. exports and the associated reduction in the levels of employment in those industries.

Only in this way could the public and its representatives get an adequate impression of the costs involved in attempting to maintain employment and production in various labor-intensive industries that have long lost their international comparative advantage. The drastic lag that the U.S. has recently been showing in comparison with other industrial countries in the rate of growth of manufacturing productivity can only be overcome by shifting the labor force into more progressive sectors, not by subsidizing the inefficiency at the consumers' and taxpayers' expense.

With the high general level of unemployment, it should be possible to co-ordinate trade liberalization with aggregate demand policies in such a way as to absorb the displaced workers into new jobs, particularly if public expenditures are oriented towards the regions most affected by the import competition.

To conclude, I agree with Murray and Walter that all import quotas are bad, and quotas on labor-intensive manufactured products are probably the worst that can be imagined from the standpoint of an open and growing world economy. That the most industrially advanced and technologically sophisticated nation on earth should resort to them and even contemplate a substantial increase in their use is nothing short of scandalous.

REPLY AND DISCUSSION

DR. INGO WALTER: It is very difficult to disagree with very much of what has been said. I would first like to respond to Ronald Findlay's question on our interpretation of the data in Table 1.

It is quite clear that the optimal way to assess the impact of QRs is to try to estimate what trade would have been like had the QR not existed. The many attempts made at estimating this are all highly suspect. This is true whether one employs time series or cross-sectional data in order to estimate the hypothetical trade in the absence of quantitative import controls. In order to avoid similar failure, we undertook a less heroic task. Specifically, we basically investigated whether or not a significant amount of LDC trade was subject to some type of QR administration. In effect, we were primarily interested in determining whether or not we were dealing with a trivial problem from a trade volume perspective. We feel that the trade data in Table 1 generally supports our predilection that a significant volume of LDC export trade is impacted by QRs. But perhaps we went a bit too far in extending the data analysis to address the issue of how much QRs have restricted LDC exports vs., in some cases, how much QRs have entrenched large market shares of LDC suppliers who may not necessarily be internationally competitive.

A second point, which relates to comments made by both Professors Ronald Findlay and Peter Kenen, deals with a type of generalization concerning the QR impact upon developing countries. Specifically, it appears that developing countries are moving increasingly toward an outward oriented development strategy, where they are looking for both the gains from trade and the gains from growth, rather than viewing these two kinds of gains as basically opposites. It is clear that QRs are going to be more important as obstacles to development in the future.

There is also the fear of pyramiding of QRs. When one particular market gets closed off because it is being disrupted, exporting countries, which have developed those industries, are forced to deflect their exports to other markets, creating problems there and generating QRs in those markets as well.

As a result, there is a fear among the developing countries and international organizations that orderly marketing type arrangements on the model of the MFA will spread from one sector to another. It is possible that shoes and leather goods will be next after textile products and then some other products after these. But any new MFA-type arrangements are almost invariably going to involve products in which the developing countries have a comparative advantage and where their outward oriented development strategy would tend to lead them.

First, as far as reciprocity is concerned, it would be first intellectually uncomfortable for me, as a representative of the developing countries, to push for more market orientation in the manufactures area--where one is basically arguing against QRs and for liberalization, either on a special or differential basis--and at the same time arguing for price rigging in commodities.

Of course, in political terms, this is not such a difficult position for developing country spokesmen to reconcile. But it would nevertheless seem to me that the pressure toward the market on the manufacturer's side would tend to undermine pressure away from the market in commodities. Maybe we would see a little bit less pressure on the commodities side if this argument were to carry a certain amount of force, which would in effect amount to a certain degree of reciprocity.

Second, to take advantage of market opportunities created by QR liberalization, the developing countries will have to take a very careful look at their own commercial and exchange control policies in order to facilitate and rationalize the importance of capital equipment and inputs. As a result, we may witness reciprocity by way of reverse trade flows instead of through policy adjustments.

DR. TRACY MURRAY: I too have very little negative reaction with anything that the discussants have said. In fact, I hope that we have the right to incorporate much of it in a revised draft. Most of Professor McCulloch's points are very well taken.*

Instead, I would like to close with an analogy in order to emphasize how we view quantitative restrictions. In fact, I think one can draw an analogy between the economy and the human body. The body works fine when it is well, but if it is sick, it does not work too well. When we become ill we go to a doctor for help; we get medicines that hopefully clear out the dead cells and eliminate the sickness. As a result, we get well and function normally again. Often sickness is accompanied by pain that can be alleviated by appropriate medicines. Pain-killers provide temporary relief from the symptoms of the sickness (pain) but do not make us well.

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*Editor's note: Drs. Walter and Murray were allowed to incorporate Dr. McCulloch's specific comments in the revised version of their paper which appears in this volume.

The economy operates in a similar fashion where resource reallocation, stimulated by market behavior (the medicine), cleans out sick industries. The pain-killer is analogous to a QR. If a country has a sick industry, temporary relief can be provided by imposing import restrictions. The industry is still sick, but the pain is not so bad. The problem is that unlike the human body, an economy is capable of living in sickness for a long, long time; QRs imposed for temporary relief have a way of becoming permanent.

What this points to is that if one wishes to cure a sick human body, and at the same time wishes to avoid unnecessary pain, one has to jointly administer medicines and pain-killers. But primary emphasis should be placed on the medicines to make sure the sick person gets well. Similarly, we might argue that protection is all right for a limited period of time. Pain is relieved while natural market forces or policy-induced adjustments are used to restructure the economy in line with international comparative advantage.

The upshot of this analogy is that the idea of QR protection should really be viewed as a type of complimentary, yet temporary, measure of adjustment assistance which has the objective of minimizing localized economic hardship while longer lasting solutions are being implemented.

DR. KENEN: The floor is open for questions.

MS. CATHY ROE - Department of Commerce: First of all I would like to say that I agree very much with Dr. Murray's statement concerning the primary reasons why QRs are used in developed countries. They are used primarily for safeguard situations. And I would say that the framework that you talked about is basically a safeguard code. The code of conduct you propose is also a safeguard code, and it is something that should be worked out under the safeguards negotiating group rather than in the QR negotiations of the MTN.

And for this reason, I would also say that there is no need for differential treatment in the QR negotiations. The work on QRs should aim at eliminating all QRs except in safeguard situations, and then leave the work to the safeguards group to come up with special and differential treatment for those QRs.

The other thing that I would like to add is that no mention has been made about QRs that are maintained by developing countries, and I feel that this is a far greater problem. QRs maintained by many developing countries affect the exports of other developing countries. For example, the QRs maintained by countries like Mexico and Brazil affect very much the exports of other deve ng countries.

I think that the statement that one of you made earlier that emphasis needs to be put on rewriting the GATT rules is also very important. I think that when you are talking about the QRs maintained by the developing countries, we have to realize that QRs are very inefficient ways of achieving certain economic goals, and that the developing countries would also benefit, or at least exporting firms from developing countries would benefit by a shift from using QRs to use of tariff and subsidy instruments.

I think that there are real possibilities for special and differential treatment for LDCs in the context of the GATT Framework Improvement Group of the MTN. LDCs might be encouraged to reform their basic balance of payments procedures and their practices with regard to infant industry protection in return for such things as improved market access and improved safeguard mechanisms and adjustment assistance on the side of the developed countries.

DR. KENEN: Thank you. Yes sir?

MR. JOHN EVANS - Retired Foreign Service Officer: I have very little quarrel with the Murray-Walter analysis of the problem, but I do run into difficulties with their proposed solutions. Their proposal that GATT adopt a code to govern the use of quantitative restrictions seems to overlook the fact that there already is a GATT code concerning QRs. What it says, in effect is: "Thou shalt not use them"-- with certain specified exceptions, one of which is that covering their use in case of balance-of-payment difficulties.

As I understand the Murray-Walter proposal, it is that, in spite of this general prohibition, there should be a GATT code spelling out in detail the manner in which QRs should be administered, especially if they affect the exports of LDCs. Again paraphrasing the Decalogue, it is as if the commandment were made to read: "You shall not kill; but when you do, you must observe certain prescribed amenities, one of which is to give the victim adequate advance notice."

While I have the floor, I share Dr. McCulloch's alarm concerning the use of differential QRs for the benefit of less developed countries. Like her I am very much afraid that this would create a vested interest in the maintenance of QRs with developing countries pressuring the developed countries to maintain their QRs against everyone else at existing levels.

MR. LARRY KENNON - Department of State/Bureau of Intelligence and Research: I found, for my part, a certain asymmetry through all of what the speakers said. They attack generally, and I think rightly, QRs and inefficiencies and distortions and so on. And where these exist for aggregate LDC-exports, this attack is doubly warranted because they limit market access that the LDCs need.

However, the speakers seem to feel that there is something right about distorting market access in favor of LDCs. But it seems to me we would then have the same inefficiencies of distorted market access in trying to favor imports from LDCs.

I would be very concerned with the idea of giving the least developed larger market access than I would the other LDCs. I think this is the infant industry argument gone wild. We can never distort the market enough so that Chad or Bangladesh, and a couple of other names I heard, could succeed in exporting goods in the fairly technological field.

With regard to my reference about the desirability of elimination of distortions affecting aggregate LDC exports, I should add that eliminating them would carry some costs. It seems, for example, that if rich countries eliminate quotas on textiles, the effect would be to hand the whole textile industry to such countries as Taiwan, Hong Kong, Korea and maybe one or two more. Other LDCs of this world, like India, would simply be excluded because of their higher cost and more antiquated and fragmented textile industries.

MR. JERRY LaPITTUS - Office of the Special Representative for Trade Negotiations: I am concerned about your choice of criteria for the allocation among eligible LDCs of preferential treatment. You said you selected a share of the import market. In view of what Mrs. McCulloch said, how would you modify that criterion. And, second, what other objective criteria did you choose, and why did you discard them in favor of imports here?

DR. KENEN: I will use that direct question to turn the floor back to our two speakers, and see if they have any concluding comments.

DR. MURRAY: Let me answer in the order I remember the questions, the last one first. In terms of alternative criteria, we did not look at a broad spectrum because this leads to the problem of negotiating weights on the various types of criteria.

Basically our feeling was that the only reason for a QR in the first place is as a pain-killer to limit imports in the import sensitive industry. And in those cases, the only countries that one really needs to be concerned about are those countries that can export the product in quantities sufficient to impact on domestic markets. Our philosophy was to close the market for those countries and let all the rest of them come in free. Thus we are calling for the non-administration of QRs for Class I or Class II countries and to impose QRs only on Class III countries, since Class III countries are those developing countries and non-preferred developed countries which have export capability sufficient to impact on the domestic industry.

I would agree with Professor McCulloch however, that countries with high per capita incomes do not really deserve differential treatment--even if they are non-competitive exporters of the product. But if they can export the product, it does not bother me any to give them special MFN treatment.

MR. JERRY LaPITTUS: Is that the basic question? Your criteria is based on the product specifics.

DR. MURRAY: This is definitely the basic consideration. For different products, there exist different arrangements of classes of developing countries. This is a measureable criterion; one can quickly determine which countries belong to the various classes by looking at trade statistics.

There are many problems with this approach. In fact, one can probably find many disagreeable things in the code of conduct that we propose. Our main purpose of outlining something concrete was to provide some illustration of the kinds of things that we think should be incorporated into an international agreement in this area.

I would like to make one other point. The whole question about differential treatment bothered us right from the start. We began by carefully reviewing the Tokyo Declaration of special and differential treatment. The word "and" means to me that there is a union of two different concepts such that the sum total represents the first plus the second. The dictionary definitions of special and differential are not the same. The word "differential" comes through with a very clear meaning. It is treating one country different from another.

The choice of the term differential is unfortunate. And I think I would argue very strongly that that word should not be there. But it is there, so we have to live with it.

DR. RONALD FINDLAY: - Maybe it could have been "intersection" and not "union".

DR. MURRAY: I think the rich countries had "special" in mind and the developing countries wanted "differential"; in order to reach an agreement in Tokyo, they included both. It is not a very desirable solution.

The Safeguard Negotiations and the Developing Countries

Gerald M. Meier*

If economists can be proud of any principle, the doctrine of comparative advantage is a strong contender. It may well be, as Samuelson has remarked, that the Ricardian theory of comparative advantage is the one proposition in all of the social sciences which is both true and non-trivial.[1] Any yet, many men of affairs--in business and government--have always been unwilling to believe in the principle and are reluctant to submit to its dictates. In recent years, dissent has intensified. In part this is because the exposition of the doctrine has become so complex that its elementary fundamental lessons about the virtues of international division of labor have tended to become submerged in more esoteric refinements.[2] More significantly, there has been greater recognition that as the structure of comparative costs changes, a different distribution of benefits and detriments ensues, and those who suffer a detriment have become more influential in seeking to overrule the dictates of the market. The desire for extra-market support also intensifies when the process of adaptation is no longer in the context of sustained growth and prosperity. The increasing resort to a market safeguard reflects these factors. But in protecting home markets, policies have been adopted that are 3rd, 4th, or n-th best policies. The current Multilateral Trade Negotiations (MTN) therefore provide a propitious

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1 Paul A. Samuelson, "Presidential Address," International Economic Relations, International Economics Association (1969), 9.

2 Cf. Bhagwati, "The Pure Theory of International Trade," Economic Journal, March 1964, 1-84.

time to re-examine what we want a system of market safeguards to accomplish and to analyze how different policies would accomplish our goals.

From the perspective of the international normative process, as illuminated analytically by principles of welfare economics and practically by international codes of conduct and national legislation, this paper examines the rationale and scope for special and differential treatment of LDCs with respect to the application of market safeguards by DCs. We begin by recalling the formal prescriptions now in effect, reviewing the effective practice of market safeguard instruments by the United States, and stating the problem in the current MTN (section 1). We then analyze the problem in terms of efficient resource allocation and other aspects of international welfare economics (section 2). Our ultimate concern will be to provide some policy implications and guidelines of value in the MTN (section 3).

1. The Problem

Market safeguards--in the sense of protecting a particular industry or sector of the domestic economy[3]--operate by (a) postponing tariff cuts, (b) raising previously lowered tariffs, (c) imposing quantitative restrictions on imports, (d) restricting the coverage of the Generalized System of Preferences (GSP) and allowing for withdrawal of preferences. The GSP raises special questions that go beyond the issue of market safeguards, and will be excluded here.

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[3] This is a narrow interpretation of safeguards. More generally, safeguards can also be used to "protect" governmental responsibilities in the areas of balance of payments, economic development, full employment, and agriculture. Safeguards can also be used as "protection" against the failure to receive the anticipated benefits from another signatory of a treaty or agreement. The more general approach is adopted in Irving B. Kravis, Domestic Interests and International Obligations: Safeguards in International Organizations (1963). The GATT contains several different safeguard clauses (Articles XI:2, XII, XVIII:2, XIX-XXI, XXV, XXVIII), but Article XIX is the most relevant here

To avoid injury from imports, the United States has in recent years resorted mainly to Article XIX of the GATT, the escape clause of the Trade Expansion Act of 1962 and the Trade Act of 1974, Voluntary Export Restraints (VERs), and Textile Agreements.

Article XIX on "emergency action on certain imports" authorizes emergency import-restricting measures:

> If, as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions, any product is being imported into the territory of that contracting party in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products...[4]

To invoke Article XIX, therefore, the following must be shown:[5]

(1) Imports "in such increased quantities";

(2) The increased imports are a result both of

 (a) "unforeseen developments";

 (b) concessions granted pursuant to the GATT;

(3) The increased imports cause "serious injury "or "threaten serious injury."

The concept of "in such increased quantities" has been interpreted to mean not only an absolute increase but a relative increase as well. It is therefore possible to invoke Article XIX in a situation in which both domestic

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[4]GATT Art. XIX, para. 1(a).

[5]For an extended discussion of the prerequisites to an Article XIX escape clause action and the types of compensatory remedies, see John H. Jackson, World Trade and the Law of GATT (1969), Chap. 23; Robert E. Hudec, The GATT Legal System and World Trade Diplomacy (1975); Hudec, "The GATT Legal System," Journal of World Trade Law, September-October 1970; Kenneth Dam, The GATT: Law and Economic Organization (1970), 99-107.

consumption of an import-competing commodity and the imports of the commodity both decrease in absolute amount, but the proportion of imports to domestic consumption increases.

The concept of "as a result of unforeseen developments" raises complex issues of causality and reasonableness with respect to what an importing nation could and should have been expected to foresee. The interpretation of this requirement has become so lenient that one can almost conclude that an increase in imports can itself be an unforeseen development.[6]

The issue of "serious injury" was examined most seriously in the Hatter's Fur Case.[7]

After considering data regarding quantities of imports and of United States production and employment in the ladies' hat "industry," the GATT Working Party found evidence of "large and rapidly increasing... imports, while at the same time domestic production decreased or remained stationary."[8] This, it concluded, was "evidence of some weight in favor of the view that there was a threat of serious injury." Further, the Working Party said:

> The available data support the view that increased imports had caused or threatened some adverse effect to United States producers. Whether such a degree of adverse effect should be considered to amount to 'serious injury' is another question, on which the data cannot be said to point convincingly in either direction, and any view on which is essentially a matter of economic and social judgment involving a considerable subjective element.[9]

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[6] Jackson, op. cit., p. 561.

[7] See Report on the Withdrawal by the United States of a Tariff Concession Under Article XIX of the GATT, Geneva, Nov. 1951 (Sales No. GATT 1951-3).

[8] Id. at 21.

[9] Id. at 22.

Again, a legal student of the subject has concluded that "as one reviews this remarkable GATT report on Article XIX, it appears quite clear that the result of the findings made was to greatly extend the scope of the escape clause and render it available for invocation in a wide variety of situations. It almost appears that a mere rapid increase in the proportion of imports to the domestic production would make invocation of Article XIX justifiable, especially when all benefit of doubt goes to the party invoking it. The net result is to render tariff concessions and other GATT obligations less stable."[10]

When a party invokes Article XIX "to suspend the obligation in whole or in part or to withdraw or modify the concession" in respect of the imported product causing the injury, the countries concerned may consult each other, and the invoking party may offer other compensatory concessions. Or the consulting parties may obtain the agreement of the invoking country to compensatory withdrawal of concessions by the other countries against which Article XIX is invoked. When, in order to avoid retaliatory withdrawals, the invoking country offers other concessions, it must do so in conformity with the MFN rule, just as the withdrawal or suspension itself must conform to the MFN rule. The withdrawal, however, is to be "to the extent and for such time as may be necessary to prevent or remedy such injury." (GATT Art. XIX, paragraph 1(a).) Because no remedial action is prescribed, protection is in effect sanctioned for so long as the threatening export capacities continue to exist abroad.[11]

[10]Jackson, op. cit., 563.

[11]This is emphasized by Jan Tumlir, "Emergency Protection against Sharp Increases in Imports," in H. Corbet and R. Jackson, (eds.), <u>In Search of a New World Order</u> (Halsted Press, 1974), Chap. 15, on page 262. Tumlir notes that the consultative procedures developed in practice actually give Article XIX a bias toward making the emergency protection permanent.

Article XIX was invoked 54 times during 1947-70, with most of the cases (42) occurring after 1960. Only on four occasions did the use of emergency measures under Article XIX lead to a compensatory suspension of obligations by a supplying country; on 25 occasions the concession was restored after a certain lapse of time.[12] From 1970-76, there were 38 Article XIX actions, and only seven of these involved prior notification and consultation.

In practice, the invoking of Article XIX has generally taken the form of an increase in bound tariffs, but in recent years the imposition of QRs has become more common. Further, Bhagwati estimates that the developing countries' exports were involved in more than half of the developed countries' invocations of Article XIX. The restrictions imposed in these cases were removed within a year in a third of the cases involving developing countries; but in half the total number of cases, the measures had been in force for over five years.[13]

The resort to Article XIX has, however, been rather limited in comparison with the invocation of domestic escape clauses, Voluntary Export Restrictions (VERs), and the Arrangement Regarding International Trade in Textiles (referred to subsequently as the Multifibre World Textile Agreement).

Countries have preferred these other market safeguard procedures instead of resorting to Article XIX because they are not restricted to remedying a "serious injury" that is due to prior tariff concessions. They

[12]Gerard and Victoria Curzon, "The Management of Trade Relations in the GATT," in Andrew Shonfield (ed.), International Economic Relations of the Western World 1959-1971 (1976), 223.

[13]Jagdish N. Bhagwati, "Market Disruption, Export Market Disruption, Compensation and GATT Reform," World Development, December 1976, p. 993.

also allow the invoking country to avoid the MFN rule and to practice discriminatory treatment. Further, they are attractive to countries because they do not require, as does Article XIX, compensation in the form of other concessions or retaliatory suspension of equivalent concessions or "other obligations" through the principle of reciprocity.

In the United States Trade Act of 1974, Title II provides for import relief from imports that are a "substantial cause of serious injury or the threat thereof" (sec. 201.)[14] "Serious injury" includes idling of productive facilities, inability to operate at reasonable profit, and significant unemployment or underemployment. "Substantial cause" includes either an absolute or relative increase in imports plus a decline in domestic producers' U.S. market share. "Substantial" is defined as "important and not less than any other." "Threat of serious injury" includes decline in sales, growing inventories, and declining production, profits, wages, or employment. After eligibility petitions for import relief are filed with the International Trade Commission (ITC), if the ITC finds serious injury or threat thereof, it must recommend to the President within six months of the filing of the petition either new import restrictions or provision of adjustment assistance. Within 60 days of receiving the ITC report, the President must decide what kind of import relief to provide or whether to provide adjustment assistance (section 202). The President may provide import relief for up to five years in the form of new or raised tariffs (up to 50% above the existing rate), suspension of duty-free re-import benefits or preferential tariff rates, tariff-rate quotas, tighter quantitative restrictions, orderly marketing

[14]See Trade Act of 1974, para. 201(b)(1), 19 U.S.C. para. 2251(b)(1).

agreements with the exporting country, or any combination of these. If no import relief is provided despite an ITC recommendation, within 90 days of receiving the President's report, Congress may then put into effect the ITC's recommendation by a majority vote of both houses (section 203). Title II also provides adjustment assistance for workers (chapter 2); for firms (chapter 3); and for communities (chapter 4).[15]

In recent years, the concept of 'market disruption' has also commanded attention, particularly as a result of the Long-Term Agreement Regarding International Trade in Cotton Textiles from 1962-73.[16] and the Arrangement Regarding International Trade in Textiles, in force since 1974.[17] According to the latter Arrangement, the determination of a situation of 'market disruption' shall be based on the existence of serious damage to domestic producers or actual threat thereof. The existence of damage shall be determined on the basis of an examination of the appropriate factors having a bearing on the evolution of the state of the industry in question such as: turnover, market share, profits, export performance, employment, volume of disruptive and other imports, production, utilization of capacity, productivity and investments. Market disruption is designated as:

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[15]Pub. Law 93-618, Jan. 3, 1975. In 1975, the ITC instituted 13 investigations of escape clause petitions. For a summary of escape clause decisions (as well as antidumping, countervailing duty, and unfair import practices decisions) 1973-75, see Council on International Economic Policy, International Economic Report of the President, March 1976, p. 45. See also Bhagwati, "Market Disruption...", Table 1 (pp. 994-997) for escape clause actions, 1947-1973; and Table 3 (pp. 1000-1001) for the relationship between Japanese VERs and US escape-clause investigations.

[16]See GATT Doc. L/1703(1962), Agreement No. 97 in App. C.

[17]GATT, Arrangement Regarding International Trade in Textiles, (1974).

(i) a sharp and substantial increase or imminent increase of imports of particular products from particular sources. Such an imminent increase shall be a measurable one and shall not be determined to exist on the basis of allegation, conjecture or mere possibility arising, for example from the existence of production capacity in the exporting countries;

(ii) these products are offered at prices which are substantially below those prevailing for similar goods of comparable quality in the market of the importing country. Such prices shall be compared both with the price for the domestic product at a comparable stage of commercial transaction, and with the prices which normally prevail for such products sold in the ordinary course of trade and under open market conditions in other exporting countries in the importing country.[18]

It is notable that the Arrangement also states that "in considering questions of 'market disruption' account shall be taken of the interests of the exporting country, especially in regard to its stage of development..."[19]

Technically, the Arrangement is separate from the GATT, but the Negotiating Parties stated that they were "determined to have full regard to the principles and objectives of the General Agreement on Tariffs and Trade and, in carrying out the aims of this Arrangement, effectively to implement the principles and objectives agreed upon in the Tokyo Declaration of Ministers dated September 14, 1973 concerning the Multilateral Trade Negotiations" (Preamble). Article 10 of the Arrangement also established within the framework of GATT a Textiles Committee consisting of representatives of the parties to the Arrangement. The Committee deals with those matters specifically

[18]Ibid., Annex A. (II), at 20.

[19]Ibid.

referred to it by the Textiles Surveillance Body, is serviced by the GATT Secretariat, and reports annually on the operation of the Arrangement to the GATT Council.

In view of the departures from the principles of GATT in recent years, one might think that the objective of the MTN should be to re-establish the GATT principles, and in our context, reassert Article XIX which now appears to be more honored in the breach than in the observance. Yet, as Jan Tumlir of the GATT Secretariat perceptively states, this hope is rather wistful. "It is hard to believe that the GATT could be reasserted by a simple collective decision to return to a situation quo ante, and Eden before the fall where rules had been observed, without some old rules being re-written and some additional principles and rules being formally accepted. The economic changes of the last decade (particularly the strong acceleration of world trade in manufactures), and the prospects which they open, make Article XIX even less satisfactory today and to even more countries than it was in the 1950s."[20]

A revision of Article XIX is in order. This is necessary from the standpoint of negotiation strategy in order to achieve trade liberalization and to prevent more serious protectionist legislation from being enacted and to reduce pressure on countries to solve their trade problems outside the multilateral framework. It is also necessary to attain more closely the conditions of economic efficiency.

The problem of how should the present MTN proceed to revise Article XIX? And, of particular concern here, should the revision accommodate special and differential measures for the LDCs? Before considering some policy guidelines, we should place the problem in its broader context and first bring to bear upon the issues some further economic analysis.

[20] Tumlir, op. cit., 261-262.

II. Analysis

This problem is essentially one of externality control policy. It is part of the general topic of devising remedial policies for externalities about which there has recently been considerable writing in both economics and law. Economists have considered the relative efficacy of penalty taxes, subsidies, and direct regulation as instruments for controlling external diseconomies which involve the interaction of many parties. Much of the discussion is an extension of the Coase theorem which relates to the treatment of detrimental externalities. This theorem asserts that the assignment of property rights and liability rules for damages have no effect on efficient resource allocation, provided that markets exist and transaction costs (i.e., information-contracting-policing costs) are absent. The parties concerned will voluntarily negotiate agreements with allocational results that will be invariant over differing assignments of property rights among the parties to the transaction.[21] Legal analysis has also incorporated the Coase Theorem, as represented most notably in Calabresi's Costs of Accidents and Posner's Economic Analysis of Law.[22]

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[21] R. H. Coase, "The Problem of Social Cost," J. Law. Econ., October 1960, 3, 1-44; Coase Theorem Symposium--Part I, 13 National Resources Journal, 557 (1973); Coase Theorem Symposium--Part II, 14 National Resources Journal 1 (1974).

[22] G. Calabresi, The Costs of Accidents: A Legal and Economic Analysis (1970); R. Posner, Economic Analysis of Law (1973). See also Calabresi & Melamed, "Property Rules, Liability Rules, and Inalienability: One View of the Cathedral," 85 Harvard Law Review 1089 (1972). Calabresi restated the Coase theorem as follows: "The same allocation of resources will come about regardless of which of two joint cost users is initially charged with the cost, in other words, regardless of liability rules." Calabresi, "Transaction Costs, Resource Allocation, and Liability Rules--A Comment," 11 Journal of Law and Economics 67 (1968).

The Calabresian analysis is especially suggestive for our problem of "the cost of market disruption" when imports cause "domestic injury." The critical question is who shall bear the "burden" or the cost of market readjustment when trade barriers are reduced? Should the burdens or costs be left where they fall due to market forces?[23]

This question raises issues similar to those posed in Calabresi's inquiry into the difficult "decisions for accidents." Calabresi notes that:

> the primary way in which a society may seek to reduce accident costs is to discourage activities that are 'accident prone' and substitute safer activities as well as safer ways of engaging in the same activities. But such a statement suggests neither the degree to which we wish to discourage such activities nor the means for doing so...
>
> We certainly do not wish to avoid accident costs at all costs by forbidding all accident-prone activities. Most activities can be carried out safely enough or be sufficiently reduced in frequency so that there is a point at which their worth outweighs the costs of the accidents they cause. Specific prohibition or deterrence of most activities would cost society more than it would save in accident costs prevented. We want the fact that activities cause accidents to influence our choices among activities and among ways of doing them. But we want to limit this influence to a degree that is justified by the cost of these accidents. The obvious question is, how do we do this?[24]

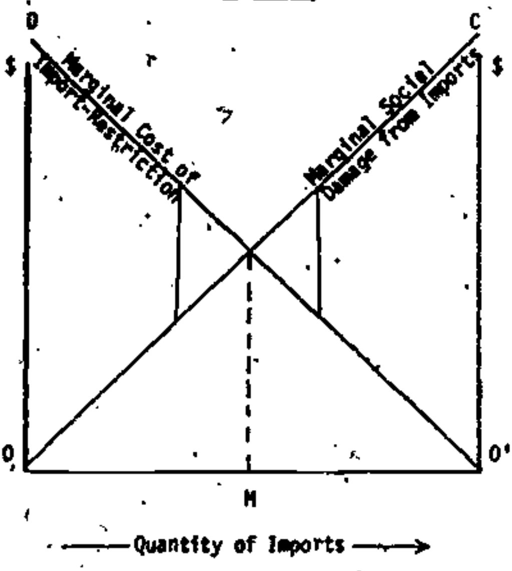
Considering these questions in terms of our problem of imports and market disruption, an economist would state that the decision to permit imports should be decided by the market--unless the market is flawed and the marginal social damage from imports exceeds their marginal social benefit. There will then be some optimal level of imports as is illustrated in Fig. 1. Suppose that in the absence of any control over imports, the increasing marginal social

[23] Cf. Jackson, op. cit., 568-69.

[24] Calabresi, op. cit., 68.

damage from imports was measured by the curve OC, increasing as imports increase. But restrictions on imports also have their costs, and the lower the imports the higher probably the marginal cost of import-restriction, as represented by curve O'D. OM, determined by the intersection of these two curves, is the optimum amount of imports. Any amount less than OM would entail an additional excess of costs of import-reduction over the value of the reduction of the damage done to society. If the amount were larger than OM, there would be an excess of the value of the increased damage done to society over the saving in costs of import-reduction.[25] If the administrative

FIGURE 1



[25]Cf. a similar analysis for pollution abatement by James E. Meade, The Theory of Economic Externalities (1973), 58.

process is costless to reduce imports to OM, then OM is the optimum quantity of imports; if administrative costs are relevant, the principle still remains to reduce imports to the point where further marginal damage reduction is not worth its costs.

The "marginal social damage" from imports is not self-defining, but is as narrow or broad as some social decision cares to make it. This is a decision of political economy. In the present problem, it is referred to as "market disruption" and "domestic injury." These are dislocation costs that are not calculated by the market.

In decreasing its imports to reduce the dislocation costs, however, a country also suffers a loss of the gains from trade (static efficiency gains) and the dynamic gains of competition from imports. The loss of the gains from trade and the dynamic gains from competition are equivalent to the "marginal cost of import restriction."

The objective, therefore, is to reduce the sum of the dislocation costs and the costs of avoiding dislocation. As already indicated in Figure 1, the objective will be fulfilled along a scale of importation between zero restriction of imports-with-maximum disruption, and total restriction-with-zero disruption.

Various policy instruments are available to reduce imports to the optimal level: subsidies, tariff quotas, tariffs, VERs, and QRs. It can be demonstrated that the hierarchy of policies is in the order listed, with subsidies the "first best" policy in the sense of entailing the least by-product distortions.[26]

[26]For an elaboration of the hierarchy of policies and choice of a first-best optimal policy or set of policies, see W. M. Corden, Trade Policy and Economic Welfare (1974), 28-31.

Coupled with the reduction of imports, the community may wish to reduce the social cost of domestic injury by paying compensation to those affected. This may take the form of various measures of "adjustment assistance."

In terms of the Calabresian analysis of accidents, the dislocation costs are analogous to Calabresi's "primary costs," while the costs of adjustment assistance are analogous to Calabresi's "secondary costs."[27]

The country that invokes a market safeguard will also want to minimize the costs of administering the policies to reduce the primary costs of dislocation and secondary costs of adjustment. This constitutes a tertiary cost consideration. The policy objective for the importing country should therefore be to find an optimal combination of primary, secondary, and tertiary cost reductions.

Moreover, there are also costs to the exporting country when its exports are restricted. Bhagwati has demonstrated that the mere possibility or threat of protectionist restrictions being invoked by the importing countries, on grounds of market disruption, imposes a welfare loss on the exporting country.[28] The actual invoking of the trade restraints would inflict a welfare loss on the exporting country that would exceed the expected loss from the threat of such an invocation at a future date.[29]

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[27] The "secondary accident costs" are the costs of special and economic dislocations which follow the immediate accident, especially if the initial cost burden is left unspread.

For an analysis of adjustment costs (through introduction of search costs into the supply curves of labor and capital, temporarily foregone income of the released resources, and the possibility of displaced resources having to accept lower earnings when reemployed), see R. E. Baldwin, U.S. Tariff Policy: Formation and Effects, Discussion Papers on International Trade, Foreign Investment and Employment, U.S. Department of Labor, June 1976, 17-32.

[28] Bhagwati, "Market Disruption...", App. II.

[29] For an instructive empirical demonstration of the cost of protectionism to exporting LDCs, see R. H. Snape, "Sugar Costs of Protection and Taxation," Economica 36 (February 1969), 29-41; H.G. Johnson, Economic Policies Toward Less Developed Countries, 87-88, 257-266.

Bhagwati concludes that there should be financial compensation by the importing country's government to the exporting country's government when the exporting country is an LDC. "First, there is a case for asking importing DCs to compensate the exporting LDCs faced with mere threats of market-disruption-related trade restraints. The DCs can reasonably be asked to "buy", with compensation payments, the right to invoke a market-disruption-related trade restraint on a product, and to forego the right to resort to such trade restraints on all products not so bought for... (2) Second, the actual invoking of such restraints, by imposing a greater loss, would equally call for further compensation to the affected exporters. Compensation, for potential and actual export market disruption, to the exporting countries affected by trade restraints related to market disruption would be the natural consequence of our analysis."[30]

Under Bhagwati's analysis, the importing DC would in effect become an insurer for the exporting LDC. But two questions remain to be answered: Why should there be special and differential treatment for the exporting LDC? And why is this policy preferred to other possible remedial policies?

To answer the latter question, we may refer to our earlier analysis. From the standpoint of economic efficiency, we should then ask who is the cheapest cost avoider or in the best position to make the cost-benefit analysis of whether the benefit of reducing imports is worth the costs of the reduction, and who is the party that can most cheaply avoid the sum of dislocation costs and costs of avoiding dislocation.

[30] Ibid., 51-52.

Suppose that the importing country does determine that the dislocation costs from increased imports exceed the benefit from the imports. Four policies can then be readily suggested: (1) The importing country simply "enjoins" the exporting country (by protectionist restrictions) if the exporting country is the cheapest cost avoider. (2) The exporting country continues to export but compensates the importing country for the dislocation costs incurred in excess of benefit. (3) The importing country "bribes" the exporting country not to export if the importing country is the cheapest cost avoider. (4) The importing country "enjoins" the exporter but also compensates the exporting country for the costs it incurs in foregoing exports.

Each of these policies could be designed to reach the efficient level of imports, as defined earlier in terms of Figure 1. But the policies will have different distribution effects. Under (1) and (2) the burden lies on the exporting country. Bhagwati's proposal is equivalent to (4). This can be justified if--as will generally be true--the importing country is in a better position to make the cost-benefit analysis and can more efficiently minimize the sum of dislocation costs and costs of avoiding dislocation than can the exporting country through VERS.

The remaining question of whether there should be differential treatment for the LDC-exporter will be considered in the next section on policy implications.

III. <u>Policy Implications</u>

When we turn to policy guidelines for the MTN, the immediate issue is whether the MTN are only "trade negotiations" and not "law reform negotiations."[31] Although trade negotiations may be the prime purpose, it is impossible

[31] R. E. Hudec, <u>The GATT Legal System and World Trade Diplomacy</u> (1975), 265.

to ignore the fact that broader rule making may be required to support negotiations over trade barriers. The U.S. Trade Act of 1974 gives a broad mandate to seek revision of the GATT, including an explicit call for "the revision of Article XIX of the GATT into a truly international safeguard procedure which takes into account all forms of import restraints countries use in response to injurious competition or threat of such competition."[32]

The GATT reform mandate for the U.S., section 121 of the Trade Act of 1974, lists a number of other particular targets of "reform" in trade barriers.[33] The difficulties with such a piecemeal renegotiation, however, should be underscored as is done by a student of the GATT legal system: "The main problem with the piecemeal approach is the question whether new rules in just a few areas will be able to stand by themselves. The GATT's current legal malaise rests in large part on a feeling that the Agreement as it now stands provides no overall balance of legal reciprocity. The negotiating plan seeks to address the reciprocity problem by looking for 'self-balancing' agreements--agreements in which each signatory government sees enough advantage in the commitments of other signatories to justify its own commitments, independently of what is being done, or not being done, elsewhere..."

"It would be encouraging to think that the GATT could repair its legal fabric bit by bit. I believe that the process can work, however, only if it achieves a critical mass--not necessarily a wholesale renegotiation, but enough new law, however many the pieces, so that defense of the new legal investment is a big enough and constant enough part of the GATT's daily business

[32] 19 U.S.C. 2131 (a) (2) (Suppl. V, 1975).

[33] Pub. L. No. 93-618, para. 121, 88 Stat 1986 adding 19 U.S.C. para. 2131. See also Alan Wm. Wolff, "The U.S. Mandate for Trade Negotiations," 16 Virginia Journal of International Law, 505.

to change attitudes and working habits generally. This is to say, that there is an overall legal 'spirit' to GATT affairs, and that, unless piecemeal reform affects that larger spirit, it risks being swallowed up by the prevailing anti-legal attitudes."[34]

Although mindful of this larger contextual problem of the negotiations, we shall concentrate on Article XIX. Further, although the economist may admit to little, if any, economic justification for market safeguards, the political economist realizes that safeguard clauses allay some of the fears of the consequences of trade liberalization, and that their provision may be necessary to facilitate a reduction of trade barriers more generally.[35] Granted the political realism of this view, we should nonetheless still attempt to rationalize the use of safeguard measures and strive for the optimal intervention to achieve even non-economic objectives. Greater resort to a reformed Article XIX would be an improvement over the present situation of safeguard actions outside of the GATT and the present substantive requirements of Article XIX. For it is clear that Article XIX is at one and the same time too exacting and too lenient.[36] Specifically, it is too restrictive in trying to maintain nondiscrimination and yet insufficiently restrictive in imposing too few obligations on those who invoke the GATT rules.[37]

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[34] Hudec, op. cit. 267-268.

[35] Cf. Kravis, op. cit., 26-27.

[36] Tumlir, op. cit., 262-263.

[37] *The Economist*, April 5, 1975.

In this problem, however, the parties involved in the interaction are in different States. A Wicksellian rule of unanimity is therefore impossible for collective or governmental decision making: a contractual conception of collective action (equivalent to a voluntary exchange process) is irrelevant. In contrast, the "natural" tendency is for one State to make a decision that affects groups in another State--without benefit to the latter and without considering the costs to the latter. The non-existence of an appropriate international regulatory mechanism means that we cannot expect to achieve the optimal level of imports, as represented in Figure 1 above, and with due recognition of cost minimization, as discussed in the preceding section. An international public sector exists in only rudimentary form--without an international fiscal authority, an international regulatory agency, or an international legislature. The domestic instruments that may be used to deal with externalities have no counterpart internationally. At best, the GATT must assume some of the functions of an international public sector and seek a multilateral policy that will be preferable to the natural tendency to invoke national policy. The preferred multilateral policy will, however, necessarily involve not only the issue of economic efficiency, but also that of distribution and "fairness"--whatever that might be. This complicates the problem, but is of foremost concern to the LDCs. A market safeguard policy is also likely to be linked with other issues under negotiation, and this adds a further complication to the problem. Finally, the problem is highly politicized--both between domestic industry and national government and among nations--so that the pure economic analysis must immediately become diluted (invigorated?) by political factors.

In section 1, we have already considered the prerequisites to Article XIX action and have alluded to some weaknesses in these conditions:

Unless an actual increase in imports has occurred, there should be little justification in invoking the escape clause. The "relative" increase concept of Article XIX is a protective device that, if allowed, could accelerate a decline in trade during recessionary periods,[38] and it has little justification as evidence of "serious injury." It would be desirable to remove the relative increase concept from the interpretation of Article XIX.

(2) The prerequisite of "unforeseen developments" is too readily taken to simply mean an increase in imports. As a causal standard, it raises difficult problems of proof and judgment. The provision cannot be analogized to the doctrine of "changed circumstances" in international law and serves no real function. Article XIX should be brought into harmony with the domestic version of the escape clause in the U.S. Trade Act of 1974 which does not require that the "serious injury" to domestic producers be shown to have been caused by "unforeseen developments."

(3) The determination of "serious injury" is too often based on national political pressures instead of economic analysis. Some type of international commission or panel of experts should be responsible for a review of a common accepted national procedure on inquiry to determine injury.[39] Even though a national authority might carry out the investigation more effectively, there should be agreement that the national body be independent of government, that all interests be given due consideration, and that the national procedure of inquiry be similar to that followed by the U.S. International Trade Commission. In the event that the national

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[38] Jackson, op. cit., 558.

[39] Tumlir, op. cit., 275.

finding of injury was not found acceptable internationally, the safeguard invoking country would then have to offer equivalent compensation to, or suffer corresponding retaliation by, its trading partners.[40] If, however, the finding is accepted, then trading partners would waive their right to compensation or retaliation.

Short of actually finding "serious injury," a national body such as the ITC could also find "moderate injury" or injury in various degrees short of "serious." Such a finding might be used to trigger an early warning system of adjustment assistance. If, as we shall emphasize below, adjustment assistance policies must complement the resort to market safeguards, then the earlier is the warning system the better it is in the sense of making adjustment more effective and mitigating the need for invocation or perpetuation of the market safeguard.

(4) If nations would not agree to waive their right to compensation or retaliation, as proposed in (3) above, they should at least agree that the invoking country should not have to offer compensation in the form of most-favored-nation concessions on selected products exported by the country adversely affected by the invocation of Article XIX. It has been noted that when the emergency action itself must conform to the MFN rule, it will adversely affect a number of exporting countries each of which may demand or withdraw a concession on a different product. In most cases, the impossibility of reaching a mutually satisfactory settlement on the basis of reciprocity can be seen ex ante, and the country in emergency will then seek some other safeguard measure outside of Article XIX.[41]

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[40]Tumlir, op. cit., 275.

[41]Tumlir, op. cit., 275.

As one observer has said, "It is worth noting that the dominant place accorded to the MFN principle in postwar international trade relations tended to make them even more fragile and subject to the accidents of bargaining than they had been before. MFN is in fact a ready-made instrument for setting in motion a downward spiral in the process of bargaining, once nations begin to adopt an adversary posture towards one another; for a dispute between two countries which leads one of them to withdraw a trade concession originally made as part of a general bargain between them is almost bound to inflict some injury on the trading interests of other countries who happen to be exporters of the products affected. Assuming that everyone insists on precise reciprocity, there is no end to the series of consequent adjustments that may have to be made."[42]

The nondiscriminatory basis of Article XIX may appear particularly inequitable to developing countries who are small suppliers or new entrants but are denied access to the safeguard-invoking country's market even though the safeguard was initially invoked because of injury from another large developed-country supplier. In most cases in which Article XIX action has been taken by GATT members, only a limited number of large suppliers were responsible for injurious imports, but all sources suffered from the MFN provision.

For retaliatory suspensions, the only contracting party injured if the MFN clause is not applied is the party invoking Article XIX. If the purpose of retaliation is interpreted as punitive, then the MFN clause should be inapplicable for retaliatory increases. Application of the MFN clause to retaliatory increases also carries with it the danger of chain reactions of further tariff increases by third countries.[43]

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[42]Andrew Shonfield (ed.), International Economic Relations of the Western World 1959-1971 (1976), 47-48.

[43]Dam, op. cit., 104-105.

The principles of most-favored-nation treatment and of reciprocity should therefore be declared to be without legitimate function in the regulation of emergency protection.[44]

(5) The waiver of the MFN rule and reciprocity does not mean, however, that there should be no international discipline with respect to the use of Article XIX. On the contrary, the principle of multilaterality might be strengthened without a MFN principle. "The principle of multilaterality would stand for common responsibilities, joint decisions and international surveillance--the continuous presence of a concerned forum in which a country can complain and seek mediation for its grievance against another country, or even seek adjudication. ...Experience ...suggests that this principle is more important than nondiscrimination pure and simple for ensuring that emergency protection will be limited to real emergencies, where there would be a right to protect and no need to compensate, and that the protective measures will be eventually lifted. The pragmatic course would be to seek ways to compromise with the MFN principle without sacrificing multilaterality."[45]

(6) The provision that under Article XIX a concession may be suspended, withdrawn, or modified "to the extent and for such time as may be necessary to prevent or remedy" the injury resulting from the concession has allowed the invoking country to make emergency protection in essence permanent. A working party long ago stated that "action under Article XIX is essentially of an emergency character and should be of limited duration... A government taking

[44]See also the similar, though more qualified position of Tumlir, op. cit., 264-265; Shonfield, op. cit., 222-225.

[45]Tumlir, op. cit., 266.

action under that Article should keep the position under review and be prepared to reconsider the matter as soon as this section is no longer necessary to prevent or remedy a serious injury."[46]

Most of the tariff increases made under Article XIX have not, however, been rescinded. Reform of this article should therefore also involve some commitment, and a procedure, giving other countries an effective assurance of a continually growing access to the protected market and of a foreseeable removal of the market safeguard. This is especially important for LDCs that are entering new export markets. To this end, the right to invoke the Article might be conditioned by requirements that (a) the protection afforded by the safeguard measure be degressive over a certain number of years, and terminal within some designated time period; (b) the invoking country is obligated to promote adjustments that will reduce the dislocation costs; and (c) the use of the safeguard measures and the adjustment efforts must be open to multilateral surveillance.[47]

If the situation of "serious injury" is to be ameliorated, and dislocation costs reduced, governments must give special attention to adjustment policies. Otherwise industries that prefer protection to adjustment will continue the pressure for retention of the market safeguard.

It must be emphasized, as Johnson has, that "from the standpoint of the advanced countries, adjustment assistance and safeguards against market disruption need to be considered as complementary and not as substitute policies. Adjustment assistance is designed to increase the speed with which change can be absorbed and digested; safeguards against market disruption are designed

[46]The Contracting Parties to the GATT, Report on the Withdrawal by the United States of a Tariff Concession under Article XIX of the GATT (1951), 29.

[47]Cf. Tumlir, op. cit., 269.

to slow down the speed of the change that has to be absorbed and digested. Optimum policy with respect to change associated with shifting comparative advantage in response to the development and diffusion of technology requires joint optimization with respect to both types of policy, not prior choice of one line or other of policy and subsequent optimization with respect to it alone. Both policies also require drawing a fine line between optimal pacing of change and protectionist resistance to change, a line which is probably significantly easier to draw and maintain where the two policies are considered jointly than when the full weight of responsibility for controlling the rate of change and absorption of it is placed on one type of policy only."[48]

The adjustment assistance must ensure adjustment out of the industry that is losing its comparative advantage: it cannot merely perpetuate the retention of inefficient resources in the depressed industry. It must either promote measures to increase productivity or stimulate an exodus of factors from the industry. No matter what their particular form, adjustment measures must avoid trade-distorting effects: an inefficient adjustment-assistance measure has no more merit than does an inefficient VER or tariff or QR.

Not only should assistance facilitate the conversion of resources to higher productivity uses, but it should do so as early as possible. Instead of delaying an investigation and an adjustment assistance program until "serious injury" has been determined, it may be more sensible to shift to an 'early warning' approach that makes it possible both to anticipate probable difficulties and to deal with these at an earlier stage. In essence, the problem is to devise an anticipatory, comprehensive approach that will be

[48] H. G. Johnson, "Technological Change and Comparative Advantage: An Advanced Country's Viewpoint," 9 Journal of World Trade Law 13.

harmonious with the changing character of the international division of labor and facilitate the movement of resources in the direction of more efficient international resource allocation. This problem of dislocation will become more acute--and the time for adjustment shorter--as technology is diffused more rapidly to the LDCs, transnational corporations expand, the developing countries accelerate their industrialization process, and these countries acquire a wider comparative advantage in the well-standardized, labor-intensive manufacturing industries that will become increasingly competitive with the older labor-intensive, import-sensitive industries of the more developed countries.[49]

The incentives for adjustment assistance will be more effective, if there are provisions for retaliation or additional and proportionately larger concessions after certain time periods if the safeguards are not removed or reduced; if the protection is sharply degressive over a fairly short period; if countries would agree to use production subsidies rather than tariffs or quotas for protection; and if persuasive methods of multilateral surveillance can be instituted.

(7) Procedural arrangements are as important as substantive rules. The objective should be to establish meaningful standards that are formed by a national determination process bound by the observance of certain common, internationally accepted principles. Two necessary principles should be emphasized: (i) that the determination of conditions on which the executive is called to take action be entrusted to a statutory body whose term of office

[49]Cf. G. M. Meier, Problems of Trade Policy, (1973), 170-178.

should not be coextensive with that of the executive, and (ii) that, after a preliminary investigation by its own specialized personnel, this body should hold public hearings in which all interested parties, including the foreign firms, could be represented and not only present their views but also cross-examine each other within an adversary procedure.[50]

It would seem logical that the invoking party should be required to go forward with the burden of proof of "serious injury." In practice, however, the invoking party has had easy access to Article XIX, and the burden of proof has been placed on the complainant against the suspension of a concession. In the U.S. withdrawal case (Hatters' Fur case), for example, the working party held that the invoking party (U.S.) was "entitled to the benefit of any reasonable doubt" and that the complainant (Czechoslovakia) "has failed to establish that no serious injury has been sustained or threatened."[51] This has made it difficult to maintain the substantive requirements with respect to causation of "injury" and it has made access to Article XIX freer than it should be. This procedural rule should be revised.

Procedures to establish multilateral surveillance must also be introduced. In the majority of cases, there has been no prior consultation before invocation of Article XIX. And in the future, in conformity with the policy guidelines outlined above, there will have to be procedures for multilateral surveillance of the impact of safeguards and the adjustment policies.

Finally, it should be a prime objective of the MTN to bring existing illegal restrictions into conformity with the revised rules, and to ensure that in the future resort to market safeguards will be within the internationally accepted principles of the GATT.

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[50]Tumlir, op. cit., 275.

[51]Hatters' Fur Case, supra note 7 at 23. See also. Dam, op. cit., 102-103; Jackson, op. cit., 562-563.

Difficult as the negotiating process may be to achieve this objective, we may take some hope from the precedents of the GATT Anti-Dumping Code and the International Textiles Arrangement.[52] Many of the procedural principles adopted by the signatories to the Anti-Dumping Code would also be appropriate for safeguard proceedings. The International Textiles Arrangement is also instructive in its provisions for a more explicit definition of market disruption based on the existence of serious damage and the assessment of certain factors; the phasing out or bringing into conformity with the ITA provisions the existing bilateral restraint agreements or unilateral quantitativerestrictions; recognition of the need for preferential treatment in respect to disruptive imports from developing countries in terms of more favorable base levels and growth rates, special consideration for imports of cotton textiles, and exclusion from restraints of handloom and traditional handicraft textiles; an annual minimum growth factor in restraint levels; and the creation of the Textiles Surveillance Body to supervise implementation of the accord and to make recommendations on the admissibility of restrictions imposed.[53]

(8) It would also be desirable if the MTN could adopt a comprehensive view of safeguards and focus on all measures instead of only Article XIX. It is essential that safeguard measures be brought under the multilateral surveillance of the GATT in order to reverse the recent proliferation of VERs

[52] Agreement on the Implementation of Article VI of the GATT. For reports of the Committee on Anti-Dumping Practices, see BISD 17, 18, 19 and 20th Supplements. Arrangement Regarding International Trade in Textiles, GATT/1974-2.

[53] For the view that the ITA is a striking innovation in the field of import safeguards and clearly provides a model for the safeguard arrangements that may come out of the MTN, see A. J. Sarna, "Safeguards Against Market Disruption--The Canadian View," 10 Journal of World Trade Law, 359-360, 369-370.

and QRs. As the OECD's Rey Report concluded, the VERs are "often of a discriminatory nature" and are an inadequate way of dealing with difficulties in particular sectors. The Report recommended that they should be replaced by improved safeguards operated within an agreed multilateral framework. The existing situation is unsatisfactory since it is "characterized by an absence of international discipline, leaving countries free to introduce a wide variety of safeguard measures."[54]

From the viewpoint of the future interests of LDCs, it is especially important that there be an effort to multilateralize and control the process whereby VERs are imposed. For, just as originally with textiles, there is considerable potential for market penetration by LDCs in other manufactured and semi-manufactured commodities.

(9) This last consideration brings us to the question implicit throughout this paper, and that should now be examined directly: is there a case for special and differential treatment for LDCs in the application of market safeguards? While advocating financial compensation only for LDCs, Bhagwati devotes only one short paragraph in justification of such differential treatment. He merely states that "They (LDCs) are, after all, the countries which have been seriously affected by the textiles restrictions and by VERs ... Further, there is greater willingness, as part of the new international economic order, to grant LDCs reasonable accommodation via framing new rules regarding their trade. Moreover, the flow of funds to be so generated are far more likely to be significant, relative to their needs, for LDCs than for DCs. Finally, discriminatory adjustment of trade rules, in favor of LDCs, is well-embedded in GATT reform, as in the enactment of Article XXIII for them at GATT."[55]

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[54]OECD, Policy Perspectives for International Trade and Economic Relations, Report by the High Level Group on Trade and Related Problems (1972), 82. See also Curzon, op. cit., 274-278.

[55]Bhagwati, "Market Disruption.. " 009.

Might we not say more? From a sense of distributive justice or redistributive justice, one might maintain that the poorer party should not be made to stand a loss which the richer party could stand better. Indeed, it has been submitted that "the idea of need as a basis for entitlement" is "the central feature of the contemporary international law of development. When we reflect on it, it may seem extraordinary how we have come to accept it and how far-reaching its implications may extend. Can we reconcile need as a basis of entitlement with other fundamental legal principles such as equality among states or their established rights? How can need fit into the still prevailing conception of a world market economy based on principles of comparative advantage and non-discriminatory trade? We have in fact already experienced the conflicts and dilemmas which these general questions suggest. It is clear enough that in treating need as a basis of entitlement states have to diverge from other principles. And to a considerable extent, that is exactly what is being done. The present rationale for international assistance and preferential treatment on the basis of need is more in keeping with the premises of the modern welfare state--that is, to provide for the minimal human needs of the most disadvantaged segments of society. For this reason, it does not seem so utopian or so revolutionary as the abstract formulation may suggest. Yet we should not underestimate its impact in international affairs."[56]

Although most international lawyers would consider it too revolutionary to uphold a doctrine that "needs are rights", many might nonetheless recognize the inappropriateness of formal equality and reciprocity as governing principles of the relations between DCs and LDCs on the basis of an attempt to counterbalance existing inequalities. This principle has been variously termed the

[56] Oscar Schachter, "The Evolving International Law of Development," 15 <u>Columbia Journal of Transnational Law</u>, 10.

"welfare" principle,[57] the principle of "the double standard,"[58] or the principle of "capability."[59]

Or one may admit to the reality of discrimination, and recognize special treatment for the LDCs on the basis that law must accurately reflect community expectations, rather than consist of a mere statement of often unheeded rules. The traditional rules then no longer represent an accurate statement of law.[60]

Another reason for special and differential treatment for LDCs is that in return for improved access for their exports in advanced country markets, the LDCs might commit themselves to refrain from organizing commodity markets with price-raising objectives and might guarantee stable supplies of primary commodities. Both LDCs and DCs may gain, in the negotiating process, if the issue of market access for LDCs were linked with the issue of supply access to primary commodities for DCs.[61] This linkage is implied in the negotiating objectives stated in the Trade Act of 1974.[62]

The implementation of special and differential treatment for LDCs with respect to market safeguards can be accomplished in several ways. First, if

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[57]Bernard V. Roling, International Law in an Expanded World (1960), 83ff.

[58]A. A. Fatouros, "International Law and the Third World," 50 Virginia Law Review, 782-823, at 811ff (1964).

[59]H. D. Lasell, "The Relevance of International Law to the Development Process," 60 American Society of International Law Proceedings 1-8, at 4-8 (1966).

[60]Myres S. McDougal, "Some Basic Theoretical Concepts about International Law; A Policy-Oriented Framework of Inquiry," Journal of Conflict Resolution (1960), 337.

[61]See Robert M. Stern, "The Accommodation of Interests Between Developed and Developing Countries," 10 Journal of World Trade Law, 417-419.

[62]See Trade Act of 1974, sec. 108, sec. 121(a)2, and sec. 121(a) 7.

the MFN clause is removed, the invocation of Article XIX need not penalize developing countries not responsible for the cause of the action in the same way as the offending country which might be a developed country. When the major disruption is caused by an LDC, it may claim differential treatment. A GATT Committee on Trade and Development proposed in a 1972 report that, in the light of Part IV and especially Article XXXVII, imports from developing countries should be exempted when escape clause action permitted by Article XIX was taken.[63]

Alternatively, more favorable treatment can be given to LDCs by considering, as is done in the Te tile Arrangement, the interests of the exporting country, especially in regard to its stage of development, in questions of market disruption. Bhagwati's proposal for financial compensation is the extreme version of favorable treatment. It is (unfortunately) unrealistic to believe that it would be adopted in the MTN.

It is of interest that as early as 1961 an Uruguay-Brazil Plan would have provided LDCs financial compensation for violations of the General Agreement by DCs.[64] Many objections, however, were lodged against this financial liability proposal. A report of the Ad Hoc Committee on Legal Amendments stated that the financial compensation plan was not only "an entirely new concept," but was also subject to the practical objections: "that it would be impossible to evaluate the loss incurred by a contracting party in its export opportunities in money terms or to work out an appropriate level of financial compensation in each case; that although a country might be affluent and capable of making cash payments, any requirement on it to assume such an obligation would seem to

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[63]BISD 18S/68 (paras. 19-20 of Document L/3625. See also, BISD 19th Suppl. (March 1973) 30.

[64]See Report of the Ad Hoc Group on Legal Amendments to the General Agreement, reprinted in "Expansion of Trade of the Developing Countries," December 1966 (Mimeographed Document) 112, 119.

require more authority than a mere finding by a panel of experts; that even if the assessment question could be solved, the problem of enforcing the payments of such an assessment would remain; that it was inconceivable that national legislatures would be willing to vote budgetary provisions for this purpose; that it was unreasonable to expect that a sovereign country would agree to be fined for its action; that it was difficult to see how a fine could be imposed on 'mutually satisfactory terms' and that the most effective redress might be the removal of the measure complained of rather than some form of compensation."[65]

In the present state of world organization, it is probably even less realistic than it was in 1961 to believe that nations would submit to financial liability by the judgment of an international dispute-settlement tribunal based on an adjudicatory approach to safeguard measures.

Short of this, however, countries might still give differential treatment to LDCs within the restrictions they adopt. Thus, in order not to penalize "the competitively weak and struggling developing countries," Tumlir has proposed that "it would be both equitable and efficient with respect to the purpose of the safeguard clause if it contained a general exemption, providing that emergency protection measures would not be applied to imports from countries whose export of the product in question towards the country invoking the clause has been growing--for a given number of recent years--at less than the average rate of growth of total imports of the product causing disruption. To take the interest of new exporters into account, the exemption could perhaps

[65]Ibid., 115. See also, Dam, op. cit., 368-369.

contain an additional criterion, according to which the clause could be invoked only against countries whose export of the product in question towards the country invoking the clause exceeded a certain absolute amount in volume or value."[66]

If a country invokes Article XIX and limits trade over a certain period by a quota or tariff quota, it might still favor LDCs by providing a more favorable scale. Instead of every country expanding exports to the importing country by 5% per annum, for example, the rate should be graduated according to market penetration. Thus, an LDC could be granted unlimited expansion as long as it has less than .1% of the market. The growth rate might then be made to decline toward, say, 5% as the share of the market rose to, say, 5%. Further, each LDC might be allowed to increase its exports to each DC by a minimum percentage (say, 10%) even though the share-of-market formulation would call for a slower rate of export growth.[67]

There are other ways that the LDCs can be favored beyond a reformed Article XIX. All preference-giving countries now combine their preference systems with some safeguard mechanism either taking the form of limitation formulas (EEC, U.S., and Japan) or the form of escape clause measures. These limitations might be relaxed. If Article XIX were revised in conformity with

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[66]Tumlir, op. cit., 268.

[67]See H. Giersch (ed.), The International Division of Labor, (1975), 145-146.

the preceding suggestions, there would be less need to declare products ineligible for preferences and a different basis for invoking limitations on preference-receiving countries.[68]

The tariff provisions for offshore assembly, such as in the U.S. tariff items 806.30 and 807.00, also favor imports from the LDCs. The wider the use of tariffs that are levied only on the foreign value-added or assembly cost, the more will it favor the importation of semi-manufactures and manufactures from LDCs.[69]

Market access for the LDCs can also be extended by reducing the degree of escalation in tariff rates in the structure of tariff differentials so that the LDCs might realize more of a competitive advantage in the processing of their primary products. The effective rates of protection are especially high on many products that are of potential export significance to the LDCs.

Finally, we are left with the ultimate question of what should be the dispute-settlement mechanism that will in the last resort act to define and delimit the scope of all the substantive provisions for market safeguards. Article XXIII has been the key provision for dispute-settlement. Whether this Article should be revised is not, however, a question peculiar to the problem of market safeguards, but is common to all disputes under the General Agreement. We have, however, attempted to furnish an analytical framework

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[68] The U.S. Trade Act removes preferences whenever the beneficiary country has supplied 50 percent by value or more than $25 million of the particular item during any calendar year. In addition, a domestic industry can seek aid under the escape clause provision (section 201) of the Trade Act. For GSP eligibility, see the <u>Federal Register</u>, October 28, 1975.

[69] See J. M. Finger, "Tariff Provisions for Offshore Assembly and the Exports of Developing Countries," <u>Economic Journal</u> (June 1975), 365-371.

and potential standards that might be useful in devising administrable rules that will allow reasonable use of Article XIX while protecting LDCs against their excessive use. This may contribute to the general objective of depoliticizing issues of trade policy as much as practicable by legally prescribed procedures that establish obligations for international economic conduct.

A Comment On Gerald M. Meier's "The Safeguard Negotiations And The Developing Countries"

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As is clear from Professor Meier's comprehensive review, there are two broad categories of approaches that can be followed to favor the interests of developing countries in connection with the use of safeguard clauses by the U.S. and other developed countries. One is to design broad arrangements that discourage or limit the application of safeguard clauses by the developed countries altogether. The other is to provide for the administration of the safeguards, once invoked, in ways that favor the developing countries. One may hazard the guess that potential trade gains for the developing countries from minimizing the use of safeguards are greater than those from a differential administration of safeguards.

The facts of life are that all countries, developing and developed countries, put their domestic interests ahead of any international commitments or international obligations with respect to trade. The problem is not therefore to find ways to draft the clauses so as to restrict the field of their application. That would be easy to do through means such as the establishment of more specific criteria for invocation and the provision of multilateral controls over invocation. This path should be followed as far as countries prove willing to go down it, but sight should not be lost of the fact that safeguard clauses fulfill a basic function in encouraging countries to enter into trade commitments which they otherwise would eschew. When it turns out that a country has underestimated the need for escape clauses, it will violate its international obligations if an important enough domestic interest is involved. In the GATT context, the United States itself set the pattern when it began violating the obligations almost before the ink from the signatures to the agreement was dry by imposing restrictions on dairy products in the early postwar years. Of course, countries will not generally sign economic agreements which they know in advance they will have to violate, and given the general priority of domestic interests much progress towards more restrictive escape clauses seems doubtful.

The hope of minimizing developed country use of escape clauses lies in seeking circumstances in which the countries will be less tempted to use them. One vital factor is the buoyancy of the economy. The lack of buoyancy in the American economy and in the trade sector led to the drastic changes in currency arrangements in 1971. In an expanding economy, it is easier for firms and workers to find alternative products and employments, and import restriction is less likely to be viewed as an essential solution to competitive difficulties. Economic expansion was, for example, a key ingredient in the relatively painless elimination of trade barriers among the six original Common Market countries in less than a decade. Of course, the prescription of a buoyant economy is like an injunction to virtue; prosperous economic conditions are to be desired on much broader grounds than trade policies. Nevertheless, it is worth reminding ourselves of the connection because it seems unlikely that any trade arrangements will long withstand depressed economic conditions in major industrial countries. The fact that swings in the trade balance can be large in their short run expansionary or contractionary impact is more likely to invite efforts to control the balance if the economy is in the doldrums and in need of stimulation.[1]

A more trade oriented consideration affecting a developed country's tendency to invoke escape clauses resides in the perception in the country of the costs of escape action. The main practical limit on each country's use of safeguard clauses to protect particular domestic interests is the realization that other domestic interests will be adversely affected immediately through retaliation or less directly through the stimulus to a more general use of escape clauses by other countries. The main path to inhibiting the use of safeguards is to raise the perception of these costs in each developed country. More stress should be placed by the U.S. authorities on the "balance of benefits" principle of GATT in domestic discussions of commercial policy so that it is more widely appreciated that jobs saved by import restriction are very likely to be lost elsewhere in the system. The provisions of GATT itself should be studied to determine whether there are changes that would increase the costs of escape action and the public perception of those costs that developed countries would be willing to accept. One suggestion along these lines is made below in connection with import quotas.

Before leaving this subject of the general impact of safeguard clauses, it may be worth commenting on Professor Meier's interesting idea of balancing the marginal social cost of import restriction against the marginal social

[1] For the U.S., recent swings in the trade balance have been large relative to the stimulatory package proposed by the Carter Administration. On Census definitions, the commodity trade balance shifted from -$1.7 billions in 1974 to +$11.5 billions in 1975. In national accounts terms, net exports of goods and services rose from +$7.[illegible] billions in 1974 to +$20.5 billions in 1975. (Survey of Current Business, December 1976.)

damage caused by imports. From the standpoint of general equilibrium, restrictions on imports to allow for external diseconomies (costs of dislocation) would create new distortions unless corresponding balancing was made of costs and benefits associated with economic changes stemming from other sources (technology, tastes, etc.).

The other approach to furthering the interests of developing countries in connection with safeguard clauses turns on the administration of the clauses in ways that discriminate in favor of the developing countries. Perhaps the one with most practical promise relates to the administration of import quotas, one of the most common devices used when safeguard clauses are applied. The suggestion is that developing countries be given more generous quotas than the developed countries. When, as is often the case, the import quota provide for gradual expansion through time, there may be greater opportunity to favor the developing countries without impinging upon trade volumes that developed suppliers already enjoy.

There are, however, two main objections to a differential administration of quotas in favor of developing countries. For one, efficiency criteria are not satisfied. Access to the protected market is by administrative fiat rather than on the basis of price and costs. False encouragement may be given to an expansion of production in a quota receiving developing country that could not be sustained in the event of removal of quotas. Secondly, the search for equity among various developing countries leads to complex arrangements in the administration of the quotas, as is illustrated by the recommendations of Murray and Walter in the paper prepared for this conference.

These considerations lead to the suggestion that the quotas ought to be auctioned off, with the proceeds put in a multilaterally administered (IBRD IMF) aid fund. There has been remarkably little attention paid in discussions of commercial policy in general and safeguards in particular, to the monopoly profits involved in quotas. The profits arise, of course, because those who are awarded the right to share in the restricted volume of sales of the safeguarding country are able to capture the difference between the world price and the country's protected domestic price. In the case of the so-called "voluntary" export restraints, the government of the impacted exporters is allowed to distribute the quotas and the monopoly profits to its exporters. This, incidentally, is a form of bribe to exporters, a topic which finds its place in Professor Meier's paper. Murray and Walter report that active markets for "export licenses" have sometimes appeared in several Asian countries in connection with exports to the U.S. under the long-term textile agreement.

Auctioning off quotas has the following advantages over distributing them in some differential way that favors developing countries:

1. The expansion of production in developing countries would not be distorted by the changing safeguard actions of developed countries.

2. The aid equivalent of the profits from the differential allocation of quotas could be directed to countries and purposes in a more rational way than if distributed in the accidental way incident to quota allocations by developed countries.

3. The revenues produced by the auction of quotas would make explicit, in the quota-imposing country, at least one part of the cost of restriction, and thereby strengthen the hands of those opposing restriction.

4. Administrative problems are minimized. Not only is there no need to seek equitable arrangements for the allocation of the quotas but rules of origin (to prevent transhipments through favored developing countries) become unnecessary.

The auction idea can be embroidered so as to favor bids by producers in developing countries if it is thought that their lack of experience in such matters would place them at a competitive disadvantage, but traveling very far along this road reintroduces the administrative problems referred to above. It would probably be preferable for some international body to provide technical assistance to developing countries in the bidding process.

From an economic standpoint, the auction approach has strong and even compelling advantages over the administrative distribution of quotas. These advantages are the greater the longer the prospective duration of the restrictions. It is true that only temporary derogations in the form of QRs are contemplated in many contexts, but as a practical matter they are likely to have a greater longevity in developed country industries troubled by long-run employment problems like textiles. In these instances, greater weight has to be placed on the rational location of production, even as among different developing countries, and the auction system holds greater promise on this score. The idea itself, auctioning quotas, has been around a long time. It should be taken out, dusted off and examined in the context of current commercial policy, particularly in the light of the interest in favoring developing countries.

A Comment on Gerald M. Meier's
"The Safeguard Negotiations And The Developing Countries"

Lawrence B. Krause

Brookings Institution

Gerald Meier has written a very curious paper. In succession he has donned the hat of a lawyer, theoretical welfare economist and a political economist (when he is at his best). Unfortunately, he did not attempt the role of a political scientist. If he had, he might have avoided the error of extreme naivete. I refer to page 135 with respect to revising GATT Article XIX where Meier advocates that 'Some type of international commission or panel of experts should be responsible for a review of a common accepted national procedure of inquiry to determine injury." Without stating who would appoint and thereby control the experts, the suggestion is worse than vacuous, it is dangerous. As we become more aware (to our sorrow) that corruption is more the rule than the exception in dealings between individuals within governments and outsiders in many parts of the world, we must recognize that no honest person would accept appointment to such a panel nor stay honest if appointed.

Before discussing the substance in the paper, I would like to point out what I consider to be a serious error of omission. Meie. chose not to discuss the issues raised by the GSP with respect to safeguards and market disruptions. Since imports covered by the GSP are most likely to be the ones causing injury and market disruption and since safeguards designed to deal with the problem must be special and differential toward developing countries, the exclusion is very unfortunate.

The first question I would like to raise concerns the seriousness of escape clause actions taken by countries under national law and then justified under Article XIX of the GATT. Meier notes that the article has been invoked 54 times during 1947-70, mainly after 1960 (42 cases). What impresses me is how few cases there are given the thousands of tariff concessions negotiated under GATT. Even though the rescinding of concessions have been permanent rather than temporary, the record is remarkably good. LDC exports may have been involved in a disproportionate number of cases as estimated by Bhagwati, but the trade restraints are trivial as compared to the restrictions not under Article XIX such as the international textile agreement. Article XIX cases are minor problems in world trade and should be treated accordingly.

Secondly, Meier quotes R. E. Hudec, I think approvingly, to the effect that a legal spirit to GATT affairs is desirable and that the anti-legal attitudes that have developed should be reversed. To this end, Meier recommends a revision of Article XIX. With respect to GATT legalisms, I could not disagree more. GATT legalisms can push countries into taking inefficient economic measures when more efficient ones are possible, require endless legal efforts to create distinctions where none exist, and are the ultimate victory of form over substance. If someone were to call me a GATT lawyer, I would take him to court for slander. The GATT is a political document stating intentions and setting up procedures and should not be considered a legal contract establishing property rights. When a country finds that it has an overwhelming need to restrain trade, whether it be for a single product or more generally, then it will go ahead regardless of legalisms. International recriminations based on narrow legalisms will only overload a country's politics and embitter international relations. It is much better to face such situations with political realism and with flexibility so as to support responsible elements within the offending country so as to minimize the damage to world trade. The role of GATT agreements should be to raise national thresholds so that few problems qualify as overwhelmingly needy. This will occur to the extent that GATT councils are recognized as forums for multinational discussion and negotiations and not a court of law.

Meier concludes his analysis of Article XIX by recommending that it be revised. While I would not object to some revision, I would not assign a high priority to it and I certainly would not endorse most of Meier's specific suggestions. Meier suggests that the definition of injury should be clarified so that it not apply when imports rise only relative to domestic production and not absolutely. In my view, the definition of injury should remain fuzzy. Clarity can strengthen the hands of protectionist elements within countries and remove necessary flexibility within GATT deliberations. Meier also suggests that the "unforeseendevelopments" requirement for injury be removed since it has no operative meaning. While obviously a trivial issue, I would come down on the side of leaving it in. The "unforeseendevelopments" clause does not stand in the way of countries doing what they must and it does imply that it would be bad form for a country to offer a tariff concession with the <u>intention</u> of withdrawing it via Article XIX. The most fundamental and most undesirable suggestion made by Meier would be a weakening of MFN requirements when concessions are withdrawn. The MFN principle is not only worth saving, it should be strengthened by revising some of the erosion that has taken place in recent years. Where MFN is disregarded, trade policy is used as a manipulative tool of foreign policy to the detriment of efficient commerce. The return to prewar selectivity and discrimination will only make trade relations worse. The apparent sensibleness of trying to protect LDC exports that are innocent bystanders when one developed country finds injury from imports from another developed country overlooks the trade deflection problem. Selective withdrawals would lead to the same problems that occur with VERs --a dynamic process that eventually results in worldwide restrictive agreements outside of the GATT framework.

Meier further suggests that more thorough oversight responsibilities be undertaken by GATT when Article XIX is invoked and to this I fully agree. A reasonable and responsible GATT committee can work with a country to help solve its trade problem. It can urge adjustment assistance in place of or in addition to trade restraints, help keep issues alive so that restraints become temporary and maintain the sense of cooperation among governments at times of stress.

I do not, however, find anything to endorse in Meier's theoretical analysis of trade welfare. It led him to make a statement on page 115 that "the economist may admit to little, if any, economic justification for market safeguards." Unfortunately, his model is seriously flawed because he has used comparative statics for a problem that is wholly dynamic. His formulation of the problem leaves out all the variables that make import injury and market disruption an economic problem--no wonder he didnot find any. One must take into account the transferability of resources, both human and physical and the time dimensions involved in order to come to grips with the economics of the issue.

It is only when Meier begins to write as a political economist that his discussion becomes interesting in that he raises the fundamental question, should there be special and differential treatment for LDCs? Meier clearly believes that there should. Basing his analysis on a sense of distributive (or redistributive) justice, he argues that when a loss is created, it should fall on the richer rather than the poorer party. This is a reasonable point of view; however, Meier fails to recognize that it already happens when a developed country restricts trade. It is the importing country that suffers most through consumption losses, production inefficiencies, misallocation of investment, upward pressure on prices and all the rest of it. If we want to prevent burdens from falling on LDCs, we would have to inhibit their ability to impose import restraints which would mean subjecting them to the general provisions of GATT, not special and differential rules. Of course, there are dislocation losses for exporters when trade is restricted. This burden on LDCs can be minimized by generally improving their access to world markets--including those in other developing countries. Market access on balance is probably improved by having a credible escape clause procedure to overcome unwarranted fears, a point Meier himself makes in the paper.

Meier raises a further justification for special and differential treatment of LDCs: the idea of needs as basis for entitlement. The domestic analogy is obvious. He further suggests that it is extraordinary how we have come to accept this principle internationally. I believe he completely misperceives international reality. The only measures undertaken by rich countries vis-a-vis poor ones have grown out of the self interest of rich countries themselves. There is always a quid-pro-quo in international dealings and those that are least obvious such as those involved in Soviet grants to Cuba or U.S. grants to Vietnam may be the most costly from the receipients' point of view. I would argue further that the <u>principle should</u> not apply internationally. Within a domestic setting, the right to have ones minimum needs taken care of carries with it a responsibility to obey the laws of the land, serve in the armed forces, pay taxes if ones financial situation changes, etc. and even here there is legitimate worry over the long run value to the recipient of blunting incentives for self help. No corresponding set of recognized responsibilities has yet been created internationally and until they are, the quo for the quid is subject to great concern.

I do not want to end my remarks on a totally negative note. I believe in reciprocity in all international dealings, but that does not mean narrowly drawn equality in every negotiation. One can always structure a bargain between participants of unequal strengths so as to help the weaker side. For instance with respect to withdrawal of concessions, room should always be left for the new entrant whose economy has not yet reached international competitiveness. What we need are general rules that have the effect of protecting the weak.

REPLY AND DISCUSSION

DR. GERALD MEIER: I would like to spend a'l my time with my good friend Irving Kravis who raises a very important issue, especially at the outset, with regard to balance of payments and flexible exchange rates. While we have not discussed that issue, the first paper implies that with flexible rates the problem would not be so severe. However, I do not believe this is necessarily true and I believe that Dr. Kravis agrees with me since he went on to say that there would still be a problem.

Now, I must come to Larry Krause's comments. My assignment was not to describe the present situation or worry how to form an international body but rather to prescribe and try to find a better policy--not the best but something better-- and that is what I attempted to do. Given many difficulties, as would be noted by a political scientist, some type of international commission or panel of experts should be responsible for reviewing national procedures in determining the extent of injury.

The footnote on the lack of remedial action, which highlights the dire need for such a commission, refers to someone with some authority--Jan Tumlir. He is close to GATT and the consultative procedure I refer to is his. I believe his sense of realism is as great as mine or others. The only way that I could see in moving away from compensation or retaliation was to have this further review of the national decision, in a two-stage approach. If this were not acceptable, then compensation and retaliation are the alternatives. This leads to a related point: Larry should not be surprised that he sees few cases of Article XIX. It has been by-passed. But the by-passing is a worse position; and I was advocating that we try to bring countries back to Article XIX but in a more acceptable fashion. The escape clause language therefore has to be more specific but, at the same time, as Irving Kravis said not too difficult to invoke.

Now, on this question of legal "spirit", I think Larry is misinterpreting law. He is viewing law as rules while I am viewing law as policy. And if economists are not concerned with policy and if political economists are not concerned with policy, I do not know what this discussion is about!

The GATT, of course, is not a legal document. From the very start Hudec called it "diplomats jurisprudence." It is not even legalistic. The collection of articles comprising GATT are referred to as the GATT "code," but any lawyer, of course, would say these articles are not a code of law--nor was that my intention. My intention was to bring a revision of GATT into a more consistent and more effective policy framework. And I would affirm that no matter what policy you endorse, you are going to create and distribute values. Hence, by revising the GATT legal spirit, i.e., by improving the policy framework, those values such as policy coordination and some redistribution of resources should be made more explicit. I do not know how they can be ignored, even if you do not look upon policy as the identification and distribution of values.

Finally, I think, Larry, in saying that he wants to strengthen the most-favored-nation treatment by revising some of the recent erosion, is back to where I am with an international reviewing body. Again, a political scientist would ask: "How do you strengthen the most-favored-nation treatment?"

With regard to another of Larry's comments, "dynamic", is, of course, a very good emotive word and is always better than "comparative statics." But the socially optimal time path of adjustment, in whatever context considered, still must be defined by someone or by some international group reviewing national decisions.

DR. KENEN: The floor is open to discussion. Yes sir?

MR. MICHAEL SHARPSTON - The World Bank: On the international advisory body, do we not actually have an example we can look at and see whether we think it is good, bad or indifferent? For instance, the Textile Surveillance Body is not excessively corrupt and it has not been totally useless. Thank you.

DR. KENEN: Is there any response? No. Okay, are there any further comments? Yes sir?

MR. DAVE DUNFORD - Department of State: The issue of selective versus MFN application of safeguards, which Professor Meier's paper raises, is of considerable current interest. I would like to throw some more weight on the side of Dr. Krause's criticism of selectivity. First of all, selectivity entails administrative costs. You have to find out where the imports were produced such that rules of origin are necessary. More importantly, I think MFN application acts as a constraint on governments which contemplate taking safeguard actions in that they know that these actions must apply to all imports or to all exporting countries. Finally, I am not sure how we can relate "injury" to a particular source unless there are some unfair trade practices involved, for which we have other mechanisms--anti-dumping or countervailing duties.

One point of fact--the GATT Article XIX does provide, according to my understanding, for selective retaliation. Retaliation against a safeguard action need not be MFN.

MR. MICHAEL FINGER - Treasury Department: I am affiliated with one wife and three children. We buy and wear cotton underwear. As consumers, we have a major and fundamental interest in the formation of protection measures. I think that instead of trying to get at the question of protection through a set of international rules, we would be much better off to find ways to strengthen the role of consumer interests in the procedures within the United States which lead to our invoking protection. After all, we, as economists, understand that protection hurts somebody in the United States. Hence, where the optimal solution would be to prevent protection from occurring, we should find a way to mobilize consumer interest rather than to try to find a way to form international rules or international organizations which would oversee the whole matter.

MR. STEVE LANDE - Office of the Special Trade Representative: Well, I was surprised not to hear anyone speaking in defense of special and differential treatment. Everyone speaking has generally been saying, "Well, we hope we do not have to do special and differential treatment. It probably is basically evil. It is not good. If we can just get back to the perfect MFN world and have our trade rules work practically and correctly, we do not have to consider special and differential treatment." But the problem, from the developing country point of view, is that the perfect MFN world does not exist and will not exist after the MTN. It is from this premise that many of the LDCs' requests for S&D are derived. And it is also from this premise that many people who advocate trade liberalization, as many people have indicated they do, should push and should actively favor S&D--not as a permanent solution but perhaps as a forerunner to MFN solutions. Hence, GSP is good if it gets the world down to a zero-duty situation, which might well be the result of the program.

I also have a comment concerning the safeguard situation. The LDCs believe that the safeguard system via QRs presently allocates quotas based upon a country's former position or, say, based upon its position within a representative period. Therefore, very often Japan, for example, in the Multilateral Fiber Agreement--perhaps Italy, if we move on shoes--will receive the most advantageous quotas when you consider their positions during representative periods. This method is based upon efficiency in a static world. And, where the QRs remain in effect for five years, one continues this pattern of trade allocation, regardless of changes in relative efficiency across countries. Therefore, the issue, from a developing country point of view, is that the above scenario should be expanded to account for dynamic growth as well as static allocations. If one accepts the LDCs' basic and reasonable premise that they are the more competitive dynamic suppliers, then one should consider certain S&D treatment as a means of enhancing world efficiency.

Another point, which has been discussed in one or more of the papers, was the issue of perhaps giving something to the LDCs which are the small suppliers, e.g., those LDCs supplying less than five or ten percent of the market--or those LDCs that are growing at a slower rate of growth than others. Again, this is the opposite of economic efficiency because it is mainly those developing countries which already have a large share of the market, and perhaps which are growing faster, that are the more efficient supplying developing countries. And to the extent that you come up with an import restraint measure which hurts these countries, you are going against the whole theory of economic efficiency that you intended to encourage.

Various economists have identified a general problem of overcapacity plaguing developing countries. If developing countries which already have adequate capacity are not allowed market access because of safeguard actions to utilize this capacity, and other developing countries new to the markets are allowed market access, the new entrants will be encouraged to develop greater capacity. Hence the overcapacity problem of developing countries and the world would be aggravated and world welfare decreased.

The last point I would like to make concerns the United States Trade Act of 1974. Generally, many people do not view the Trade Act as a trade-liberalizing mechanism, specifically with regard to the safeguard provisions. However, the Trade Act comes very close to the ideal model that economists have been proposing. Specifically, the trade act provides for five years of relief. This relief should decrease each year, with the possibility of an additional relief period. It is this degressive and eventual phasing out mechanism that many of you have suggested for the GATT. Now, I do not say the Trade Act is perfect. It certainly is criticized by many, specifically by developing countries. But on this one specific aspect, it works in a fairly good direction.

Finally, I disagree with one point that was made on the GSP. Someone said that the products of GSP are probably those products which will most likely come up against the safeguard mechanism. That is not true since when the system was established we chose non-import sensitive products to place on the GSP list. Therefore, these products are probably less likely to surface in a safeguard action.

Thank you.

DR. KENEN: Are there any further comments?

Yes, sir?

MR. JOHN EVANS - Retired Foreign Service Officer: I want to ask Larry about his suggestion that "legalisms be eliminated from the GATT. Larry has suggested that the GATT is most useful as an organ for consultation and negotiation. When negotiation is concluded how does he think its results should be recorded? Where should the negotiations lead?

DR. LAWRENCE KRAUSE - Let me take the opportunity to respond to that and to make a point in which I am in strong agreement with Gerry Meier. We both believe that restrictions outside of Article XIX are more serious restraints to trade than the ones within it. So we fully agree on that. However, where I would weaken the criteria for granting restrictions under Article XIX, he would strengthen those criteria and, as a result, make it more difficult to utilize Article XIX.

Now, the point that you are raising is: Where will we go from there?

Well, there are things that are expected under a GATT agreement, e.g., the removal of tariffs and non-tariff barriers, and these concessions are expected to remain. However, there are times when countries will feel they must withdraw a concession or impose a new restraint. As a result, I think the GATT has an obligation to foster a discussion of this situation, wherein the country is going to undertake this activity regardless of any argument to the contrary, in order to minimize the damage resulting from such action. It is a political conference and not a conference to try to establish property rights.

MR. JOHN EVANS: My point, Larry, is that the result of any negotiation must be the acceptance of some kind of instrument that will incorporate the obligations that have been undertaken by the parties to the negotiation. The so-called GATT legalisms are an effort to record the results of the original GATT negotiations and some later bargaining. If they are eliminated what would take their place? You may want to change the commitments, themselves, or express them differently. But how can you eliminate them entirely?

DR. KRAUSE: But you are eliminating them! The U.S. has instituted the Domestic International Sales Corporation which is illegal under the GATT, and yet it exists. Countries do what they believe they have to do. The issue resolves into a choice between providing a mechanism for doing sensible things or providing a mechanism that forces countries into circumventing these things and adopting inefficient methods.

DR. KENEN: Are there any other comments or questions?

MR. GEZA FEKETEKUTY - Office of the Special Trade Representative: I have a question to any of you. I just wonder to what extent one can make a distinction between the following two situations. One is the situation of a potential producer in a small developing country who would clearly have a comparative advantage but who encounters enormous risk because he faces a world market in which he does not know the rules of the game. Specifically, he faces the possibility of safeguard actions in any number of large, developed country markets. In the other situation, which is becoming increasingly prevalent, the firms of developed countries generally have large markets or, where they do not, they merge or integrate in order to provide the required security necessary to accommodate the initial investment. So, the question is, does an economic disincentive exist which retards development in developing countries precisely because of an excessive risk factor? And if that is the case, what kind of an arrangement can one make to overcome this?

DR. MEIER: I would certainly find that there is unquestionably a risk factor, and that is the premise of the entire problem. I was trying to avoid that risk factor issue by advocating favorable differential treatment for countries entering the market as new producers of manufactures or semi-manufactures. Unless an LDC country's exports are growing above the average of all the suppliers, I do not see how this country can be subject to domestic injury invocation. Differential treatment in this sense would not harm efficiency. What would harm efficiency is the safeguard measures.

Differential treatment does not harm efficiency when applied to new entrants who are entering the market for the first time and whose exports are growing at less than the average rate, or whatever other standard is used for consideration of domestic injury. All exporters are not equally guilty of injury, and the LDC is usually least guilty because it is the newest and smallest entrant. The safeguard measure is invoked primarily against the large exporter but MFN forces the restriction upon all exporters. There is no virtue to MFN when it goes in a downward direction. MFN was put in for trade liberalization and to avoid nondiscrimination against the third party. But when you begin using it for a safeguard measure, the impact upon efficiency is in the wrong direction; such that you are over-correcting when you apply MFN. Hence, it is applying this safeguard tranquilizer in just such a haphazard fashion and forcing everyone to be subject to it is what causes problems. Therefore, a specific policy should remove the externality and the injury where it occurs, and it should do this as equitably as possible.

MS. ROBIN WHITE - Department of State: Dr. Meier, I think it is interesting that a country which has often been the target of safeguard actions, i.e., Japan, argues in favor of retaining the MFN principle. Japan feels that this dissuades a country because the country faces the pressure of all other countries who argue against the safeguard action, which, incidentally, would affect them.

DR. MEIER: I understand that.

MS. WHITE: So, for the LDCs' sake, some might be in favor of the MFN principle.

DR. MEIER: The LDCs would <u>not</u> favor the MFN. Japan would favor it.

DR. KENEN: Are there any other comments or questions?

Yes?

MS. CATHY ROE - Department of Commerce: I have a question for Lawrence Krause. He ended his discussion by saying that GATT needs general rules which would have the effect of protecting the weaker nations. Why do you think they do not already exist in the GATT and what kind of general rules do you have in mind?

DR. KRAUSE: I am afraid we got on the wrong track when we went to GSP, where the intention to help LDCs is laudable but the scope of that help is by construction very limited. Instead we should directly address the more fundamental problem, which is a multilateral negotiation to reduce tariff escalation on a Most Favored Nation basis on products in which these countries would normally find their comparative advantage. That is the kind of thing I would like to see, and of course, the numbers that are shown in Table II of the Murray-Walter paper show how fast the exports of developing countries are growing without GSP. I'am afraid we have pushed in the wrong direction to help the exports of developing countries.

The Subsidy and Countervailing Duties Negotiations and the Developing Countries

Daniel M. Schydlowsky*

I. Introduction

Concern with export promotion of non-traditional goods, particularly manufactures, has been on the increase among governments of less developed countries. Export support schemes of various sorts, including export subsidies, have been in force in a number of countries since the early 1960s. In the last few years, however, as some countries have had notable success with the promotion of non-traditional exports, other countries have attempted to follow their example, and the use of such promotion schemes, including subsidies, has become much more widespread. At the same time, the success of the export promoting pioneers had led to concern on the part of importing countries about the legitimacy of the export promotion instruments used. In the context of precarious balance of payments positions for some industrialized countries in the early 1970s and the oil price increases which produced a current account deficit for the industrialized world as a whole, the proliferation of export promotion policies, particularly export subsidies, has become a logical target for international regulation and agreement.

An accepted element of any new agreement on the use of export subsidies and other promotion schemes is that equity and international relations considerations justify a different treatment of export subsidies and other

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promotion schemes adopted by less developed countries, as compared to the developed countries. This paper addresses itself to an analysis of the kind of special treatment which is justified on efficiency grounds as well as being responsive to equity considerations insisted upon by LDCs. We will begin by exploring the context in which LDCs adopt export subsidization. Then two alternative versions of acceptable export subsidization are considered. Finally, some matters of technique and administration are discussed.

II. The Context

The development strategy of less developed countries has been overwhelmingly based on the expansion of industry. It was hoped that industrialization would boost the rate of growth, reduce overt and disguised unemployment and cure what was considered excessive dependence on traditional exports. The policy adopted to this end was vigorous protection of all import competing industrial production, behind substantial tariff walls and other import restrictions.[1] Such a policy obviously implied protection of industrial production for a particular market, namely the domestic market, but not protection of industrial production for exports.[2]

1 For a discussion on these import substitution policies see: Schydlowsky D.M., "Latin American Trade Policies in the 1970's: A Prospective Appraisal", Quarterly Journal of Economics, Vol. 16, May 1972.

Hirschman, Albert O. "The Political Economy of Import Substituting Industrialization in Latin America" Quarterly Journal of Economics, Vol. 82, No. 1, February 1968.

Balassa, Bela, "Growth Strategies in Semi-Industrial Countries" Quarterly Journal of Economics, Vol. 84, No. 1, February 1970.

2 Little, I.M.D., Tibor Scitovsky, & Maurice Scott, Industry and Trade in Some Developing Countries. A Comparative Study, Oxford University Press, 1970.

The development strategy adopted, based on import substituting industrialization, had an inherent inconsistency built into it, which, however, only became apparent after a number of years. Production of industrial goods requires imports of industrial raw materials and intermediate goods. Thus the higher the level of industrial production, the greater the imports of inpu required. On the other hand, since industrial goods were not being produced for export, industry itself did not produce a direct foreign exchange offset to these growing import requirements: industrialization was foreign exchange using. The only offset which industry provided was the foreign exchange freed through import substitution of previously imported industrial goods. As imports of particular commodities produced went to zero, this offset disappeared. Thereupon, the success of industrialization strategy, namely a rate of growth of industry in excess of the rest of GNP generally, implied a rate of growth of demand for foreign exchange in excess of the rate of growth of supply of foreign exchange. Thus success of the strategy implied of necessity balance of payments crises.

When such crises did occur, and the post war economic history of the LDCs is studded with such instances, industrial growth had to slow down, foreign debt had to be accumulated and/or foreign private investment had to be lured in. None of these measures cured the fundamental inconsistency of the strateg Slowing down industrial growth meant abandonment of the primary policy objectives and increasing foreign debt simply implied postponing the day of reckoning, since only an exponential growth of debt, acceptable to neither borrowers nor lenders, would have postponed the need to repay and to substantially reduce badly needed imports of industrial inputs at a later date. Foreign private investment was no longer effective. If it was in the modern industrial sector, it too was foreign exchange using and if it were in the primary sector, it would produce some alleviation, but would require a remission of profits, thus having its own "import requirement".

The inconsistency of the development strategy could only be overcome if industry was made foreign exchange earning, rather than only foreign exchange using. In turn, making industry foreign exchange earning implied extending the protection which was originally given to the production for the domestic market to production for all markets: i.e., protection against imports had to be extended to protection for exports. Hence export subsidization of one form or another was and is an essential requirement of a growth strategy based on an industrialization which is sustainable in the long run. The motivation encouraging the adoption of export promotion and subsidy systems by less developed countries is thus abundantly clear.[3]

To complete the picture of the setting in which export subsidization and other kinds of export promotion take place in less developed countries, it is useful to look briefly at the structure of the trading rules adopted by these countries. A particularly notable element is that less developed countries pride themselves upon having a single exchange rate. Many of them even subscribe to article VIII of the IMF. At the same time, however, all LDCs operate with a multitude of high and differentiated import restrictions. When this import regime is put together with the unitary exchange rate, what emerges is a de facto multiple exchange rate system consisting of a single "financial" exchange rate and as many "commodity" exchange rates as there exist differentiated tariffs. A peculiarity of the

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3 For an extensive treatment of the strategy, its inconsistencies and its causes and consequences, see: Diamand Marcello, Doctrinas Economicas, Desarrollo Independencia, Buenos Aires, 1973.

system is that commodity exchange rates differ for the same good when it is imported or exported: commodity import exchange rates are high and commodity export exchange rates are low. Furthermore, most import commodity rates are substantially above the financial rate. On the export side, some countries have operated at times with an export tax on traditional export commodities which reduced the commodity exchange rate for traditional exports below the financial exchange rate. A good example is the system which was operating in Argentina in 1966 and had approximately the following set of rates:[4]

Rate	Composition		Pesos per $
Agricultural Export	= Financial less 9% tax	=	200
Financial	= Financial	=	220
Non-traditional Export	= Financial + 18% tax rebate	=	260
Raw Material Import	= Financial + 50% duty	=	330
Semi-manufactures Import	= Financial + 109% duty	=	460
Components Import	= Financial + 173% duty	=	600
Finished Prod. Import	= Financial + 218% duty.	=	700

A quick inspection of this rate structure will show why industry fails to generate foreign exchange and thus is foreign exchange using. Industry buys its raw materials at an exchange rate of 330 pesos per dollar, its imported semi-manufactures at 460 and its components at 600. This implies an average cost exchange rate for imported inputs of approximately 400 pesos per dollar. Domestically produced inputs have implicit exchange rates only slightly lower, since most domestic producers do not sell at prices much below those of similar imports. Thus industry's cost exchange rate for all material inputs is roughly between 380 and 420 pesos per dollar. At the same time industrial wages reflect the cost of living which is raised by the tariffs on goods consumed by workers. Furthermore, profit rates are

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4 CARTTA (Camara Argentina de Radio, Television, Telecomunicaciones y Afines)., "Proyecto de Modificacion de la Estructura Arancelario-Cambiaria", September 1966.

based on the cost of capital goods which are also subject to tariff. Hence total industrial costs are based on an exchange rate exceeding 400 pesos per dollar. At the same time, a dollar's worth of exports yields only 260 pesos per dollar (the commodity exchange rate for untraditional exports). The implication of this situation for the profit rate on exports is rather dramatic.

The effect of the existence of this de facto multiple exchange rate system with its particular structure goes beyond the direct discouragement of exports, however. It has caused an "inefficiency illusion" to exist about industry in less developed countries. This illusion results from translating domestic industrial costs into dollars at the financial exchange rate and finding these costs to be substantially above the price of the comparative imports. Since domestic costs are based on the commodity exchange rates in fact incurred, and these are substantially above the financial exchange rate, it is not surprising that domestic costs of production will be higher than international prices when converted at an exchange rate lower than the one on which these costs are based. This commonplace practice of converting costs at the financial exchange rate, has, in the absence of the obvious explanation, produced the inefficiency illusion effect and given less developed-country governments and publics the impression that they have an industrial structure totally out of kilter with comparative advantage and hopelessly inefficient. The fact of the matter is, however, that much of that inefficiency is simply the result of an improper comparison by the use of an exchange rate that is not applicable to the respective costs. When domestic costs are transformed by an appropriate exchange rate, i.e., one that is related to the commodity rates, it turns out that industrial costs are much lower than generally believed.[5]

The inefficiency illusion and the anti-export bias in the exchange rate system have interacted to their mutual reinforcement and to the hindrance of a change in policy. The inefficiency illusion reinforces the belief of policy-makers that industry is not efficient enough to export. The anti-export bias in the exchange rate structure makes exports impossible. The resultant lack of exports confirms the policy ~~maker's~~ view that industry is unable to export. In view of the obvious scarcity of foreign exchange, however, the impossibility for industry to export means that additional import substitution must be undertaken. This in turn implies import restrictions which cause an increase in the inefficiency illusion. As a result the policymakers become even more convinced of the inefficiency of industry and its inability to export and at the same time the higher import restrictions increase the anti-export bias, thus making it even less likely that industry will become foreign exchange generating.

The inefficiency illusion also operates at an international level, generating the conviction that export promotion tools, particularly subsidization, are given as crutches to hopelessly inefficient industry, which could not survive in world competition on its own feet. Because of the formal separation of the unified exchange rate and a differentiated tariff system, the de facto existence of a multiple exchange rate system is lost from sight and therefore the inappropriateness of the simple cost comparisons

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Schydlowsky, D.M., op. cit., 1972.

Schydlowsky, D.M., "Price and Scale Obstacles to Export Expansion in LDCs", Y. Ramati, ed. Economic Growth in Developing Countries, Material and Human Resources, Praeger, 1975.

Balassa, Bela, "Latin American Trade Policies in the 1970's", Comment, The Quarterly Journal of Economics, Vol. 89, No. 3, August 1975.

Schydlowsky, Daniel M., "Latin American Trade Policies in the 1970's" Response, The Quarterly Journal of Economics, Vol. 89, No. 3, August 1975.

are not realized. The implications of realizing the nature of the exchange rate system and the size of the cost exchange rates affecting industrial costs for an assessment of export subsidization measures are very considerable indeed.

In the context just described, export subsidization and other measures, henceforth all called subsidization for short, have two fundamental justifications. The first of these is that export subsidies are designed to offset the excess of the industrial cost exchange rate over the financial exchange rate. On this basis, export subsidies simply refund a tax levied through the import price structure. We will discuss this justification for export subsidies in the following section under the name of the semi-traditional view. The second justification is based on the recognition that in addition to the non-unitary exchange rate other distortions exist in the economy, particularly in the labor and capital markets. These distortions introduce differences between private marginal costs and social marginal costs. Evidently, world welfare requires that production costs be minimized in terms of real costs i.e. in terms of marginal social costs. Thus subsidization will be justified to the extent that differences exist between marginal private and marginal social costs. This justification for export subsidization will be discussed in section IV.[6]

III. Acceptable Export Subsidization/I: A Semi-traditional View

It has long been recognized that exporters should not be placed at a competitive disadvantage as the result of taxation levied on the inputs into the exported product. Thus, industries transforming imported raw materials or intermediate goods into output that would be exported have

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[6] Ffrench-Davis and Pinera argue in favor of regarding "compensating" subsidies as acceptable, but do not clearly define the scope of the term. Ffrench-Davis, R. and Pinera, Jose, "Export Promotion Policies in Developing Countries", CEPAL, Seminar on Export Promotion Policies, Santiago, Chile, Nov. 1976.

always benefited from a refund of the duties paid on the imported materials, in this way being allowed to compete on the basis of their own productivity, unhampered by the taxation on the inputs that would have been levied if the refund would not have been forthcoming. The refund of such import duties, generally known as "drawback", is incorporated into most trade legislations and is universally regarded as acceptable "export subsidization".

As long as transformation activities operate 100% with imported inputs, the principle that each exporter should compete on the basis of his own productivity and not be penalized for artifically raised input costs is well served by the drawback. As soon as domestic production of inputs exists, that is no longer so. When some inputs are sourced domestically behind tariff protection, costs are no lower than when the competing import is bought. However, if the refund is only made available on that part of the increased costs corresponding to imported inputs, the general principle that the exporter should compete on his own productivity no longer holds in the presence of such local sourcing, therefore, the export subsidy should refund the full increase in cost due to the import protection. Accepted practice with regard to indirect taxation leads to the same conclusion.

It is only a small step to generalize the argument for material inputs to all cost increases arising from taxation on inputs. Three such cost increases not affecting materials bear particular mention.

a) Increase in labor costs due to protection on finished goods. If the supply of labor is a function of the real wage, the once and for all increase in the price level inherent in the presence of tariffs will lead to a once and for all rise in the money wage. The corresponding proportionate change might be called the tariff equivalent affecting wages.

b) Import duties on capital goods raise the cost of these capital goods and hence the annual depreciation. Furthermore, at any constant rate of return an increase in the cost of the assets implies that the annual profits in nominal terms must be greater in order to maintain the same real rate. Thus nominal capital costs per year rise as a result of taxation of capital goods.

c) Since interest costs are largely a function of inventories and working capital needs, the existence of tariffs increases the required working capital and hence the required interest costs.

We are now ready to formulate the general principle embodying the semi-traditional view of the acceptable level of export subsidization: "Refund all excess costs compared to the free trade situation at the existing exchange rate which result from the imposition of trade taxation on imports and exports".

The instrument which implements this principle is usefully called a "generalized drawback" to indicate at the same time its ancestry in the "traditional" drawback and the generalization which is undertaken to cover all repercusions of import protection onto increased export costs.

IV. Acceptable Export Subsidization II: An International Division of Labor Point of View

The purpose of world trading arrangements is the maximization of world welfare through the specialization of the different countries participating in world trade according to their respective comparative advantage. In practice, however, world trade flows are determined by the absolute advantage obtaining at each moment in time. Evidently absolute and comparative advantage need not coincide. However, when they diverge in the absence of restrictions on trade, balance of payments disequilibria ordinarily occur. When such disequilibria are adjusted through modifications in the exchange rates and when factor markets are undistorted and full employment obtains, the exchange rate adjustment necessary to equilibrate the balance of payments will also bring absolute advantage into line with comparative advantage.[7] Thus, given balance of payments equilibrium and full employment, achievement of specialization according to comparative advantage under free trade is equivalent at the micro level to the simple competitiveness criterion: a country has comparative advantage in all the goods which it can sell at or below the world market price.

When product and factor markets are distorted, i.e., when exchange rates are overvalued, import restrictions exist and factor markets do not clear at competitive prices due to imperfections and restrictions of various sorts, market competitiveness no longer provides a correct guide to comparative advantage. Rather, it is necessary to calculate marginal social cost in lieu of marginal private costs and compare the former with world price.

Conventional rules for accepting export subsidization are clearly understandable and justifiable in the light of the above discussion. If undistorted markets are assumed to hold, export subsidies are harmful to world welfare, since countries should not be exporting those goods in which they are not competitive at market prices. Furthermore, if there exists taxation on inputs which distorts factor and product markets, such taxation is legitimately offset by an export subsidy, since in the presence of such distortions, market price is no longer an appropriate guide to "real" competitiveness.

Less developed countries are well-known to have distorted factor and product markets. Labor is unemployed and underemployed, with market wages being held up by government legislation and institutional forces of various

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7. When trade restrictions are used for BOP purposes, the divergence between absolute and comparative advantage persists.

sorts (unions, peer group income sharing, traditional floors, etc.). Capital markets are segmented and interest rates are regulated through government imposed ceilings on rates paid and charged. Foreign exchange markets are distorted due to the presence of tariffs and other import restrictions, export taxation at various rates and possibly exchange control. In addition, the basic price, the financial exchange rate, is typically pegged by the government (the fact that it may be a crawling peg does not affect the fundamental existence of distortions in the market).

Furthermore, it should be realized that these distortions in the separate markets interact to produce a composite divergence between market prices and marginal social costs. Thus, for example, a marginal social cost of labor below the market wage implies by itself a marginal social productivity of capital above the market return to capital. The marginal social utility of foreign exchange above the official exchange rate implies that the marginal social productivity of capital in the exporting industries is above the marginal private productivity. In turn, tariffs on imports competing with domestic production implies that on this count taken separately, the marginal social productivity of capital in these industries is below the private marginal product. A proper social calculus will take into account the interaction of the distortions in the separate markets in a general disequilibrium system of shadow prices, which would adequately measure the marginal social cost or marginal social utility of the various inputs and outputs involved.[8]

8. For such a "general disequilibrium" set of shadow prices see: Schydlowsky, D.M., "Project Evaluation in Economics in General Disequilibrium: An Application of Second Best Analysis", Discussion Paper No. 1, Center for Latin American Development Studies, Boston University, March 1973.

Given such a set of prices, world welfare requires that LDCs produce for world use those commodities in which the marginal social cost of production lies below the world price. This implies valuing factor costs at their marginal social costs (shadow prices) and then translating these costs from local currency into foreign exchange values by use of the shadow price of foreign exchange. Whenever the dollar cost obtained in this fashion is below the world price, the corresponding LDC will be held to have a comparative advantage in that commodity compared to the rest of the world. Where several LDCs have costs below the world price, the one with the lowest cost will be held to have the comparative advantage.

While comparative advantage measured as social competitiveness may exist in the broad range of industrial goods, private competitiveness may not exist. This divergence between marginal social cost and private costs is legitimate ground for export subsidization.

Two further elements need to be mentioned:

a) A major empirical difference exists between short run and long run marginal social costs in LDCs due to the severe under-utilization of installed capacity that appears to be the norm in many and perhaps all of them.[9] Under such conditions, the marginal social cost of capital is at most equal to the user cost and may be as low as zero. Combined with a marginal social cost of labor below the market wage, the result is to generate a strong <u>short run</u> comparative advantage in a wide range of manufactures. Evidently, however,

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9 Data collected for six Latin American countries in the course of a 3 year study shows possible increases of industrial production of up to 50%. This is found in: Schydlowsky, D.M., "Capital Utilization, Growth, Employment, and Balance of Payments and Price Stabilization" Discussion Paper No. 22, Center for Latin American Development Studies, Boston University, Dec. 1976. For a more pessimistic view covering two Asian and one Middle-Eastern country see: Hughes, Helen, "Capital Utilization in Manufacturing in Developing Countries" World Bank Staff Working Paper No. 242, Sept. 1976.

long-run marginal social costs will be higher and long run comparative advantage will be different. Subsidization for the short run should thus differ from subsidization for the long run.

b) World prices do not reflect consumer utility whenever import duties exist in the major consuming countries. Such import taxation drives a wedge between world marginal social cost and consumer marginal utility. Export subsidies offsetting such import duties are welfare increasing and thus are fully justified on world welfare grounds.[10]

However, since import duties vary by country, an export subsidy affecting this distortion would have to be specific by country of destination, which would be an administrative nightmare.[11] Offset then becomes either impossible or an average figure needs to be chosen. Since the spread of developed country tariffs is relatively narrow, the latter is probably the best solution.

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It should be noted, however, that the levying of import duties on the part of developed countries on exports from less developed countries together with the corresponding offsetting subsidies signify a redistribution of fiscal income from the poor to the rich, with the consequent worsening of world income distribution. Thus, it is preferable to remove the wedge between marginal social world costs and marginal consumer utility by repealing the import duties than it is to accomplish the same objective by imposing an offsetting export subsidy.

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I am indebted to Bela Balassa for pointing this consequence out.

The general principle of acceptable export subsidization on world welfare grounds can now be stated:

"Refund the difference between marginal social cost and marginal consumer utility, including the average import duties of the main importing countries".

The instrument which implements this principle can usefully be called a "generalized compensatory subsidy" to indicate at the same time that it is of general application and compensatory of pre-existing distortions.

V. Minimizing Explicit Subsidization: Compensated Devaluation

Viewing the trade regime of LDCs as an implicit multiple exchange rate system, where the composite of financial exchange rate plus trade taxation is what matters, allows consideration of various alternative measures of financial exchange rate and trade taxation. Thus, rather than having a financial exchange rate which is close to the commodity exchange rate for traditional exports, it would be equally possible to have a financial exchange rate close to the commodity rates for industrial production. Evidently, in the latter case import duties would be significantly lower and export taxes would be higher than in the former case. A change in the financial exchange rate accompanied by such offsetting changes in trade taxation constitute what is called a compensated devaluation.[12]

12 Such a policy was first proposed by this author for Argentina in 1966 and published as: Schydlowsky, D.M., "From Import Substitution to Export Promotion for Semi-Grown-Up Industries: A Policy Proposal", Journal of Development Studies, Vol. 3, No. 4, July 1967. A similar proposal was independently made by Marcelo Diamand and published as: Diamand, Marcelo, Bases Para una Politica Industrial Argentina, Cuadernos del Centro de Estudios Industriales, Buenos Aires, 1969, and as: Diamand op. cit., 1973.

In terms of the exchange rate system typically used by LDCs and exemplified by that existing in Argentina in 1966 in Section II above, the compensated devaluation would look as follows:

Pre-Compensated Devaluation		(Pesos/Dollar)		Post-Compensated Devaluation		
Commodity	Tax/Subsidy	Financial	Rate	Financial	Tax/Subsidy	Commodity
200	-9%	220	Agricultural Exports	330	-39%	200
200	0	220	Financial	330	0	330
260	+18%	220	Non-traditional	330	+18%	390
330	+50%	220	Raw Material Imports	330	0	330
460	+109%	220	Semi-Manufactured Imports	330	+39%	460
600	+173%	220	Component Imports	330	+82%	600
700	+218%	220	Finished Product Imports	330	+112%	700

Note that the commodity exchange rates for imports have stayed unchanged, as has the commodity exchange rate for traditional exports. Only the commodity exchange rate for non-traditional exports has risen to 390 pesos/$. This rise evidently constitutes the equivalent of a subsidy of 50% on non-traditional exports compared to the level of the initial pre-compensated devaluation situation.

It is immediately obvious that adoption of a compensated devaluation reduces the amount of explicit export subsidization that needs to be undertaken to offset the implicit export taxation inherent in the exchange rate system or to compensate for the divergence between marginal social costs and marginal private costs. At the same time, it must be realized that there are important differences between the effects of a compensated devaluation and explicit subsidization which render the two policy measures not fully equivalent.

The first difference that needs to be borne in mind is that as the size of the adjustment of the financial exchange rate increases, it becomes less and less possible to compensate the devaluation of the financial rate through reductions in import duties on the lower tariff items without going to import subsidies. Setting tariffs that would have to become negative for full compensation, at zero implies that incomplete compensation of the adjustment of the financial exchange rate will occur. As a result, cost of production will rise, effective rates of protection will change, and the structure of incentives to production will change as well.

A second difference to be borne in mind is the effect on the capital account. An outright subsidy does not affect the cost of paying outstanding foreign exchange denominated debts. A compensated devaluation is a tax on all foreign exchange debtors and a subsidy to all foreign exchange creditors. Since business firms typically tend to be foreign exchange debtors, the loss of wealth caused for them by the compensated devaluation may well lead to a temporary loss in risk bearing ability, thus reducing the effectiveness of the export promoting price stimulus.

The third difference of importance relates to the treatment of traditional exports. Under a compensated devaluation, traditional exports are taxed explicitly as compared to the implicit tax levied through the exchange rate when explicit nontraditional export subsidies are used. The existence of an explicit traditional export tax has the advantage that it can be replaced by a tax on the fixed resource entering into traditional export production, such as land or mining resources. Such a change in the nature of the tax, i.e., change from a production tax to a Ricardian land tax, removes the burden of taxacion from new output, thus eliminating a distortion between producer marginal revenue on traditional exports and the price of these exports.[13]

The fourth difference is the effect that a compensated devaluation has on the industrial inefficiency illusion. Since the financial exchange rate rises without an equal increase in the cost exchange rate of industrial production, industry appears suddenly to have gained in efficiency. However, the consequences of the industrial inefficiency illusion for development policy are considerable and negative thus any achievable reduction in this illusion should be regarded as an important advantage.

Since large explicit export subsidies, ven if justified, i.e., if consistent with the argumentation presented in sections III and IV, do give rise to pressures for the imposition of countervailing duties it would seem wise for LDCs to minimize such pressures by adoption of compensated devaluations as their "baseline" export promotion tool, to be supplemented by explicit subsidies to the extent made necessary by the differentiation in the structure of exchange rates (which a compensated devaluation cannot really deal with). Such a policy mix is consistent with the internal development desiderata relating to the substitution of export taxation by Ricardian rent taxation and to the reduction of the inefficiency illusion.

VI. Implementation Aspects

This section will briefly review the problems of implementation that might arise in LDCs where a generalized drawback or a generalized compensatory subsidy is to be applied. It will also briefly discuss the disputes that

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Diamand op. cit., 1973. He argues forcefully and convincingly that such a change would have far-reaching positive consequences.

might arise with importing countries over the appropriateness of the subsidies provided and the manner in which such disputes might be settled.

A generalized drawback requires three elements of information for its application to a product or sector: the cost structure, the level of taxation of inputs, and the repercussion of taxes on the nominal wage level. Information on the taxation of inputs is public knowledge, since it consists of the tariff schedule and the tax regulations. Information on the implication for the nominal wage level is a one time calculation which, once done, is applicable to al wage costs. The only piece of information which is specific to each commodity is the cost structure, and this can be obtained on the basis of industrial censi, which are run periodically, on the basis of the industrial surveys, which are usually undertaken annually, or on the basis of petitioning by individual would-be-exporters. If the last of these alternatives is chosen, the previous two can be used as checks on the truthfulness of the application made, in order to avoid over-subsidizatio

It should be noted that the information required for the application of the generalized drawback is somewhat easier to obtain than information required to apply the <u>conventional</u> drawback whenever the conventional drawback allows refund of import duties paid on imported inputs more than one stage back.

Importing countries that wish to challenge the generalized drawback provided by the exporting LDC would naturally have to focus their attention on the structure of costs, since both the tax rates and the effect on wages are public knowledge.

Challenges would have to be based on calculations showing that with a plausible cost structure and the existing taxes and cost increases for labor, the rate of export subsidization is excessive. The plausible cost structure can be taken from the importing country's industrial experience. The solution to the dispute will then consist of evaluating the respective cost structures. If the exporting country can document that its cost structure corresponds to the facts, then the export subsidy will stand, since the justification for the subsidy is to offset cost increases in fact incurred. The forum in which conciliation between importer and exporter will take place is a matter for intergovernmental negotiation, but might well fit into the GATT organizational framework.

Application of the generalized compensatory subsidy requires the same cost structure information as the application of the generalized drawback, and requires in addition the availability of a set of shadow prices for the inputs and outputs. The first of these elements can be obtained in the manner described above; shadow prices would need to be calculated by the government and announced publicly on an annual or semi-annual basis. Furthermore, the shadow prices should be the same ones that apply to the government's own investment activity. Disputes could again arise regarding the cost structure; however, disputes would not be appropriate with regard to the shadow prices unless the exporting government failed to use the same shadow prices on which export subsidies are based in its own investment planning. Where there was considerable fear and justified reason to believe that the shadow prices were tilted to generate high export subsidies, or were otherwise incorrect, it might be worth considering the possibility of governments being required to negotiate the value of their shadow prices with a suitable international agency, preferably a multilateral one. Whereas such a procedure would appear to have the advantage of an international setting of shadow prices, it does pose the problem of adopting a single world-wide methodology for the calculation of shadow prices and it does imp' some restriction on government sovereignty possibly a restriction in excess of what governments would find acceptable.

VII. Implications for the Adaptation of These Subsidy Proposals on the Productive Structure of the Developed Countries

The type of subsidization deemed acceptable in the foregoing is exclusiv export subsidization conducive towards bringing LDCs' productive structures closer to the underlying comparative advantage of the countries involved. A a result, the changes in location of world production which they would bring about imply an increase in world welfare. It follows that importing countri should cooperate in bringing about the adjustment process called for by thes export subsidies, in order to further the welfare of the world as a whole. Were importing countries to resist the changes in their own productive structures which are implied in a worldwide move to production consistent with comparative advantage, the effectiveness and desired result of the export subsidies would be lost. Hence, cooperating developed importing countries should provide adjustment assistance to those sections of their productive sectors which require such assistance in order to be able to complete a reallocation process in the face of increased import competition from less developed countries.

It should be noted that while the export subsidies of less developed countries produce a reallocation push in the developed importing countries, greater export revenue in LDCs will imply a higher level of economic activity and a higher rate of growth, which will generate a substantial increase in the demand for imports from developed countries. Thus, the LDCs will not only produce a resource reallocation push in developed countries but concurrently with that they will also provide a demand pull effect which will help absorb the factors of production released from the industries in which LDCs now become exporters into industries for which demand by LDCs has increased.

The relative speeds of the reallocation push and demand pull effects is likely to be of major importance in determining the ability of importing developed countries to adjust smoothly to a pattern of trade more in accordance with the underlying comparative advantage of all participants in world-trade. The export growth of LDCs' non-traditionals will be determined basically by two features: 1) the amount of excess capacity available in the industrial sectors, and its size in comparison to developed country importing markets, and 2) the rate at which sales efforts will achieve penetration into the importing markets. Information is available on the first of these elements, and indicates that considerable potential supply is available.[14] However, given the relative size of the world's LDCs and the markets of the developed countries, that export supply is still relatively small. Regarding the effectiveness of the sales effort, little direct information is available; however, the guess can be hazarded that sales penetration starts at a low level and gathers momentum as it advances, with cumulative effects over time.

The import demand effect on the part of LDCs will occur roughly at the same time as exports increase, since most LDCs spend foreign exchange earned at about the same rate as it enters their Central Banks' coffers. It is therefore probably reasonable to assume that an export promotion effort based on either of the two acceptable export subsidy schemes

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[14] Schydlowsky Op. cit., 1976.

would have considerable impact in a five year period. This implies reallocation of resources in importing developed countries at a speed which is certainly in excess of the natural replacement rate of machinery. Therefore, adjustment assistance needs to be provided from the outset, in sectors in which it is observed that LDC originating imports are beginning to appear as a significant part of supply on the market.

VIII. Conclusion

International acceptance of export subsidization by LDCs is justified on two alternative grounds:

a) no export producer should be penalized for taxation of his inputs; he should be allowed to compete on the unadulterated basis of his own productivity.

b) production for export should take place whenever marginal social cost in the producing country is below price (marginal utility) in the consuming country.

The first justification leads to international sanctioning of the generalized drawback; the second to sanctioning of the generalized compensatory subsidy.

In order to minimize international problems and to further their own development ends, LDCs would be well advised to adopt compensated devaluation as their "base line" policy and supplement with export subsidies as differentiation might require.

Neither implementation problems nor resolution of disputes seem unduly complicated, due to the public nature of many of the data inputs going into the construction of the value of any individual generalized drawback or generalized compensatory subsidy.

A Comment on Daniel M. Schydlowsky's "The Subsidy and Countervailing Duties Negotiations and the Developing Countries"

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In his interesting and imaginative paper, Mr. Schydlowsky makes three major recommendations. First, to the extent possible, developing countries should transform explicit export subsidies into implicit subsidies through a compensated devaluation. Secondly, existing drawback schemes should be generalized to offset taxes and tariffs on all direct and indirect inputs used in export production. Thirdly, a generalized compensatory subsidy should be applied to remove the divergence between the marginal social utility in consumption in the developed countries and the marginal social cost in production in developing countries. I will deal with these propositions in reverse order. I will then make some recommendations of my own.

A Generalized Compensatory Subsidy

The proposal for a generalized compensatory subsidy can be considered in two parts: adjustment for the divergence between marginal social value and the world market price in the importing developed countries and adjustment for the divergence between marginal social cost and the world market price in the exporting developing countries. Following Schydlowsky, I will neglect the difference between FOB export and CIF import prices on the assumption that the price paid for transportation services equals the marginal cost of transportation.

As to the first of these divergencies, Schydlowsky advances the following propositions: "World prices do not reflect consumer utility whenever import duties exist in the major consuming countries. Such import taxation drives a wedge between world marginal social cost and consumer marginal utility. Export subsidies offsetting such import duties are welfare increasing and thus fully justified on world welfare grounds" (p. 187)

While billed as a 'non-conventional' view, this argument represents the textbook case for free trade based on the loss of consumer satisfaction due to tariffs. In effect, Schydlowsky suggests re-establishing free trade conditions in the developed countries through export subsidization in the developing countries at a rate equal to the tariff imposed in the former group of countries, so as to reduce prices paid by the consumer to the world market level.

If export subsidies indeed reduced prices to the consumer by the full amount of the tariff, prices to producers in the developed countries would decline commensurately. But developed countries can hardly be expected to countenance undoing the protective effects of their tariffs by establishing free trade conditions "through the back door."

Incidentally, concern on the part of the developed countries with the application of export subsidies in developing countries has had little to do with balance-of-payments deficits in the early seventies or the oil price increase. In fact, exchange rate flexibility has largely eliminated the need for protection on balance-of-payments grounds. Rather, one should emphasize the power of special interest groups, labor and business, in industries whose comparative disadvantage is not offset by exchange rate adjustments, as well as the concern of political decision-makers with noneconomic objectives and the problems of adjustment to free trade.

At the same time, export subsidies would fully offset tariffs, and thus remedy distortions in consumption in the importing countries, only if certain assumptions are fulfilled. They include perfect competition as well as infinite export supply elasticities in the developing countries and infinite elasticities of substitution between product varieties produced in developed and in developing countries.

These assumptions are rarely fulfilled in practice. Thus, rather than the price paid by the domestic consumer declining by the full amount of the export subsidy, there may be little effect on prices if developing countries have a small share in the world market and export supply elasticities as well as substitution elasticities are low. In the extreme case, prices to consumers will remain unchanged and profits of exporters in the developing countries will rise by the full amount of the export subsidy.

Once we admit the possibility that domestic prices in the importing countries may not decline by the full amount of the export subsidy, and introduce competing developed-country suppliers, the analogy will be with the general preference scheme rather than with free trade. Schydlowsky's proposal will then be equivalent to a 100 percent preference to developing country exporters financed, however, from the budget of the developing, rather than the developed, countries. The polar cases distinguished here are those of Harry Johnson: Price reduction by the full amount of the prefer (export subsidy) or no price reduction at all.[1]

Correspondingly, the well-known objections to the generalized preference scheme apply to Schydlowsky's proposal as well. To begin with, trade diversion may dominate trade creation. Also, with the movement towards free trade among the industrial countries, export subsidies would temporarily provide competitive advantages to the developing countries, leading to a resource allocation that may not be sustainable in the long run. At the same time, in addition to its adverse revenue effects, Schydlowsky's proposal is open to objections on administrative grounds which again do not apply to the general preference scheme: with tariffs differing among developed countries, export subsidies would have to vary according to the destination of exports.

If we do not accept arguments for subsidization based on the premise that distortions in consumption in the developed countries would be remedied thereby, the question remains if export subsidization could be admitted on the grounds that it would remedy distortions in production in the developing countries. Such distortions, resulting in differences between marginal social cost and the world market price, are said to find their origin in differences between the market and the shadow prices of primary factors. This proposal may be queried from the practical as well as from the theoretical point of view.

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[1]H. G. Johnson, "The Theory of Effective Protection and Preferences", Economica, May 1969.

Schydlowsky exhibits some unease in the face of practical problems *, but he persists nevertheless. In his view, the "shadow price would need to be calculated by the government and announced publicly on an annual or semi-annual basis." And, "disputes would not be appropriate with regard to the shadow prices unless the exporting government failed to use the same shadow prices on which export subsidies are based in its own investment planning" (p.194).

Now, few governments of developing countries consistently use shadow prices in their investment planning -- if they engage in investment planning at all. And, the surveillance Schydlowsky suggests by "a suitable international agency, preferably a multilateral one in the event that there was considerable fear and justified reason to believe that shadow prices were tilted to generate high export subsidies, or otherwise incorrect" (p.194), shows too much confidence in the ability of these agencies to estimate correct shadow prices. In particular, notwithstanding the reference to his very interesting paper on disequilibrium exchange rates, neither Schydlowsky nor anyone else has solved the problem of the consistent estimation of shadow prices in the partial equilibrium framework that is universally applied.

An additional consideration is that the provision of export subsidies on the basis of differences between the shadow prices and the market prices of individual factors would not have the desired effects as far as factor usage is concerned. This is because resource allocation takes place in response to market rather than shadow prices, and hence, in increasing output in response to export subsidies, producers will expand the use of all factors, irrespective of whether their shadow prices are below or above the market price.

A more appropriate solution is to directly remedy distortions in factor markets that give rise to differences between shadow and market prices. This conclusion is strengthened if we consider that in semi-industrial countries, which export manufactured goods, factor market distortions are due largely to government actions. Such actions take the form of artificially lowering capital costs through a policy of low or negative real interest rates, the subsidization of capital-intensive public utilities, and low tariffs or free entry of capital goods as well as raising labor costs through social security legislation and restrictive regulations that reduce labor mobility.

A Generalized Drawback Scheme

Having noted that, under international rules, "industries transforming imported raw materials or intermediate goods into output that would be exported have always benefited from a refund of the duties paid on the imported raw materials" (p.182), Schydlowsky suggests that this be extended to imports used in producing domestic inputs that enter into export production. In fact, this is presently the case as the relevant GATT rules have been interpreted to relate to duties on both direct and indirect inputs.[2]

[2] Provisions of Article XVI:4. Report of Working Party adopted on November 19, 1960 (L/1381). GATT, Basic Instruments and Selected Documents, Ninth Supplement, Geneva, 1961, pp. 186-7, para 5.

The same considerations apply to indirect taxes. International rules permit refunding indirect taxes paid on both direct and indirect inputs used in export production and these rules are widely applied. Thus, indirect taxes on direct and indirect inputs are refunded automatically under the destination principle if value added taxes are employed. And, under the destination principle, refunds are made for estimated indirect taxes paid at various stages of production also in countries such as Brazil and Mexico, which have cascade-type taxes.

At the same time, refunding indirect taxes paid on direct and indirect inputs used in export production under the destination principle is not a subsidy since it only re-establishes tax neutrality for exports and imports.[3] Note further that refunds of duties and indirect taxes are cumulative so there is no danger that one of these would not be admissible.

Schydlowsky further suggests that refunds of duties and indirect taxes on material inputs be extended in the form of a "generalized drawback" to other cost items. These include import duties paid on capital goods, the increased interest cost due to the need for greater working capital to purchase goods subject to tariffs, as well as increases in labor costs resulting from the imposition of tariffs on the goods labor consumes.

Import duties and indirect taxes on capital goods used in export production are covered by international rules in the same way as material

[3] Bela Balassa and Michael Sharpston, "Export Subsidies by Developing Countries: Issues of Policy", Commercial Policy Issues, No. 3, Geneva, 1977 -- Under the origin principle, neutrality requires that no refund be made, nor are indirect taxes imposed on imports as under the destination principle. This alternative is, however, applied in a few developing countries.

inputs, hence no changes are necessary on this count. In fact, most developing countries provide duty free entry and tax exemptions on capital equipment used in export production.

In turn, there are practical problems of estimation in regard to the increased interest cost and wages due to protection. Furthermore, the question arises if "the game is worth the candle", i.e., whether the magnitude of these refunds would be appreciable in actual situations. This issue will be discussed in connection with the proposed compensated devaluation scheme below.

Compensated Devaluation and the Alleged "Inefficiency" Illusion

Schydlowsky correctly notes that, in cases when the official (or financial) exchange rate applies to primary commodities while tariffs are levied on manufactured goods, the exporter is subject to an implicit tax because he pays duty-inclusive prices on his manufactured inputs. He furth claims that this "has caused an 'inefficiency illusion' to exist about industry in less developed countries. This illusion results from translating domestic industrial costs into dollars at the financial exchange rate and finding these costs to be substantially above the price of comparative imports" (p.179). At the same time, in Schydlowsky's view, "much of that inefficiency is simply the result of an improper comparison by the use of an exchange rate that is not applicable to the respective costs" (p. 179).

The fact that making estimates at the existing exchange rate overstates levels of protection, and of inefficiency, has been known for some time. Also, estimates of net protection, adjusting for the difference between the actual and the free trade exchange rate, have been made for several developing countries.[4] However, these estimates show that a considerable degree of inefficiency remains even after the adjustment.

Similar results are obtained if calculations are made utilizing the tariff data for Argentina presented by Schydlowsky. In the examples given in Table 1, at the end of this comment, it is assumed that material inputs and value added each account for 50 percent of the value of domestic output for both semi-manufactures and finished manufactures, and that all material inputs are imported.[5] World market values for output and material inputs are now obtained by deflating domestic values by the tariff.

In the case of finished manufactures, we find that adjusting the domestic value of output by the 218 percent tariff and that of the material inputs (semi-manufactures) by the 109 percent tariff, we obtain an effective rate of protection of 567 percent. In turn, for semi-manufactures, which use raw materials subject to a tariff of 50 percent on inputs, the result is 245 percent. The high effective rates of protection thus point to a considerable degree of inefficiency in Argentine industry.[6]

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[4] Cf. Bela Balassa, "Growth Strategies in Semi-Industrial Countries", Quarterly Journal of Economics, February 1970.

[5] Bela Balassa, The Structure of Protection in Developing Countries, Baltimore, Maryland, The Johns Hopkins University Press, 1971, Ch. 3.

[6] To the extent that material inputs are produced domestically at a cost exceeding the import price, the efficiency of domestic industry will be overstated.

It may be objected that part of the high effective protection may be due to excess profits. Argentine profit rates are not sufficiently high, however, for this to be an important consideration.

The numerical magnitudes are affected, but the general conclusion remains unchanged, if we follow Schydlowsky in making adjustments for the effects of protection on wages. To take the case most favorable to Schydlowsky, it will be assumed that value added consists entirely of wages. In turn, wages are assumed to be spent in equal proportions on foodstuffs, finished manufactures, and services, where the latter consist largely of wages and can be disregarded. Now, with a 9 percent export tax on foodstuffs and a 218 percent tariff on finished manufactures, the average duty on goods consumed by labor will be 42 percent.

Correspondingly, in addition to the 16.7 pesos tariff reimbursement on material inputs, domestic producers of semi-manufactures will now receive a 14.7 pesos reimbursement for tariffs imposed on the goods labor consumes, totalling 31.4 pesos. This compares with 52.2 pesos, the absolute difference between domestic and import prices for semi-manufactures indicating an excess cost of 20.8 pesos over and above the tariff reimbursement. The same conclusion applies to finished manufactures where the total amount of tariff reimbursement will be 40.8 pesos and the price difference 68.6 pesos, with an unreimbursed excess cost of 27.8 pesos.

Let us consider next the effect of a compensated devaluation on the numerical results. Taking Schydlowsky's example of a 50 percent devaluation accompanied by a corresponding reduction in tariffs, tariffs on material inputs will disappear in the case of semi-manufactures so that no refunds will be required on this count. And, with a 39 percent export tax on foodstuffs, adjusting for the cost of goods consumed by labor will require an additional tax of 3.1 pesos rather than a refund.[7] By contrast, the excess of domestic over world market prices is 28.3 pesos.

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[7]A fortiori, the same conclusion applies to industries that use foodstuffs as inputs.

Thus, notwithstanding the decline in effective protection from 245 percent to 130 percent, the excess cost of domestic production has increased from 20.8 pesos to 31.4 pesos following the compensated devaluation. The same conclusion applies to finished manufactures where the effective rate of protection has declined from 567 percent to 346 percent while the excess cost of domestic production has increased from 27.8 to 41.9 pesos.

It appears, then, that while adjustment for a compensated devaluation lowers the measured effective rate of protection, i.e. the percentage excess of domestic over world market value added, it increases the measured excess cost of domestic production in absolute terms. And while too much should not be read into the comparisons of the results without, and with, compensated devaluation, the existence of inefficiency is nevertheless apparent.

This is not to say that a compensated devaluation would not be desirable. Suggestions to this effect were made by the present author in 1966 for the sake of improving the competitive position of nontraditional exports in the developing countries.[8] More recently, it has been recommended to combine a compensated devaluation with import subsidies, a possibility which Schydlowsky apparently excludes.[9]

Note further that over the past two decades several developing countries have carried out compensated devaluation, with favorable effects on their nontraditional exports. There have also been cases of explicit

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[8] Cf. Bela Balassa, "Integration and Resource Allocation in Latin America", paper presented at a Conference on the Next Decade of Latin American Development held at Cornell University in April 1966 and at the Conference on Strategies for the Foreign Sector and Economic Development held in Buenos Aires in September 1966. Published in Spanish in Comercio Enterior, September, 1966 and in Estrategias De Industrializacion Para La Argentina (Marie Brodersohn, ed.), Buenos Aires, Institute Torcuato di Tella, 1970.

[9] Bela Balassa and Michael Sharpston, "Export Subsidies by Developing Countries: Issues of Policy", op. cit.

import subsidies for foodstuffs, thereby reducing the cost of goods labor consumes and moderating wage claims, which would have adversely affected the competitiveness of exports. Also, export subsidies over and above tax and tariff rebates have come into use, leading to further increases in nontraditional exports. This, in turn, brings us to the question of the economic justification of export subsidization in developing countries.

Export Subsidization in Developing Countries

We have seen that the proposed generalized compensatory subsidy is open to objections on practical as well as on efficiency grounds. In turn, refunds of tariffs and indirect taxes paid on inputs used directly or indirectly in export production are acceptable under international rules and have been used by most developing countries. At the same time, refunds for tariffs levied on goods consumed by labor may not amount to much, given the tendency observed in many developing countries to keep down the cost of living by the use of subsidy measures as well as the increased reliance placed on compensated devaluation. And, as tariffs continue to be used in developing countries, and show a pattern of escalation from lower to higher levels of fabrication, tariff refunds on inputs fail to eliminate discrimination against exports and in favor of import substitution.[10]

Such discrimination interferes with efficient resource allocation and it has been shown to have adverse effects through the expansion of high-cost import-substituting industries, the loss of economies of scale, and inadequate specialization, eventually leading to a slowing-down of

[10]It will be recalled that the refund of indirect taxes under the destination principle is not a "genuine" subsidy; rather, it re-establishes tax neutrality for exports and for import substitution.

economic growth.[11] Conversely, countries that have provided equal incentives to exports and import substitution in the manufacturing sector have exhibited a rapid growth of exports and GNP.[12]

While the provision of equal incentives to exports and import substitution in the manufacturing sector of the developing countries is justified on efficiency grounds, international rules are asymmetrical in the treatment of the two. Thus, while import protection is considered to be in the purview of every country, importing nations may employ retaliatory measures in cases where export subsidies have been granted.

The asymmetry is not warranted, however, since import protection and export subsidies are symmetrical in their effects on the economies of foreign countries; they favor domestic production at the expense of foreign industry that will be adversely affected in its export or in its own domestic markets. Accordingly, the question of export subsidization becomes part of the broader issue of preferential treatment to manufacturing activities in the developing countries.

Such treatment is warranted because manufacturing activities provide social benefits in the form of the "production" of skilled labor and technological change that are not fully captured in the entrepreneur's profit calculations. There is a difference in this regard between manufacturing

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[11] Cf. Bela Balassa, "The Structure of Protection in Developing Countries," ch. 4.

[12] Cf. e.g. Bela Balassa, "Export Incentives and Export Performance in Developing Countries: A Comparative Analysis", Washington, D.C., World Bank Staff Working Paper No. 248, January 1977.

and agricultural activities as the latter generally use less skilled labor and, moreover, technological change is promoted chiefly by agricultural stations rather than by individual farms. And, although ideally preferential treatment of manufacturing activities should be provided by production subsidies, these are not practicable in most developing countries because of their limited capacity to raise taxes, so that a combination of import tariffs and export subsidies would need to be used instead.[13]

While import tariffs cum export subsidies on manufactured goods produced by the developing countries are warranted on economic grounds, it would be desirable to limit the extent of export subsidization, so as to assure that developing countries do not employ excessive subsidies that distort competition and involve an economic cost to them. I have elsewhere suggested that this be done by adopting international rules to limit the acceptable rate of export subsidy to the average tariff on manufactured imports in the exporting country.[14]

This proposal represents an application of the "market principle" by providing equal incentives to exports and import substitution in the manufacturing sector of each developing country. At the same time, the necessary data are easily ascertainable from the customs records of any country. Thus, average tariffs can be calculated as the ratio of tariff revenue to import value.

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[13] For a detailed discussion, see Bela Balassa "Reforming the System of Incentives in Developing Countries", World Development, June 1975 -- Republished in Bela Balassa, Policy Reform in Developing Countries, Oxford, Pergamon Press, 1977, ch. 1.

[14] Bela Balassa and Michael Sharpston, "Export Subsidies by Developing Countries: Issues of Policy" op. cit. -- In the same paper, the application of international rules is proposed to exclude particular products and countries showing evidence of superior competitiveness from the scheme and to administer injury provisions in cases that fall outside the scheme.

It has been objected that countenancing export subsidization in the developing countries would reduce pressures for tariff reduction in these countries. Experience indicates, however, that in practice the opposite has been the case. Thus, by easing the foreign exchange constraint, export subsidization has permitted developing countries to liberalize imports as they are now able to avoid excessive import substitution. This conclusion applies to countries in the Far East, such as Korea and Taiwan and in Latin America, such as Brazil and Colombia.

Finally, it should be emphasized that, since developing countries tend to spend the entire increment of their foreign exchange earnings, increased exports due to export subsidization will give rise to increased imports. Thus, the acceleration of economic growth in these countries led by exports will benefit the developed countries through the expansion of export industries where they possess comparative advantages. At the same time, through an intensification of assistance to import-competing industries, the problems of adjustment could be reduced.

Table 1

Rates of Protection and Tariff Refunds

	Without compensated devaluation (220 pesos per dollar)			With compensated devaluation (330 pesos per dollar)		
	Domestic Values (Pesos)	Rates of Protection	World Market Values (Pesos)	Domestic Values (Pesos)	Rates of Protection	World Market Values (Pesos)
Nominal and Effective Protection						
Semi-Manufactures						
Material Inputs	50	50%	33.3	50	0%	50.0
Value Added	50	245%	14.5	50	130%	21.7
Value of Output	100	109%	47.8	100	39%	71.7
Finished Manufactures						
Material Inputs	50	109%	23.9	50	39%	35.9
Value Added	50	567%	7.5	50	346%	11.2
Value of Output	100	218%	31.4	100	112•	47.1
Labor Cost Calculation						
Foodstuffs	25	-9%	27.5	25	-39%	41.3
Finished Manufactures	25	218%	7.8	25	112%	11.8
Total	50	42%	35.3	50	-5.8%	53.1
Tariff Refunds						
Semimanufactures						
Material Inputs	16.7			0		
Labor Cost	14.7			-3.1		
Total	31.4			-3.1		
Finished Manufactures						
Inputs	26.1			14.1		
t	14.7			-3.1		
Total	40.4			11.0		

A Comment on Daniel Schydlowsky's
"The Subsidy and Countervailing-Duty Negotiations and the Developing Countries"

Matthew J. Marks

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I think before starting, I should say something about my background because I have heard the heavy economic coloration in everything that has been said here. I am not an economist; I am a lawyer. I have had many years' responsibility for administering the Countervailing Duty Law in the Treasury Department. I also had experience in GATT discussions, representing the United States. My comments are going to be colored by this background.

The thesis of Professor Schydlowsky's paper is that a theoretical comparative advantage should be calculated for each developing country based on:

a) cost structures;

b) levels of taxation of imports;

c) repercussions of taxes on the nominal wage level.

Each developing country should be allowed to subsidize its exports to the extent that the subsidies are consistent with the country's theoretical comparative advantage. Importing countries of the developed world, in making the necessary internal adjustments to these subsidies, will further the welfare of the world as a whole.

A number of comments can be made with regard to this thesis:

1. <u>Limited Concern of Nations in World Welfare</u>

Importing countries of the developed world will be prepared to take measures to further the welfare of the world as a whole only to the extent that these measures are not inconsistent with what these importing countries deem to be their own welfare. Developing countries are likewise concerned primarily, if not entirely, with their own welfare. To put it bluntly, the interests of developed and developing countries in world welfare is strictly circumscribed. I highlight this very obvious fact because of its importance to the Multilateral Trade Negotiations. They will succeed only if they are premised on reality.

2. Obstacles to Nations Seeking to Advance Their Own Welfare

Even the concern of nations for their own welfare is circumscribed. Examples are:

a) the unwillingness of developed countries to submit to required economic disciplines, such as restraint in the use of energy; and

b) the failure of even relatively wealthy developing countries to take steps clearly in their own interest to make foreign investment attractive. This is highlighted in an article in the Washington Post describing the current scene in Nigeria.[1]

3. Need for Discipline of Market

Discipline is required for both developed and developing countries to act in their long-term self-interest. Hopefully, the long-term self-interest of nations will be consistent with world welfare. This discipline is rarely self-generating. The exigencies of the marketplace, although sometimes brutal, force such a discipline on nations who would not, of their own volition, submit.

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4. Would Adoption of the Schydlowsky Thesis Undermine Discipline of the Market?

I fear that adoption of the thesis outlined in the Schydlowsky paper would retard the economic advance of developing countries by delaying their adaptation to the realities of the market. Screened from reality by international acceptance of export subsidies, developing countries would lose whatever incentive they might otherwise have to compete effectively in the international marketplace.

5. Other Alternatives for Increasing Trade of Developing Countries

It would be a mistake to provide in the Multilateral Trade Negotiations for a blanket exception affecting exports of developing countries. If exemptions allowing developing countries to utilize export subsidies are drawn too broadly, the larger and wealthier developing countries will quickly drive the poorer countries to the wall.*

It should be kept in mind that a tax system is required to finance export subsidies, and the larger, wealthier developing countries are far better able than the poorer countries to finance such costs. The Multilateral Trade Negotiations will hopefully result in the delineation of particular circumstances which warrant special exemptions. Any exemptions granted should be temporary and subject to review for renewal. They should take into account competition among the developing countries for export markets. They should provide for a "graduation" formula. The more successful a developing country becomes in its export sales, the less it has need for resort to exemption from normal GATT restraints on export subsidies.

Ambassador Harald Malmgren in an essay entitled "International Order for Public Subsidies", prepared for a meeting in Bellagio, Italy, sponsored by the Trade Policy Research Centre in June 1976[2], highlights still another essential point for the Multilateral Trade Negotiations which has not been adequately grasped to date:

> "Stabilizing and making predictable the rules of the game by which the more developed countries function should be the first priority of the developing countries .... The issue of special derogations for developing countries should be viewed as a matter of secondary priority, in terms of its economic value to them."

6. Conclusions

We should not accept subsidies lightly. In the language of Ambassador Malmgren correctives which appear to be helpful, tend in the long-term to lead to economic distortions which become capitalized and extremely difficult to eliminate.

Finally, since the Multilateral Trade Negotiations will succeed only, if based on political realities, let us not forget the problem of the individual producer in developed countries. No matter how efficient he may be, he is not in a position to compete effectively against the subsidy resources of a foreign government, even if that government is a poor developing country.

2 Harald Malmgren, "International Order for Public Subsidies", a Thames Essay of the Trade Policy Research Centre, London, 1977.

REPLY AND DISCUSSION

DR. PETER KENEN: Thank you, Mr. Marks. Dan, I wonder if you would like to reply now or would you rather wait until we have questions from the floor?

DR. SCHYDLOWSKY: I would like to respond now, while the points made are fresh in everybody's mind. Let me first respond to Bela's comments. I should begin by saying that I am delighted that he shares my view that export subsidies by LDCs are justified on economic efficiency, not only equity, grounds. Furthermore, he shares my liking for a generalized subsidy, although he differs on size and justification for it.

Bela does not like a subsidy to cover the difference between marginal social cost in the LDCs and marginal social utility in the importing DCs because: (a) on the demand side the General Preference Scheme would be superior and in any case "trade diversion may dominate trade creation"; and (b) on the supply side "subsidies will expand the use of factors whose shadow price is below the market price as well as the use of factors when the opposite is the case." He also cites implementation problems.

I will treat these objections in turn. On the demand side, two things can occur as a result of an export subsidy: (i) price in the importing country can fall, with the consequent increase in consumption and reduction in domestic output; or, (ii) price stays constant and there is only a reduction in domestic output. The world welfare effect of any increase in consumption is clearly positive. The world welfare effect of a displacement of DC production by LDC production depends on whether the marginal social costs of LDC production are lower or higher than the marginal social costs of DC production. I would venture to say that under normal circumstances (i.e., when DC economies are at normal levels of employment) marginal social costs in LDCs are well below those of DCs. In the current stagflation this conclusion is more questionable; however, I think that it holds nonetheless. Hence world welfare would be increased both by the increase in consumption and by the displacement of DC production.

What then of the superiority of the General Preference Scheme? Of course it is better to have a subsidy on LDC exports financed by the importing developed countries than by the exporting LDCs! However, this applies not only to a subsidy equal to the importer's tariff but to any subsidy, including the one Bela himself espouses.

On the other hand, I do not find the argument that trade diversion may dominate trade creation at all convincing and the reason is that while trade diversion may dominate at <u>market prices</u>, that same trade diversion will be found to be world welfare augmenting at shadow prices, to the extent that marginal social costs are lower in LDCs than in DCs.

Bela's argument on the supply side is a conventional appeal to adopt a first best policy. While LDC factor prices remain distorted, however, second best remedies come into their own. My proposal is avowedly second best in kind: Expanding the use of a factor bundle of fixed composition that <u>in toto has marginal social</u> cost below the utility it generates is welfare creating notwithstanding the fact that expanding factor use non-proportionately would be even more welfare augmenting. The best may be the enemy of the good, it does not therefore make the good into bad!

Regarding the implementation problem, I am a great believer in the power of the carrot. Given an incentive to do so, many governments who do not now use shadow prices in their investment planning will begin to do so, the international agencies will further sharpen their skills and economists will more generally share my conviction that shadow prices can be consistently estimated.

Let me now turn to Bela's comment on my proposal for a Generalized Drawback. Here I am afraid that he has misunderstood me. I proposed that the refund consist of "all excess costs compared to the free trade situation at the existing exchange rate which results from the imposition of trade taxation on imports and exports "(underlining added). In particular the drawback should include not only tariffs paid on direct and indirect imports but also the increase in the cost of domestically procured inputs that have gone up in price as a result of trade taxation. Those cost increases, although tariff caused, are not covered by current GATT rules.

Now let me turn to the question of the "Inefficiency Illusion" and my proposal for a Compensated Devaluation. The first thing I should like to point out is that there is a very important difference between the cost exchange rates of the various sectors and the estimated free trade exchange rate. Hence the adjustment for general overvaluation in the studies Bela refers to[1] does not correctly adjust for the use of a wrong exchange rate in cost comparisons.[2]

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1 Balassa, B. "Growth Strategies in Semi-Industrial Countries", Quarterly Journal of Economics, Feb. 1970; Balassa. B. & Associates, "The Structure of Protection in Developing Countries, Baltimore, Md: Johns Hopkins Press 1971.

2 For a careful empirical calculation of such rates see Berlinsky, J. and D.M. Schydlowsky, "Incentives for Industrialization in Argentina", Occasional Paper No. 1, Center for Latin American Development Studies, Boston University, to appear in Balassa & Associates, Development Strategies in Semi-Industrialized Countries, forthcoming.

The second fundamental fact I should like to point out is that the inefficiency illusion can and does coexist with real inefficiency. This is presumably the point which Bela intends to make with his table where the strong reduction in inefficiency illusion due to 50% compensated devaluation still leaves a high level of effective protection in place. However efficiency must be measured by valuing domestic factors at shadow and not at market prices, thus the social effective rate of protection (= direct domestic resource cost of foreign exchange minus one) and not the effective rate of protection as usually measured is the appropriate indicator of efficiency.[3] As a result, nothing can be concluded from Bela's table regardi real inefficiency.

I should also clarify the increase in excess (money) cost of domestic production which Bela claims to find as a result of a compensated devaluation. The simple explanation is that while the absolute amounts rise (due to the 50% devaluation in the financial rate) the percentage of excess (money) cost to output cost at world market values stays constant at 44% for semi-manufactu and 89% for manufactures (after allowing for rounding errors in the table). Such constancy is not surprising since a fully compensated devaluation leaves all domestic relative prices unchanged.

Thus I must say that I fully agree with Bela that "too much should not be read into the comparisons of the results without and with compensated devaluation" (p 209). However, that "the existence of inefficiency is nevertheless apparent" (Ibid) is by no means clear from the table as it stands.

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[3] See Balassa, B. and D. M. Schydlowsky, "Effective Tariffs, Domestic Cost o Foreign Exchange and the Equilibrium Exchange Rate", JPE, June 1966, also Balassa, B. and D. M. Schydlowsky, "Domestic Resource Costs and Effective Protection Once Again", JPE, Jan/Feb. 1972.

Despite his foregoing argumentation, however, I am pleased to note that Bela feels compensated devaluation[4] to be desirable and points out that it has been successfully used by some countries.

Bela also recommends export subsidies, albeit only on infant industry and externalities grounds. I am a bit puzzled at this position in view of his earlier arguments about the complications of calculating shadow prices. Surely the quantification problems involved in infant industry and externality protection are nothing short of formidable.

Bela's concrete recommendation to limit the subsidy rate to be below the ratio of the subsidizing country's tariff collections to imports will render it virtually ineffective. We know very well that an own-weighted import index is a downward measure of protection. Hence Bela's avowed goal of symmetry would not be achieved. Moreover the worse the balance of payments situation, the higher the protection of products other than food and fuel, but often the lower therefore the tariffs on food and fuel. If these two categories absorbed 80% of import expenditure and had zero tariffs, the subsidy would be restricted to 20% of the tariff collections on the remaining imports (capital goods? essential raw materials?). Why such an export rate subsidy ceiling would effectively keep the country from generating exports can clearly be seen by recalling the excess domestic cost figures from Bela's own Table I.

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[4] For clarity's sake it should be pointed out that a compensated devaluation is not simply the devaluation required by any arbitrary reduction in tariffs to maintain the balance of trade constant; it is a carefully balanced and offsetting movement of tariffs and exchange rates designed to make non-traditional exports more competitive while keeping domestic prices constant. The balance-of-trade-maintaining devaluation has indeed been known for a long time and it is this type of adjustment touched on by Balassa in his 1966 paper (See Balassa, B. "Integracion Economica y Asignacion de Recursos en America Latina." M. Brodersohn ed. Estrategias de Industrializacion para la Argentina, 1970, pp. 53, 73) Compensated devaluation was proposed as an export promotion policy independently in the mid 1960's by M. Diamand of Buenos Aires (See. "Proyecto de Modificacion de la Estructura Arancelaria-Cambiaria" (mimeo) Camara Argentina de Radio, Television, Telecomunicaciones y Afines. Sept. 1966) and in 1966 by myself (See "From Import-Substitution to Export Promotion for Semi Grown-Up Industries: A Policy Proposal", Journal of Development Studies, July 1967).

Now let me turn briefly to Matt's interesting remarks. I fear that he views the Multilateral Trade Negotiations as a "zero-sum game" (What one gains, another must lose). Yet what comparative advantage theory tells us is that trade expansion can be a positive sum game. In the attempt to maximize that positive sum and distribute it fairly, export subsidies have a constructive role to play.

Moreover the "erosion of discipline" caused by export subsidies is contradicted by recent experience, as Bela has correctly noted: Countries liberalize their import trade more easily as a result of export success than as a prelude to it. Thus if we want import barriers in LDCs to come down, we should back the export supports!

Finally, there is the question of equity between LDCs. First of all, the world market is large enough for crowding out between LDCs to be limited to a very few goods. Second, as LDCs succeed in exporting, their home markets grow thus offering new opportunities for export on the part of other LDCs as well as DCs. Hence LDC export promotion is world market augmenting. Finally, the finance for these export devices can be provided by each LDC itself out of the tax revenue which the higher level of its domestic activity will provide for it.

DR. KENEN: Let us turn directly to comments and questions from the floor for the next fifteen or twenty minutes.

MR. LORENZO PEREZ - Agency for International Development: I share the concern of some of the discussants about Professor Schydlowsky's idea of proposing a compensatory subsidy that is needed because of the policies that the LDCs are following. It seems to me we are talking about defending, on efficiency grounds, special and differential treatment in the use of subsidies by developing countries. If this is so, we should be concerned about what is the cause of those market distortions that we are trying to correct by imposing a compensatory subsidy. Hence, I wonder if it would not be wiser to propose that temporary use of subsidies to correct these distortions be tied to some sort of mechanism by which the LDCs will change those policies that originally made the subsidies necessary.

MR. CONSTANTINE MICHALOPOULOS - Agency for International Development: My comments are addressed to Mr. Marks because I heard him say that in the context of the MTN, he could envision a situation under which special exemptions can be made for the developing countries. The paper presented by Dan Schydlowsky presents one case on the basis of which such exemptions can be made. Professor Balassa has indicated a modification on that particular basis of exemptions. I was wondering whether it is Mr. Marks' view that this basis for making the adjustment is a proper one or not, and if it is not what other basis for exemptions should be made, and how could that be administered? Thank you.

DR. KENEN: Are there any further comments and questions?

MR. PETER SUCHMAN - Deputy Assistant Secretary of the Treasury: I am Mr. Marks' successor and I also have a bit of experience in dealing with some of the same problems that he has encountered. Therefore, my comments may be colored in the same direction as Matt's.

I am terribly concerned with the administrability of the program as suggested in the Schydlowsky paper. I think, that as is the case with many of the works in this area that I have read, the authors tend to forget that these programs they are suggesting have to be constructed within a legal framework, especially a domestic legal framework. I think it is totally unrealistic to suggest that the United States Congress, leaving aside for the moment the Executive Branch, is going to agree to accede to rules regarding subsidies in international trade of an international body, whether it be the IMF or GATT or the OECD. Therefore, we are going to be left with some kind of law to administer in this country; and since the United States has the single, largest unified market for the developing countries, the question is, what should that be?

I do not think the kind of proposal made is administrable. I do not think that we could legislate, in acceptable Constitutional terms, standards that are based on rather vague economic concepts such as shadow prices, which administrators could apply and which would be upheld by the courts. And so, I think, that has been one of the problems with the literature in this area in that it has not been based on acceptable legal standards for administration.

Secondly, the other problem, that Matt touched on, is the need to disaggregate the domestic effects of foreign export subsidies. It is all well and good to look at the macro effects and say that you are increasing world welfare; but, as a matter of fact, if you just look at footwear, for instance, and look at the composition of the domestic labor force in this industry, you are dealing with more than 50 percent women, with workers who, for the most part, are either under 21 or over 50, and with many minority workers in essence you are dealing with the marginal labor force. These are people who do not have a great deal of mobility, so one has to consider the social costs incurred in the developed country, as a result of following these kinds of programs.

Finally, I would just urge those who are proposing such programs and really believe them to be easily acceptable to talk with the people in the Congress and get the reaction that they have to such a proposal. I think the acceptability, at least in this country, is zero. It may be possible that Congress will accept special and differential treatment, but, it is going to have to be explained in laymen's terms, to the 535 members of the United States Congress.

DR. KENEN: If there are no further questions or comments, I will first ask Dan for his reply to some of these comments and questions, after which I will ask Bela and Mr. Marks for their further comments.

DR. SCHYDLOWSKY: Let me go directly to a fundamental point, the distinction between first best and second best. I am quite certain it has been on a lot of your minds -- why offset a distortion, rather than getting rid of it? There is a lot of literature in the field which says that we ought to attack the root of the problem. In spite of this, there exists a proliferation of alternatives with rankings of first, second, third, and "nth" best.

Now here I side with Peter Suchman. Economists and others have been preaching to the world to adopt first best solutions for at least a hundred years, if not longer -- almost certainly, longer. But it is awfully difficult to get people to do it for a variety of reasons--some good, some not so good.

We need to do something which is feasible, and I may not have satisfied Peter's views as to what is feasible; but I still think that it is a lot better to propose second best solutions, than to fruitlessly attempt to eradicate problems at their source. I think if we went to the LDCs or anybody else and told them to get rid of their minimum wages and free their financial markets completely, by getting rid of tariffs and any other distortions they might have, they will thank us very politely, if they are gracious, but will show us to the door. Such a mental exercise serves to focus our thinking toward developing second best measures which compensate for existing distortions.

Now Lorenzo Perez's idea, I think is very interesting--to adopt those temporary second best measures that gradually lead to a first best situation. This is clearly a suggestion that is excellent, and ought to be explored further. Is there a way of phasing things in such a manner that we wind up with a first best? Yes, I think a way could be found so that the interests of the LDCs and the developed countries would coincide and by being gradual, this method has promise of being feasible and implementable.

I would like also to return to some of Matt's points. First is the issue of commonality of interest--that the developed countries also have an interest in liberalizing their trade in order to enhance world welfare. However, I think there is a problem with this, just as there is any time when one adopts something that has costs which are very visible.

While the United States and other developed countries have moved, over the years, towards liberalization, in spite of the fact that it was painful, this movement has been clothed in arguments about reciprocity and "we are getting some advantages and giving up some others." and so on and so forth.

The fact of the matter is that people are willing to incur costs for gains that they think they will get. However, while the costs of liberalization have always been clear, the gains have never been clear; yet the costs have still been incurred. Hence, it is not clear to me why one should not continue to do the same thing by simply turning it now to the LDCs.

There is also an issue here as to who pays the import tariff, and I am not so certain that I even really want to stand by my proposal that the LDCs should subsidize the equivalent of the DC import tariff. Maybe they should and maybe they should not, I think that is really debatable. It would indeed be much better if the developed countries just eliminate their tariffs on a preferential basis as Bela has suggested, but that is not very likely to happen.

But while there is a broad commonality of interest, this does not apply to my shoe-producing friends in New England. They are going to get hit and there is just no question about it. The United States probably needs to produce some minimal amount of shoes. Sweden believes that shoes are a strategic good and they have enough shoe production capacity to shoe their Army. Some of these types of arguments for domestic production are very convincing and can be handled without high import restrictions. And there, I think, the developed countries are flexible enough to provide production subsidies for the volume of output that they need. And that is the way to do it.

There is the more fundamental issue that this point raises, and unfortunately, it makes me feel that I have not been clear enough in my paper. I thought I had managed to say that the terms of competition for exporters in less developed countries were not fair terms of competition--that they were hobbled by taxes, which take the form of high input costs. Exporters are not competing on a fair basis, such that this trend in competition has been skewed by the structure of input costs. I also indicated that there is a longstanding principle that the terms of competition should be fair in the legal sense. Therefore, it is legitimate to adopt measures that restore that balance--that compensate for the existing and pre-existing unfairness in the terms of competition.

Concerning the legal argument, legal theorists and lawyers are very clear about their desire to be consistent. (If A is acceptable, then B which is equivalent to A, must be acceptable also). Now if one accepts the concept of devaluation, then the exact equivalent (namely, the export subsidy) ought to be equally acceptable. In fact, according to current legal arrangements, it is not. This seems to point out a legal inconsistency, and we need to do something about that if we do not want legal principles to be applied in an inconsistent fashion. This straightening out of any inconsistency simply responds to good legal practice.

Well, my last point deals with the administrability of my proposals. My second one, which is the generalized compensatory subsidy, would certainly be the more difficult to administer because of the issue of agreeing on shadow prices.

The other one, which is the generalized drawback, is quite easy to administer. I think that Congress could probably be convinced of this. I would be interested if I could get some more details on why you think this is difficult to do.

The strange thing about such proposals is that those which had appeared very difficult to apply twenty years ago, look quite simple to us now. There is a learning process which has been taking place. And I do not think that one can say: Well, it is so difficult to do, let us not even bother. Because that is a statement that says that the human being cannot learn (and that Congressmen cannot learn either). I think Congressmen can learn like the rest of us.

So with that optimistic note, let me stop.

DR. KENEN: Bela, do you have any concluding comments you would like to make?

DR. BALASSA: Yes, I would like to start with "the learning process." Indeed, what is the important lesson which the LDCs have learned? It is that compensated devaluations, which Danny and I have been recommending for fifteen years, will favorably affect industrial exports. They have also learned about the effects of reducing distortions in capital markets as well as in goods markets. Quite a number of countries have incorporated this learning into their trade policies.

Korea and Taiwan are examples and there are others as well. These successful cases indicate the need to continue advising the LDCs how to improve their policymaking in the future.

Let me come back to the question which Danny again raised -- the asymmetry in treating tariffs and subsidies.

Need for a symmetry of treatment is well understood at the World Bank. As noted in my joint paper with Michael Sharpston, it does not make sense to countenance tariffs and not to countenance export subsidies because they have the same effect on domestic production in a developed country. With LDC-imposed tariffs, the developed countries lose foreign sales; in turn, if LDCs pay subsidies to industrial exporters, developed countries lose domestic sales. More recently, this idea has been endorsed by the Under Secretary for Economic Affairs of the State Department, Mr. Richard Cooper.

We have further proposed that developed nations accept export subsidization of manufactured goods to the limit of the average tariff in the LDC. This is easy to measure. We have information on tariff rates as well as information on the value of the imports so that or can easily derive an average tariff. While the concept is imperfect, the measure is simple to derive and will allow for symmetrical treatment of tariffs and subsidies.

DR. KENEN: Mr. Marks, do you have any comments?

MR. MARKS: Yes. The first point I want to make is that when you take the second best approach, which is to compensate for distortions, you create a new problem; namely, that you have removed all pressures to eliminate these distortions, once you have compensated for them. And that, I think, is a disaster, because we should try to move toward the elimination of distortions.

Secondly, reference has been made to the compensated devaluation, which of course appears in the paper. This, of course, would result in a multiple exchange rate system, as I understand it, which recognizes the actual situation based on the commodity taxes of the developing country.

Under the traditional countervailing duty law, as interpreted by the Treasury Department, multiple exchange rates can be interpreted to be bounties or grants within the meaning of law and they have been countervailed at times.

DR. KENEN: Could we pause here to clarify that point?

MR. MARKS: Surely.

DR. KENEN: The compensated devaluation is not a multiple exchange rate practice. It involves a change in the financial rate in response to changes in trade taxation. You have only one explicit official exchange rate -- which is devalued compared to its pre-existing level -- but you have lower import duties and higher export taxes than you had before.

DR. BALASSA: You change the basic exchange rate, and alter tariffs and export subsidies.

MR. MARKS: All right.

Now then, the thought occurs to me -- this comes to Bela Balassa's thesis -- that we ought to have export subsidies to compensate for import tariffs. As I see this, it would take away the powers of decision from the developed countries that originally imposed these import tariffs.

DR. BALASSA: I am sorry but this is not correct.

The proposal is that a developing country like, let us say Brazil, has an average tariff of 25 percent. So developed nations would countenance a 25 percent actual subsidy in Brazil on manufactured goods -- taken as a counterpart of accepting two tariffs.

MR. MARKS: So, we are back to the first point I made that this removes pressure to reduce the original tariff. Hence, do we want to remove these pressures, or do we want to be in the situation where fifty years from now Brazil will still have a 25 percent tariff?

If we do not accept a proposal such as this, what do we do? I have many misgivings about any broad derogation which would permit an imposition of export subsidies free of a license under a GATT umbrella. I think this is an unrealistic approach. I think that, basically, it has to be looked at on a product-by-product and country-by-country basis. Then from that there may grow a realization that it is possible to perhaps establish some rule for a broader derogation.

DR. BALASSA: May I have one minute in which to comment on that?

I think that the opposite is the case -- that my proposal would increase the pressure for tariff reduction. I suggest this on the historical evidence: countries that had imposed export subsidies have been able to reduce their tariffs because through exports they have obtained the foreign exchange necessary to pursue industrialization strategies without encountering foreign exchange constraints.

Chairman's Concluding Remarks

DR. PETER KENEN: Before I try to perform my concluding duties, let me, on behalf of the sponsors and all of you, thank those who have presented paper today, those who have discussed them, and the members of the audience who participated in the discussion.

It is my difficult task to draw this discussion to a conclusion. If you are awaiting a synthesis or a single set of recommendations on all the issues, you will be disappointed. All that I can hope to do; and I will try not to ta long doing it, is to offer some thoughts that occurred to me as I read the pap and listened to today's discussions.

In this morning's discussion, I detected some reluctance on the part of t speakers, the discussants, and members of the audience, to endorse more extens and pervasive differential treatment for the exports of developing countries. We have, of course, gone in that direction in agreeing to the GSP -- but there would seem to be reservations about further movements in that direction, in th administration of QRs, and in the administration of safeguards.

There was general support for moving in the direction of special measures using the distinction drawn in the first paper, i.e., to single out products o commercial-policy problems that are of special interest to the developing countries so as to give them priority in the process of trade liberalization. But there was no such support for permanent or temporary differential treatmen within particular policy domains. This is partly for the reason emphasized several times, that the granting of specific differential treatment creates constituencies opposed to further liberalization, even as the granting of the GSP has created a constituency that is lobbying actively against further multilateral tariff reductions because they would reduce margins of preference presently afforded the LDCs.

Schydlowsky's paper is exceptional in that it argued for a double standard for reasons of efficiency, not just equity. If his proposal were carried to its logical conclusion, incidentally, developed countries would also have to offer export subsidies to the extent that they have import duties, or to the extent that they have internal distortions -- and they do have internal distortions. Here, efficiency is the criterion for allowing export subsidies, and equity is the basis for allowing LDCs exclusively to use them.

I do have some reservations, not only about the details of the proposal made this afternoon, but also about the general principle. There is, of course, a rationale for differentiating on a political basis, as well as on an administrative basis, between the issues we talked about this morning and those we talked about this afternoon. It is, as I suggested in my opening sentence this afternoon, one thing for us to agree to modify our own practices in trade with certain countries. It is another to allow developing countries to do things that we, the group of developed countries, do not ourselves do.

Very different political overtones attach to those two types of permissiveness. And there *may* be a stronger case for granting more freedom to the developing countries to do things we do not allow ourselves to do than for us to puncture our own rules and practices with exceptions that may be difficult to administer or contain, or which generate political abrasions as we decide that one country is eligible and another is not or withdraw certain concessions as countries graduate from one category to another.

This leads to one of my objections, and that of many other people, to the present GSP. The competitive-need formula, on the basis of which preferences are withdrawn, may sometimes be tantamount to a marginal tax rate in excess of a hundred percent. It may penalize success so heavily as to nullify the long-run benefits of the original concession.

Let me turn now to specific issues raised in some of the papers today, and let me also offer a suggestion of my own having to do with the complex of QR and safeguard problems that are probably the most important that we face if we propose to preserve a liberal trading order.

Dealing very briefly with the subsidy question discussed this afternoon, history suggests to me that countries which subsidize exports in order to offset their own protective import tariffs may thereby forego opportunities to reduce those tariffs; by subsidizing exports, they may diminish the exporting industries' incentives to lobby against tariffs on their inputs. There is a constituency, after all, in an export-oriented developing country, that should be opposed to import tariffs which handicap its doing business in world markets. That constituency should be strengthened, not weakened.

Going one step further, the theory of the second best -- if I recall it correctly in all its MIT permutations -- says that a labor-market distortion should be offset by a factor-market subsidy, and not by a goods-market subsidy or by one paid at the border when goods are exported. Thus, when we are concerned with the effects of labor-market distortions, including minimum wages and inflated labor costs caused by high wage-good prices due to import restrictions, we should recommend across-the-board labor subsidies. As I understand the present GATT rules, these would not violate the rule against export subsidization.

If one is to make a case for export subsidization, it should be based on the narrower argument that special handicaps are encountered at the border. But I would answer this case too, with objections based upon practicality. A few years ago, some of us were involved in what seemed at first to be a simple exercise; it was the attempt to calculate cyclically adjusted trade balances and to decide by how much the United States should devalue the dollar in order to achieve a given improvement in the cyclically adjusted balance. In spite of the large amount of econometric work that had gone into the estimation of aggregate trade equations, there was no agreement on the numbers, and for good political reasons.[5] Here, too, we may underestimate the difficulty of administering what may seem to be a simple rule for subsidization with the degree of agreement and transparency required from a legal point of view.

Let me turn now to the subject of this morning's meeting and call attention to a proposal that was made several times in the papers and in the discussion. It is to use a tariff quota to deal with market disruption. For those of you who are not familiar with it, the tariff quota imposes a basic tariff rate on a specified quantity of imports (the quota) and a higher tariff rate on quantities in excess of the quota. I would argue that a temporary tariff quota may be the best way of dealing with a market disruption.

If there is to be relief temporarily from import competition, each of the countries already exporting into the affected market would be granted a quota based on its historic share, with some part of the total quota remaining unallocated so that new countries can enter the market in stated amounts at the old, low tariff rate. Imports from any country in excess of its quota would enter freely but would pay a much higher tariff rate. Countries experiencing improvements in their competitive positions (reductions in their marginal cost) would thus be able to take full advantage of those improvements even to the extent of displacing goods from other countries within those countries' quota limits. The tariff surcharge imposed beyond quotas would have to go to zero gradually, according to a predetermined schedule, just as any other temporary safeguard relief should vanish gradually.

There are several reasons for going in this direction. First, the distortions introduced by a tariff quota, both as to the source of imports and as to the freezing of patterns of comparative advantage, are smaller than the distortions introduced by an outright quota. Second, a tariff quota avoids to some extent the problem of penalizing, through a uniform increase in tariffs or an absolute quota, countries that are not "responsible" for the immediate injury; i.e., the upsurge of imports that has generated demands for relief; the pre-existing quantities of goods would come in from those countries at the old tariff rate. Third, the tariff quota has the advantage that there is precedent for a scheduled reduction of tariffs (that is how the Kennedy Round trade concessions were phased in), whereas the precedents for liberalizing QRs, as in the OECD code of the '50s, are less satisfactory. There was more procrastination, more concealment, more back and forth movement in the administration of those provisions.

The only cases in which I would permit retaliation would be one in which a country failed to abide by the schedule for reducing the tariff surcharge or one in which it imposed safeguards of any type without living up to the procedural standards that Gerry Meier suggested. It is, I believe, increasingly important to have agreed procedural standards.

What would I say, then, with particular reference to developing countries?

It would seem to me desirable to move as rapidly as possible to new safeguard measures, especially to tariff quotas, going so far as to replace existing voluntary export restraints and the multifibre agreement. At the same time, we should begin gradually to include textiles and other sensitive products within GSP, for symbolic as well as economic reasons. The exclusion of sensitive products, but especially of textiles, is the sorest ulcer in trade relations between developed and developing countries.

Finally, it would be possible to grant preferential treatment to developing countries in the administration of safeguard provisions, as by applying the GSP margins of preference to tariff surcharges imposed by tariff quotas. Thus, the penalty or surcharge rate put in place temporarily to protect against injury might be made half as high on imports from developing countries.

Let me make two more comments along somewhat different lines, then open the meeting to discussion.

There may be other areas in trade policy that offer opportunities for special or preferential action in favor of developing countries. I have in mind particularly the vast domain of public-sector protection. We think of public-sector protection primarily in relation to such commodities as aircraft, electrical-generating equipment, and other highly sophisticated goods. ...t governments are also purchasers of many other goods, including large quantities of textiles and apparel. And I should think that the much-needed codification of rules for government procurement might allow for limited preferential treatment.

My last point has to do with adjustment assistance. It was introduced in the early '60s as a substitute for import-reducing safeguards but has won almost no adherents in the last fifteen years. It is perceived to be ineffective, partly because of remediable defects in the program but also because it confronts a fundamental difficulty. I can illustrate the point by recalling the explanation we give to our students as to why there is a well-defined difference between a market-disrupting technological change that arises at home and one that arises abroad. Taking first a simple mercantilist approach, consider the distinguishing characteristic of a domestic change. The beneficiaries and the losers are domestic, which means that there will be domestic constituencies on both sides applying pressure for and against protective action. But when we confront an improvement in competitiveness abroad, the gainers are on one side and the losers are on the other. It is thus easy to demand that the gainer--the foreigner--bear the costs of measures taken to cushion the adjustment process.

But there is, I think, a more sophisticated point at issue here. When there is technological change within an economy, the advancing sector draws resources directly and indirectly from the injured sectors. There is a pull of resource from lagging sectors to the advancing sector. But when injury occurs at home on account of developments abroad, the pull is elsewhere. Resources are not attracted from the injured sector. This suggests to me that our emphasis on retraining and other sorts of adjustment assistance, measures that are essentially permissive but do not create jobs, must be redirected. We may have to go further in the direction of area redevelopment and special assistance to the regions and industries that are adversely affected in order to generate employment opportunities not merely re-equip workers to fill opportunities. While I have every faith in the long-run value of retraining programs, the mix of adjustment policies must focus much more than it does now on the creation of opportunities for persons who are injured.

We have a long way to go, and I am very skeptical of promises that protective measures will self-destruct or that a predetermined schedule designed for the elimination of safeguard barriers will be obeyed unless opportunities are created at home that aid the complaining constituency.

I will close with the little story that is told from time to time about the first reactions of Detroit and Japan to the imposition of automotive emission standards. When faced with these standards, it is said, the Japanese hired engineers and the Americans hired attorneys. I suggest that our tradition is to stretch out scheduled changes and our lawyers are good at it. On this pessimistic note let me ask for comments on these and any other red herrings that may have been drawn across the table in the last few minutes.

DR. BALASSA: I have problems with the statements that have been made to the effect that foreign trade destroys jobs and does not create new ones in their place. If you operate with flexible exchange rates an increase in imports will bring with it a commensurate increase in exports and a resultant creation of jobs. In addition, it has been shown by several people that the labor-intensity of exports and imports does not differ in the United States. This means that if we admit more imports, we will export more and with the increased exports we will create jobs in the export industries to replace those lost in import-competing industries.

MR. MARKS: I just want to comment on your statement, Peter, dealing with adjustment assistance.

I think it is awfully difficult to view anything in the area of adjustment assistance unless we face up to the different definitions of that term that are prevalent, here in the academic community, in the Congress and in the Executive Branch. To the academic community, adjustment means that you permit the workers in this country, let us say, to move to another industry where they might enjoy a comparative advantage. As far as Congress and the Executive Branch are concerned, adjustment assistance means that with just a little help, they are going to beef up and beat that damn competition which is coming from imports.

Thank you.

DR. KENEN: That is extremely important.

MR. GEZA FEKETEKUTY: It seems to me that we have made a distinction between two kinds of adjustment assistance. Industry assistance is what you say has presumably been given to firms to try to beef up their capital investment or whatever, so they would be competitive. Generally, the support for that kind of adjustment assistance is low.

The adjustment assistance which has been used has been labor assistance, which basically becomes the supplemental unemployment benefit sort. This, in fact, does, in a sense, help to tide workers over the period while they are looking for another job.

DR. BALASSA: Which might be in a different industry.

MR. FEKETEKUTY: Yes, which might be in a different industry.

The problem is, of course, in areas, such as where the shoe industry is located, there are not many alternative jobs. This may be a reason why adjustment assistance is so unpopular with the unions.

MS. HORTENSE FIEKOWSKY - Labor Department: Professor Schydlowsky, I have been amused by the invocation of adjustment assistance as a sort of "holy ghost" to assist the quorum advocating help for the LDCs. We have not found the adjustment programs too successful as substitutes for jobs lost due to imports. Even if other jobs were created in equal amounts, new opportunities do not exist for old workers. A 40-year old man cannot start at the bottom rung. When an older man loses his job, he is permanently out of a job. A deliberalized adjustment assistance program is no substitute for a job even if it pays the equivalent of a job for the rest of a laborer's working life.

Other developed countries have forms of adjustment assistance not related to trade; and as you know, they have not found them to be a means for liberalizing their import restraints on LDC-products.

Finally, I have one general observation. I think all these attempts to help LDCs overcome their economic problems are equivalent to a social worker trying to alleviate the problem of poverty. We have a lot of specific solutions, but the problem of the LDCs lies within the LDCs themselves and is not directly affected by these little bandages that we are talking about here.

DR. KENEN: I hear rumblings from the head table.

DR. SCHYDLOWSKY: I think you have got more than half a point there. LDC governments obviously have to do lots for themselves. One of the things they have to do is diversify their export structure so that the path of industrialization may generally follow the export route. The LDCs' industrial sectors generate output for their domestic markets which are based on imported raw materials and intermediate imports of various sorts. The faster this sector is set to grow, the faster it generates growth in domestic employment but the more foreign exchange it needs. And it is just a fact of history that the primary sectors, which provide the foreign exchange to pay for the imported inputs needed by industry, are not ·e to grow that fast. So these LDCs manufacture balance of payments crises through their choice of this particular path of industrialization which has this feature built right into it. Hence, every four or five years you get a balance of payments crisis in every LDC and the only way to get out of that is by exporting some of the industrial products. If you tie that together with existing excess capacity and a lot of other things, it just strengthens the case for chronic periodic balance of payments crises.

So, they have to help themselves but they can not do it unless somebody is willing to absorb their exports and this is why the United States and other developed countries have to be prepared to absorb some of their products.

Now it would seem that, although an initial output has to be absorbed in the developed countries, it is not true that such absorbtion should dramatically expand because as less developed countries raise their industrial level, they, themselves, will absorb more of the industrial goods. This market enlargement effect, which some people regard as quite significant, causes some cross-hauling of exports and imports between LDCs. To start this scenario, LDCs need some pump priming where their exports are initially absorbed exclusively by developed countries. This involves accepting those exports under whatever name. The costs of this could be borne by the LDCs which employ the export subsidies or they can be borne in part by the developed countries, which involves the use of GSPs.

MS. HORTENSE FIEKOWSKY: LDC development does not have to be export-led with DC assistance. We have examples of many LDCs that have developed from an internal situation, or from their own trade liberalization efforts without depending on the developed countries up to this point. So I do not think we have any obligation to try to help the ones that could not respond.

DR. SCHYDLOWSKY: I think the only one that has been successful in the long haul, has been the Soviet Union.

MS. HORTENSE FIEKOWSKY: No, we have some examples in Brazil, Korea, Taiwan and Argentina.

DR. SCHYDLOWSKY: Well, those cases represent export-led growth.

MS. HORTENSE FIEKOWSKY: They did not require any help from us to expand exports.

DR. SCHYDLOWSKY: They have been subsidizing their exports in various ways. And while the record is pretty clear that they have used subsidies, they havenot been hit on it, except in the case of Brazil.

DR. BALASSA: Well, I thought I heard Mr. Goldfinger talking. I remember meeting him two years ago at the World Bank where he represented the AFL/CIO in discussions on adjustment problems. He made a similar statement, as you have done, when he asked the question. How long? He answered: Fifty years. Indeed, it is difficult to argue with unsubtantiated statements of this sort.

But may I correct a factual error in your statement? Brazil, Korea and Taiwan have all experienced industrial growth which has been export-led.

Apart from the gains due to specialization from comparative advantage, this has been due to the fact that the countries in question do not have sufficiently large domestic markets to permit efficient production in the presence of economies of scale. In turn, restrictions on their exports would have been detrimental to the United States and other developed countries since they would have earned less foreign exchange to import from these countries.

The second point is that adjustment assistance has worked in several countries in Europe and this is supported by the findings of the recent OECD study.[1] And, in at least one case, in a Uniroyal plant in Rhode Island producing rubber footwear, it has also worked in the United States.[2]

Thank you.

DR. KENEN: Any more questions?

Dan, you wanted a further comment, and I want to reply to Bela.

DR. SCHYDLOWSKY: Really, one of my further comments is to emphasize even more strongly the point that less developed countries use their export proceeds to import from the developed countries. There is very little hoarding of foreign exchange reserves, so that what goes out on one side comes back in on the other.

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[1]Development Centre of the Organization for Economic Cooperation and Development: Adjustment for Trade, Studies on Industrial Adjustment Problems and Policies, 1975.

[2]J. F. McCarthy, "Contrasting Experiences with Trade Adjustment Assistance," Monthly Labor Review, June 1975.

Now it is true that Brazil displaces the production of shoes in New Hampshire and it does not generate demand for shoes on the other side. The major demand is for machinery and the mach.nery may not be produced in the same New Hampshire town in which the shoes are produced. This is what adjustment to shifts in comparative advantage is all about and one has to be aware that this is where the problem exists. One has to be aware of the fact that as developed countries' supplies in some industries are displaced, the demand for developed countries' supplies in other industries simultaneously increases.

Now here we have the difference between LDCs and DCs which comes back to the point Peter was making earlier. LDCs do not accumulate foreign exchange reserves, except in the oil countries (and we make a difference between the oil producing LDCs and the other LDCs). Oil producing countries cannot spend all of their reserves, and any exports from them do not come back into the expenditure stream.

But the developed countries, Europe and Japan, do have very different balance of payments situations. There is no guarantee that they ill channel back to us what they displace in terms of domestic production, because their reserve policies do not rigidly set specific reserve levels such that any excess above those levels is rapidly spent. So the developed countries have to rely on the flexible exchange rate, the thing I mentioned before, to generate, again, demand to offset the displaced domestic production.

In the LDCs, we do not need to rely on flexible exchange rates. They simply do not accumulate exchange reserves because there is much too much to expend them upon.

DR. KENEN: Let me make just one or two comments in reply to some of these issues, including comments on the red herring that I dragged across the table -- my suggestion concerning tariff quotas.

First of all, Mr. Marks has raised a very important issue. Academic economists do fail to deal with a number of the barriers to labor mobility, including the problem of vested pension rights. What is worse, we fail to recognize that occupational mobility has a geographic dimension. If you look, for example, at the literature on optimum currency areas, you will discover a total confusion of occupational with geographic mobility. Very often, the optimum currency area is defined implicitly as an individual worker, since he may not be able to change occupation without also changing location.

It seems to me, moreover, that we have to give more emphasis to localized adjustment assistance, if only because we have one-member constituencies in Congress, and there will always be strong pressures to protect or help constitutents where they are, rather than helping them to go elsewhere.

I would like now to say a few words about tariff quotas. First, it probably is true that a disturbance that involves an increase of exports to us will eventually involve an increase of imports from us. However, I suggest the process is slow and diffuse, and is certainly less well perceived than when a disturbance arises domestically.

I would also ask you not to invoke flexible exchange rates as a solution to a problem of this kind. We do not have flexible exchange rates. We have one freely fluctuating rate between the mark and the dollar, a couple of others that do not fluctuate as freely, and a few that are steadily depreciating. The rest, however, are fixed. It is a disservice to dramatize the difference between August 14, 1971 and February, 1973. The exchange-rate regime is a mixed system, and it does not solve trade problems or monetary problems as readily as some of us promised that it would.

With respect to the problem of new producers, I did suggest that one might underallocate the initial quota (i.e., the quota coming in at the old tariff rate). This would leave room for the assignment of small quotas to new producers. To illustrate, any country that did not have as much as a one percent share of imports into the U.S. market on the benchmark date could increase its sales at the old tariff rate until its sales reached, say, two or three percent of total imports within the original quota.

Finally, let me address myself to the problem that arises when LDCs are the "source" of the injury and are also subject to an LDC penalty rate that is only half as high as the penalty rate faced by other countries. The solution is to set the rate at what you want it to be for the LDCs, then double it for the DCs' rate. In other words, you can impose the import limitation that you want by appropriately adjusting the rate structure.

On that note, I will subside in favor of one more comment or question from the floor.

MR. JERRY LaPITTUS: Dr. Schydlowsky, your argument might be slightly .akened by advocating a single policy solution for two distinct sources of the divergence between social and private marginal costs.

In passing, you remarked that besides externalities in production and infant industries, LDC export competitiveness is weakened by a host of domestic policy distortions such as overvalued exchange rates and export taxes. As a result of advocating export subsidies for both externalities and policy distortion problems you get the people in this audience (and you would get the people in the Multilateral Trade Negotiation) upset for a very good reason. You would be advocating a system of permitting export subsidization as a result of and as a solution to policy distortions within the LDCs themselves. You immediately get the response that I believe Mr. Marks mentioned -- that if you were to permit the LDCs to subsidize exports on grounds of policy distortions, you would not resolve, but rather, perpetuate the problem, and this is a danger that must be avoided.

To resolve the problem, you should distinguish between production externalities and policy distortions as sources of divergence between social and private marginal costs. Production externalities do provide an efficiency-based reason for subsidization which may prove acceptable from the point of view of most economists. Offsetting domestic policy distortions by export subsidization is not likely to be regarded as an acceptable form of subsidization in the context of the MTN.

I do not know whether you agree or not -- whether it merits comment on your part.

DR. SCHYDLOWSKY: I am familiar with the argument. It is a first-best argument. But it seems to me to be in the same category as the one about fixing exchange rates. Because fixed exchange rates generate discipline, the thinking was that the moment you let the exchange rates fluctuate there is going to be nothing to encourage discipline.

I am convinced that you cannot get rid of distortions except over a fairly long period of time and only after you have a much higher growth rate. So it seems to me you have got to start with the compensation, the bandages if you will, which is your second best measure. You can then gradually work your way to the first best measure.

The point is that you have got to start there because when we insist upon first best measures, nothing happens. Hence, I have concluded there is no point in beating my head against the wall. I would rather walk around the wall if I want to get behind it, rather than trying to do the impossible -- going through it.

DR. KENEN: We have reached our scheduled time for adjournment.