Transformation Assistance from Developed Countries to Developing Countries

—An Aid to Trade Expansion?—

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I. Introduction

The pressure for protection is always greatest during periods of recessionary unemployment. The recent persistent calls in the UK for import controls are one example of a tendency which has been evident throughout the developed world in the mid 1970s. Nevertheless, it will be argued, these demands have not in the event been translated into restrictive measures on trade. This is certainly true so far (1977) of trade within the developed world, largely because of widespread recognition of probable retaliation in kind by other countries. But the case in respect of trade between developed and developing countries is much less clear. The formal position of protectionist interests in this type of trade has in one respect been greatly strengthened in recent international agreements. This is to do with developed countries' discretionary powers to revoke these agreements;

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the greater potential for escape clause action considerably undermines the value of such agreements to developing countries in view of past demonstrations of the developed countries' willingness to take such action when domestic interests press strongly enough for it. The purpose of this paper is partly to examine the consequences of such discretionary powers in trade for LDCs; but more generally to put forward in the light of this and other difficulties associated with a shift towards a more outward looking policy by LDCs the case for trade transformational assistance from the developed world to LDCs. LDCs should not be penalised as they presently are for the vagaries of developed country trade policy; moreover, if the developed world is indeed genuinely concerned that there should be a global expansion of trade there is a case also for financial assistance to LDCs in the business of changing the industrial structure in favour of export activities.

It may seem paradoxical to be pointing to a resurgence of protectionist potential when the immediate evidence of the past few years suggests a move on the part of the developed world in the opposite direction towards a general expansion of trade. The collective pressure of LDCs for improved access to developed markets has resulted in the adoption of preference schemes for LDCs first by the EEC and Japan and then by the US and others. Collective negotiation continues in the North-South dialogue and elsewhere as part of the pressure for a new international economic order. Whether the success so far is due to the newly maintained solidarity of the Third World or the threat in the background of oil price increases, or even a renewal of the oil embargo by OPEC countries on their own or on other countries' behalf unless terms are improved, is difficult to say. But in any case the gains to LDCs are more apparent than real. The commitment to the principle of preference is both circumscribed and contingent on the absence of deleterious effects within the developed world. The preference schemes are limited in scope; a quantitatively successful developing country soon defines itself out of the group of countries subject to tariff preference.[1] Secondly, the provisions under which 'safeguard' action may be taken to protect developed country producers facing competitive

(1) See R.N. Cooper, "The European Community's System of Generalised Tariff Preferences: A Critique," *Journal of Development Studies*, Vol 8, July 1972; and below, p. 206 ff.

imports have been strengthened. The GATT itself (operative from 1948) included a provision for the re-imposition of import restrictions without time limit in certain circumstances (Article 19). In the US Trade Act of 1974, the conditions under which such action may be taken there are made much easier, and the same would appear to be true of the EEC and Japan. Article 19 of the GATT, which allows tariff cuts to be withdrawn, did not seem of course to be very important during the fairly long period, up to the mid 1960s, in which there was no reduction in the general level of tariffs. It is of greater significance now, when moves are being made to promote global trade expansion, which in the first instance makes an outward-looking development strategy a more attractive proposition to developing countries. But the incentive to them to undertake such a policy is illusory if the tariff reductions on which access to developed country markets in part depends are liable to be reversed on sufficient pleading from domestic interests. A genuine, effective and enduring trade liberalisation policy plainly requires measures to prevent or at least discourage the re-imposition of restrictive policies in the future.

This paper attempts to suggest *one* such possible measure—the idea of adjustment or transformation assistance, in the context of promoting trade expansion as between the developed western world and the developing countries. We do not attempt to evaluate here the case for trade expansion *per se*. We argue that a case exists for the developed countries to finance, whether as a complement to increasing trade liberalisation amongst themselves, or as a complement to expansion of their trade with developing countries on a multilateral or bilateral basis, a programme designed to help in adjusting productive activity in the developing countries so that it accords more with the needs and risks of a more open-door situation of wider trade. We would justify this in terms of two principles generally recognised as providing the basis for domestic adjustment assistance programmes, such as have been undertaken in the developed countries (and incidentally well recognised in the teaching of Welfare Economics). These are, first, the principle of promoting the optimum allocation of factors of production by reducing or removing frictional difficulties; and second, the principle of compensation to parties adversely affected in this process. Such

a programme is also in the interests of the developed countries both because of their direct interest in trade expansion, especially in critical situations like the present, and in their more general self-interest in furthering economic development. Adjustment assistance paid by developed to developing countries would help them to mitigate the risks involved in adopting the more 'outward-looking' stance required for trade expansion. The risks involved in such a shifts in policy are significant in light of current developed country polcies and attitudes and the adjustment payments proposed would also ensure that in the event of the trade expansion being reversed by the unilateral action of a developed country(or countries), the developing countries would know that they will be compensated for loss of export earnings built up on the assumption of a long-term and secure relationship. Such payments would also have the additional effect of acting as a deterrent—or at least a penalty—on restrictive policies by developed countries.

It is necessary to stress again that we see such adjustment assistance payments as only *one* element facilitating a policy of systematic trade expansion. We are setting aside the more fundamental questions to what extent the present framework of world trade and the terms of exchange should be changed before the developing countries find it in their true long-run interests to participate to a maximum extent. We take it for granted that the developing countries wish to expand their exports in the framework of the actual trade system and have decided (rightly or wrongly) that this is necessary in their own interests. However, it should be noted that the implementation of our proposals for automatic compensation to LDCs to cover developed country policy induced variations in the demand for their exports, and to assist in trade-related structural transformation should modify the attitude of those LDCs which have been hesitant to commit themselves to an outward-looking strategy. The disproportionate burden of risk which LDCs are made to carry by the practice of protectionist intervention by developed countries is an important aspect of the subordinate position which countries like Algeria and Tunisia see for themselves in the present world trade system. It is not by any means the only feature of trade disadvantageous to LDCs, but improvement on this count should at least stimulate a re-evaluation of the costs and benefits

involved in a more open economic policy. It is unlikely thought to affect policy in another group of countries, such as Cuba, the Korean Democratic Republic and Vietnam, which maintain quasi-autarky in the belief that integration in the world trade system is incompatible with true national determination thereafter, and for whom modification of part of this system is insufficient to validate the whole.(2)

The ideas sketched out in this paper are necessarily exploratory. Thus far, 'adjustment assistance' has been treated as part of a *national* programme to solve *national* problems. We believe it has a part to play in the *international* context in respect of expanding trade between the developed and developing world. There are in fact two precedents for this proposal for international compensation in relation to trade. Under Article 19 of the GATT a small number of compensatory payments have been made by importing countries on their withdrawal of trade concessions on the grounds that they threatened "serious injury" to domestic producers. In all such cases, however, the compensation was made by one developed country to another.(3) Secondly, the United States paid Turkey significant compensation as an inducement to Turkish farmers to stop them growing opium poppies. This was a measure designed expressly to reduce export production, but it is relevant to the more common situation of sudden loss of an export market. (Complete elimination of the market was indeed the main objective but it could not in this case be arranged by normal (or abnormal) methods of intervention.) We suggest that the principles for compensation embedded in these two examples, which this paper is designed to explore, should be generally extended in matters of international trade and become the basis for a class of transfer payments from developed to developing countries. But even if the wider case should be accepted there remain many questions of mechanics and of political feasibility and acceptability to be discussed.

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(2) We were prompted to consider these points by our colleague Reg Green.

(3) See J.N. Bhagwati, "Market Disruption, Export Market Disruption, Compensation and GATT Reform," *World Development*, Vol. 4, No 12, 1976. Bhagwati makes no comment in his text on the compensation payments made under GATT though a number of such payments are included in his Table 2.

II. Compensatory Payments as a Means of Reducing the Degree of Risk and the Possibility of Disruption

An open economy is generally characterised by an instability in the employment of factors of production. Subject to stronger competition both in world markets and at home from competing imports, an open economy generally exhibits both more rapidly declining sectors of production and more rapidly developing sectors, while overall obtaining the benefits of exploiting comparative advantages. These benefits in developing countries should be in terms of employment and more equal income distribution as well as GNP.(4)

Therefore, trade liberalisation and trade expansion create problems of adjustment and frictional unemployment, as a result of factor immobility. In the developing countries, given the lower level of infrastructural development, both social and physical, problems of adjustment are likely to be particularly acute and prolonged. Moreover, an open economy is much more subject to major swings in its balance of payments on both current and capital accounts and this, together with the fact that trade liberalisation is generally accompanied by less restriction on the international negotiability of the local currency, makes the country more prone to international monetary influences.

The precise point here is that any developing country that decides on a policy of 'outward-looking' trade liberalisation is choosing a policy which is not only disruptive of its previous structure and vested interests but which carries a high element of risk—a higher element of risk than is associated with a more 'inward-looking' policy. Moreover, the extra element of risk relates to variables largely outside the control or even the effective influence of the developing country itself. Furthermore, the gains from a liberalised trade expansion policy are likely to be more widely spread (e.g. amongst consumers) than the losses (although this can be avoided if the additional export earnings are used for the import of non-competing capital goods and raw materials as a basis for wider broad-based develop-

(4) See H.W. Singer *et al.*, *Trade Liberalisation, Employment and Income Distribution: A First Approach*, IDS Discussion Paper No. 31, October 1973.

ment). Thus, not only is the policy more high-risk to the country as a whole, but where the additional imports or the required changes in policy hit sectors built up on the basis of protection from foreign competition, foreign exchange shortage or high exchange rates, etc., the likely sufferers are generally able to identify themselves as a cogent body of opposition and as a general rule are able to exert more 'political clout' than are those who will benefit from a liberalisation policy.

Instead of the developed countries helping so as to reduce the degree of risk involved, the reverse has in fact occurred. Many of the policies of the developed countries result in *yet greater risks* for the developing countries if they decide to follow a policy of trade liberalisation. We will attempt to show that adjustment assistance and compensatory payments by the developed countries to the developing countries could play a part in substantially reducing the risks involved.

The increased risk arises for the developing countries on both the demand and supply side of developing their export trade. On the demand side they are increasingly dependent on the actions of the developed countries that constitute their main external markets, while on the supply side the development of the export industries and their 'gearing-up' requires injections and commitment of fairly high-risk capital, particularly where the the technology required is new and where new products or better qualities of existing products are required.

On the demand side, the much heralded preference schemes such as the GSP are broadly considered by the developed countries as being in the nature of 'voluntary concessions' to the developing countries, and therefore, as being non-binding. In the long drawn out discussions within the GATT to reconcile GSP in favour of developing countries with Article 1, the final formula adopted was based on a draft circulated as "text proposed by the donor countries". Although a waiver was later accepted that abolished the reference to "donor countries", the final draft made no reference at all to the principle of "the right to development", and hence the *obligation* to grant preferences to developing countries. Yet, as one writer has recently pointed out, "the granting of preferences is not a donation, that is, a mere act of generosity; rather it is the consequence of an obligation—though not

a conventional one—that has been recognised by the *'opinio juris'* and repeatedly stated by the international community; it rests on the very foundation on which the new international law and the so-called 'right to development' are based.(5) This describes a wish rather than the actual situation.

The withdrawal or limitation of 'preferences', while it is generally accepted as a matter for 'consultation' with affected parties, is therefore not held to require any measure of compensation to the developing countries affected. Much the same goes for the erosion of preferential margins granted to developing countries, through a more generalised policy of tariff reductions (see Section IV below). Thus the developing countries are particularly vulnerable to a unilateral cancellation of their preferential access to developed country markets, and disruptive action of this kind could have severe effects throughout the economy. Such action should constitute effective grounds for the claiming of compensation on behalf of the adversely affected party. In accordance with the generally accepted principles of contract governing international trade dealings, the affected party should be enabled to demand either (i) restoration of the previous position; (ii) other equivalent trade concessions; or (iii) the payment of compensation in financial terms.(6) Compensation should be related to the cost of adjustment on the part of the developing country economy to the less favourable situation. Preference schemes should *not* be regarded as a special category of international trade agreements, since non-fulfilment by one party can result in costs to the other party in precisely the same way that non-conformity to any other trade agreement can result in costs to the affected party.

While the possibility of unilateral action, on the part of the developed countries, causing a disruption of trade for the developing countries exists in respect of the various preference schemes 'granted' to the developing countries, it is also a more general problem. The developing countries are

(5) Hector Gross Espiell, "GATT: Accommodating Generalised Preferences," *Journal of World Trade Law*, Vol. 8, No 4, July-August 1974, p. 348.

(6) Our argument implies that the second option does not eliminate the need for the third, i.e. an accompanying compensatory payment to cover the cost of structural changes which would be necessary to take advantage of the altered set of tariffs.

dependent upon the developed countries continuing to allow, and indeed to allow increasingly, access to their own markets by the developing countries. This represents one of the elements of a high risk strategy in adopting a policy of trade liberalisation.(7) Moreover, even aspects of developed country policy not necessarily directly related to trade, such as decisions to reduce inflation by restricting demand or to aim for a lower growth rate etc., can seriously affect developing country export prospects. Much of this risk element could be eradicated, were developed countries to provide firmer market guarantees, backed by agreement to pay compensation for cost of readjustment, in the event of such guarantees being set aside as a result of their own policies.

The developing countries are further concerned that such disruptive action may be taken against them precisely in so far as they successfully take advantage of trade opportunities and 'invade' the developed country market. The higher their export sales, the greater will be the inevitable internal pressures in developed countries to restrict imports from developing countries. Furthermore such pressures are more likely in recessionary periods when exports will in any case be below trend through lack of demand. Thus LDCs are doubly subject to restricted access at such times. Producers in developed countries are then most vulnerable to 'serious injury' which under GATT rules is the criterion for protective measures. Article 19 of the GATT allows a country to suspend a trade obligation incurred under the treaty or to withdraw or modify a trade concession when imports of a particular product are such as "to cause or threaten serious injury to domestic producers". Similarly, Britain's previous GSP scheme incorporated safeguard clauses in terms of which Britain reserved her right to withdraw preferential treatment when a product was imported "in such increased quantities and under such conditions, as a result of preference, as to cause or threaten in the opinion of the British government serious injury to domestic producers of like or directly competitive products".(8)

EEC policy is formulated slightly differently. Preferential manufactured imports are limited in principle by the use of tariff quotas (plafonds) and

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(7) See, for example, Mahbub Haq, "Developing Country Alternatives," *Aspects for Partnership-Industrialisation and Trade Policies in the 1970s*, IBRD, Washington DC, 1973.

(8) See *Trade and Industry*, 23 September 1971, p. 578.

by ceilings on preferential imports (butoirs)—above this limit tariffs can be reimposed. Three categories are utilised—sensitive, quasi-sensitive and non-sensitive—and this depends on the degree to which the import competes with domestic production. The EEC Commission has the last word in deciding when and which restrictions will be imposed. "EEC officials suggest that the ceiling on non-sensitive items may never be invoked as long as market disruption does not occur. The difficulty here is that the system, as it stands, does not provide the kind of long-term assurance that an investor needs before he can afford to commit large funds to a particular project requiring substantial export markets. Thus, unless liberalised, the EEC system of GSP may fail to provide adequate incentives to investors to tackle the EEC market, simply because of the fear that the more successful a firm is in gaining a share of the market, the more likely would it be that protective measures would be taken against it sooner or later."(9)

Thus, besides the arbitrary element involved in the reimposition of tariffs (clearly increasing the degree of uncertainty to developing countries), it is quite obvious that "in the tariff quota system operating on manufactured products in the Community's scheme, the growth of duty-free imports is related inversely to the existing level of such imports."(10)

So far as restrictive actions actually taken under the terms of the various national agreements are concerned, we do not know of EEC actions, and it is reported that the British escape clause was invoked only once up to 1973, against some leather products.(11) The measures taken under US trade laws and under GATT are however more easily available. Bhagwati lists the countries which have invoked Article 19 of GATT and the products to which the measures applied, and also all the applications made to the US Tariff Commission for escape clause action.(12) Of the latter only a small proportion were successful; but between them the lists cover many products which are important in world trade and of which LDCs provide a large share. These restrictions are in a sense only of historic interest, since the

(9) Sidney Dell, "Regional Groupings and Developing Countries," in P. Streeten, *Trade Strategies for Development, Ninth Cambridge Conference on Development*, Macmillan, 1973, p. 209.

(10) Peter Tulloch, *The Seven Outside. Commonwealth Asia's Trade with the Enlarged EEC*, Overseas Development Institute, London, 1973, p. 10.

(11) See Tulloch, *op cit.*, p. 8.

(12) Bhagwati, *op. cit.*, Tables 1 and 2.

current legislation of the US, EEC and Japan, as has been mentioned, supersedes the GATT formula, relaxing the conditions under which restrictions can be reimposed. But they provide a base-line guide to the future—successful applications for restrictions will probably be more numerous in the future and this is one ground as far as LDCs are concerned for predicting more widespread import restrictions.

But LDCs have greater cause for anxiety. Many developed countries, although contracting parties to the GATT, have bypassed these escape clauses, and in a series of bilateral agreements have completely ignored a fundamental principle of the treaty that there should be no quantitative restrictions on trade. Most of these agreements are between a developed and a developing country though there are a few instances between pairs of developed countries; they are designed to regulate the volume of trade in particular products over the medium term. The most imporant of these agreements relates to textiles but there are a great many other less well-known agreements currently in force for the 'voluntary' restraint of exports (VERs) by LDCs.(13)

The 1962 Long Term Arrangement for Cotton Textiles, negotiated in 1974 to become the Multi Fibre Agreement (including wool and man-made fibres), has a curious formal status. It was drawn up under the auspices of GATT, but quite apart from being inconsistent with one of its main principles, it was negotiated completely without reference to the relevant GATT Committee (on market disruption). This was possible because of the 'flexible' nature of the GATT organisation in which "the strictness of [application of the rules] tends to be influenced by the relative importance of the members involved."(14) Subsequent negotiations of VERs have mostly been carried out between pairs of countries item by item without pretence of GATT approval.

The significance of these various restrictive agreements is that the MFA, the most complete of them, relates to the class of manufactured products

(13) See Bhagwati, *op. cit.*, Table 3 for Japanese exports to the US, Table 5 for imports to Canada and Table 6 for imports to the US, all subject to 'voluntary' restraint. See also M.Z. Cutajar and A. Franks, *The Less Developed Countries in World Trade*, Overseas Development Institute, London, 1967.

(14) Cutajar and Franks, *op. cit.*, p. 131.

which by the simple law of comparative advantage is perhaps the most obvious candidate for a geographical redistribution of production. The textile industry in the developed world is in general relatively highly labour-intensive and the LDCs have clearly demonstrated their competitiveness in international trade in textiles. In cotton yarn and woven fabrics and in clothing the LDCs' share of OECD imports rose from 26% to 32% and from 24% to 36% respectively between 1967 and 1973; and the overall global trade balance in textiles and clothing is substantially in favour of LDCs.(15) Yet the developed world is managing by concerted negotiation to control the quantity of LDC imports; the main purpose of the MFA is to limit the growth in LDC textile imports to 6% p.a. (up to 1975 it was 5% p.a.).(16) It could be argued that in this context the textile industry in the developed world has been overprotected, especially as, in the UK at least, textiles, as a low-wage industry, has persistently suffered from shortages of labour.(17) The lengths to which the developed world has gone to protect the industry in terms of domestic adjustment assistance as well as trade restriction suggests that LDCs must expect the future defence of other 'threatened' industries to be equally strong, and that they will not be given easy access even to those markets in which the potential gain to developed country consumers would be indisputably large. Closely regulated trade, such as exists in textiles, may result in short-term certainty of a kind for LDCs, but the longer-term uncertainty is not at all removed. The short-term certainty is of a low rate of growth of total LDC exports and the longer-term uncertainty relates to the probability of a small change in the growth ceiling where a downward change is equally as likely as an increase. These market conditions do not constitute a strong inducement for setting up new LDC productive capacity.

In the light of all this, the question of disruption of trading patterns (and of depression of export prospects in a regulated market) is a very serious

(15) Overseas Development Institute, *Briefing Paper: the Textile Trade, Developing Countries and Multi-Fibre Agreement*, November 1976, Tables 1 and 2. However, production is still concentrated in the developed world.

(16) The share of LDCs in British imports of textiles fell from 33% to 18% between 1967 and 1973. ODI, *op. cit.*, Table 4.

(17) C. Miles, "Adjustment Assistance Policies: A Survey" in G. Ohlin, *Adjustment for Trade*, OECD Development Centre, Paris 1975, p. 18.

one. The GATT should therefore attempt to establish exact criteria for estimating "market disruption", and to formulate wider safeguard measures for LDCs in the event of its occurrence. More importantly, it is crucial to LDC incentive to increases their export production that the principles of GATT should be properly observed by its contracting parties in all their trade agreements, bilateral as well as multilateral. There can be no doubt that the GATT has contributed to a general reduction of restrictions on trade in the post-war period, but this is liable to be forgotten in the face of persistent and uncensured neglect by developed country signatories of one of its cardinal principles. Moreover, it is within the developed world that the major benefits of the trade expansion have been enjoyed so far. We suggest that the proposal for compensation is a feasible means of universalising the spirit of GATT in respect of the escape clause provisions. The ultimate right of national governments to intervene in trade on behalf of 'seriously injured' national industries is recognised under this proposal(18) but only because it is unrealistic to suppose that any government will ever absolutely sign away the capacity to intervene. At the same time, the main objection to the exercise of this power is removed, because the groups who suffer as a result of it, namely exporting LDCs, are compensated for damage. *A priori*, we expect the developed countries to reimpose trade restrictions on LDC imports when the cost of domestic adjustment assistance is too high—protection is a device for shifting the incidence of injury. The first best dynamic trade policy would, in general, be for structural changes in both countries concerned; and to promote this, compensation payments to LDCs by DCs should be combined with vigorous adjustment assistance measures at home—where this refers to financial assistance for *phasing out* industries or parts of them rather than continually propping them up to no long-term purpose.(19) Payments of both types should be seen as elements of policy to cover a strictly transitional period.

The payment of compensation has been urged by Tinbergen, for example,

(18) And the definition of 'serious injury' might even be loosened.

(19) cf. the British textile industry, "even with the most advanced production methods the cost structure is such that it is not possible to produce garments such as shirts and men's trousers at prices competitive with · · · imports." ODI, *op. cit.*, p. 4, citing a NEDC document.

in the case of emergency import restraint;[20] and, as has been mentioned, it has in a few cases actually been carried out in transfers of this type between developed countries. But the main principle should be extended to cover *all* cases of disruption due to unilateral action.[21]

On the supply side, risk of another type arises for the developing countries in attempting to develop their export industries. The opening of new export markets requires a large initial investment and this is generally high-risk capital—precisely what is in such short supply in any developing country. Moreover, if we are to hold to the 'infant marketing argument', which favours giving assistance to exports at rates exceeding the protection granted to home market sales, and if such assistance is given to export outlets which are not at present competitive, but are estimated to become so in the future, large amounts of speculative capital will be required.[22]

The so-called 'gearing up' of the export industries process which, like domestic adjustment assistance programmes, seeks to relocate factors of production in the expanding sectors of the economy. Such a process frequently relates to the production of commodities to specifications appropriate to developed country markets, the establishment of selling organisations in the developed countries, etc. Thus, the developed country ought to bear a considerable part of the costs of this process, since these could be considered as primarily internal to the developed country economy, or of a technical advice nature. In saying this, one must not overlook the fact that on present evidence this would require a considerable shift in outlook on the part of the developed countries.

One of the lessons impressed upon the developed countries as a result of the oil crisis is the necessity of ensuring that essential supplies from

(20) See Section V below.

(21) Bhagwati, *op. cit.*, suggests a two-stage compensation process: Firstly, developed countries should pay the relevant LDC exporters a certain sum to reserve the right to reimpose trade restrictions in recognition of the welfare loss they suffer otherwise under uncertainty. The corollary is that for products for which DCs do not make such a payment the discretionary power is foresaken and thus the export market is fully guaranteed. Secondly, DCs should make a further compensation payment to cover damage to LDC exporters in the event that the restriction is actually imposed. The difficulty with this scheme is the absence of means of determining the size of the first type of payment, though the upper end of the feasible range would be set by the adjustment costs to DC producers were no restrictive action to be taken.

(22) For a consideration of the 'infant marketing' argument, see particularly UNCTAD—'Export Incentives' in *Development Digest*, Vol. X, No. 2, April 1972.

abroad are maintained at adequate levels as the degree of international interdependence is increased.(23) Extra-market devices such as the holding of buffer stocks provide only a temporary solution. The fundamental precondition of a continuous supply of necessary imports from the developing world is for the developed countries to ensure the capacity to supply such commodities. This will require the 'gearing up' of those industries so that a continuous, and indeed expanding supply is forthcoming. This is particularly vital, of course, for the 'essential non-competing imports' such as agricultural and mineral commodities. The 'gearing up of developing country export industries acquires added urgency in the light of evidence that they have low supply elasticities for their exports—certainly lower elasticities, in general, than the developed countries.(24)

III. Adjustment Assistance as a Means of Compensating for Losses Arising From More Outward-Looking Policies

The adoption by many developing countries of import-substituting industrialisation behind high tariff-walls was somewhat of a haphazard, *ad hoc* and enforced policy. Writing of Latin America, where such a policy was most evident, Raul Prebisch has said of the import-substituting industries that "the criterion by which their choice was determined was based not on considerations of economic expediency but on immediate feasibility, whatever the cost of production."(25)

More recently, there have been numerous calls on the developing countries to dismantle their systems of high protective tariffs, both in their own interests and in the interests of international trade.(26) A more liberal trade

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(23) Kathryn Morton, *A Hand Worth Playing, the Stake of Developing Countries in the International Trade and Monetary Negotiations*, Overseas Development Institute, London, 1974.

(24) J.M. Finger, "The elasticity of supply of material exports is lower in the LDCs than in the DSs", 'GATT Tariff Concessions and the Exports of Developing Countries' *Economic Journal*, Vol. 84, September 1974.

(25) R. Prebisch, *Towards a Dynamic Development Policy for Latin America*, New York, United Nations, 1964, p.71. and Santiago Macario, "Protectionism and Industrialisation in Latin America," *Economic Bulletin for Latin America*, March 1964—he terms the policy one of 'import substitution at any cost'.

(26) See ILO, *Sharing in Development: A Programme for Employment, Equity and Growth for the Philippines*, ILO, 1974. Also B. Balassa *et al.*, *The Structure of Production in Developing Countries*, IBRD, 1971.

policy, it is claimed, would benefit them through its effects in promoting more rational and efficient structures of production internally, as well as more employment and more equitable income distribution.

However, precisely what internal adjustments this would entail for the developing countries has received much less systematic attention. It would obviously involve both inter-sectoral and intra-sectoral adjustments. An example of inter-sectoral adjustment would be that, since the system of protection and import substitution has generally favoured the development of manufacturing industry over agriculture, the revision of the system will, *ceteris paribus*, cause factors to be relocated in agriculture. Within the manufacturing sector, import substitution has generally been based on protection for consumer goods and this protection has not been equally extended to other aspects of manufacturing activity, such as the production of capital and intermediate goods. The revision of the system of protection will therefore tend also to cause a relocation of facors *within* the manufacturing sector. If we add to this the effect of the necessary policy changes accompanying trade liberalisation such as a firmer monetary policy and a devaluation of the exchange,[27] it is clear that the adjustments involved are of considerable magnitude. Recognising this, some economists have stressed that "such a transformation could not be undertaken instantaneously but would require a transitional period.[28] This is undoubtedly correct, but what has not been adequately taken into account is firstly, the strength of vested interests (often perfectly legitimate interests) in the developing countries who will oppose such a revision of the system of protection; secondly, the limited, and often meagre, resources of developing country governments to effect a policy of an 'outward turn' towards trade expansion and to initiate policies which will make such a transition process more acceptable to those vested interests; or thirdly, the limited capacity of such governments to overrule or set aside such vested interests.

In addition, the *immediate* impact of a policy of trade liberalisation may well be to place a severe strain on the balance of payments. Since most developing countries have very limited foreign exchange reserves to

(27) This may, for instance, entail the desirability of compensating persons or companies for whom the real burden of the foreign debt has increased.

(28) Balassa *et al.*, *op. cit.*, p. 99.

'cushion' such pressure, there may often be a case for additional assistance by the developed countries, in the form of providing some sort of bridging finance, to meet an essentially temporary foreign exchange gap. The risk is that such financing may be a form of tied aid designed to 'bribe' developing countries into policies which they do not consider to be in their own interests.(29) But such risks of abuse need not now deter us from making the general point that there may be a legitimate case for helping developing countries to a position which they consider to be in their own best interest.

Thus, the liberalisation of trade by a developing country will entail both domestic adjustments (involving the relocation of factors internally) and international adjustments (involving a changing relation with other international currencies). Our contention is that the developed countries should be prepared to aid developing country governments to overcome these problems of transition by financing, at least in part the costs of adjustment involved for the developing country.(30) The room for manoeuvre by developing country governments in terms of offering reciprocal trade concessions to the developed countries, where such a policy has been decided upon, would be significantly enhanced were this proposal to be accepted. The capacity of many developing country governments to finance either adjustment process is very limited—to such a degree that long-term advantages may have to be sacrificed for short-term stability.(31) To enhance the capacity of the developing countries to opt for their most advantageous long-term trade policies, developed countries need to be persuaded, in their own and in developing country interests, to aid the developing countries with their adjustment processes. Essentially, therefore, such a policy of adjustment assistance should be seen as complementing a policy of further trade liberalisaton.

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(29) This points up the limitations of the US payments to Turkey to stop opium production as a general example for compensation payments. In that sense the payment really was a bribe which the Turkish government did not pass on to individual farmers; their subsequent protest then provided the grounds on which the government revoked the arrangement.

(30) One study which comes close to suggesting this is Little, Scitovsky and Scott, ***Industry and Trade in Some Developing Countries: A Comparative Study***, Oxford University Press, 1970; see particularly pp. 29, 391.

(31) Our colleague David Evans has rightly pointed out to us that this could also be helped by changing the time—phasing of trade liberalisation—rich countries lowering their tariffs first.

IV. Adjustment Assistance as a Means of Compensating Developing Countries for Adverse Effects of Trade Liberalisation amongst the Developed Countries

The export prospects of the developing countries can be severely affected not merely by the developed countries acting so as to restrict such exports, but by the fact that the very extension of trade liberalisation amongst the developed countries themselves without reference to their trade with the developing countries, could adversely affect such trade through 'trade diversion'. The extent to which this will, in fact, happen depends on the substitutability of imports from the two sources. There has been considerable dispute concerning the trade creation and trade diversion effects of the creation of Free Trade Associations amongst the developed countries. Balassa(32) concluded that the EEC resulted in no import diversion, but in fact his results are based on some very restrictive assumptions(33) and have, in consequence, been challenged. For example, Hirsch concludes that "the developing countries of Latin America and Asia experienced outward trade diversion in their trade with the EEC while the trading effects on the African countries not associated and on African EEC associates, were indeterminate."(34) In fact, between 1962 and 1969, while the developing countries *increased* their share of US, Japanese and other developed countries' manufactures imports, their share *declined* quite markedly in both the EEC and EFTA.(35) In any case, whatever the macro effects of trade liberalisation amongst the developed countries, it is usually possible at least to identify

(32) See Balassa, "Trade Creation and Trade Diversion in the European Common Market," *Economic Journal,* March 1967.

(33) Namely that: (1) developing countries have perfectly elastic supply functions for their exports; (2) the composition of demand for different imports is static over time. (For evidence that the first assumption is incorrect and that LDC supply functions tend to have lower elasticities than DC supply functions, see J. M. Finger, "GATT Tariff Concessions and the Exports of Developing Countries," *Economic Journal,* Vol. 84, September 1974, p. 570.)

(34) See V. Hirsch, "The Impact of European Integration on Trade with Developing Countries. Empirical Evidence and Policy Implications," in P. Streeten, *Trade Strategies for Development, the Ninth Cambridge Conference on Development Problems,* September 1972, Macmillan, 1973, p. 222.

(35) For evidence of this, see Statistical Office of the United Nations and UNCTAD Secretariat: Document TO/111, Table 5.

specific LDC export sectors that will be adversely affected. Britain joining the EEC is an obvious case in point. Commonwealth sugar and beef producers and Burmese rice producers, for example, suddenly faced competition from subsidised producers within the Free Trade Area. Or, as in the case of the seven Asian Commonwealth countries, for a number of products previously enjoying Commonwealth preferences, increased competition has resulted from exports being treated on the same basis as all other non-associated suppliers. Moreover, some processed agricultural commodities previously enjoying such preference are positively discriminated against in favour of some Community Associates.(36) In fact, measures of trade liberalisation amongst the developed countries have frequently coincided with an increase in protective devices designed to decrease the volume of imports from the developing countries. Even where concessions negotiated between the developed countries are equally extended to the developing countries this may not serve to compensate them for a previous arrangement whereby they enjoyed preferential treatment in a developed country market. Such a situation would constitute a *prima facie* case for adjustment assistance or other compensatory trade concessions to the developing country.

It is not suggested that the assistance given to the developing countries to adjust to the new situation, in which they are at least *relatively* disadvantaged, should be of a magnitude so as to constitute a serious impediment to trade expansion amongst the developed countries themselves. Rather, such assistance should be channelled selectively into making the developing country export industries affected more competitive. Frequently, the 'natural' comparative advantages of the developing country export industries are more than cancelled out (meaning that they cannot compete on an 'equal' basis with the same exports originating in a developed country) by the extent of direct and indirect government subsidies in the developed country.(37) Tinbergen(38) has suggested that compensation should be based

(36) See particularly Peter Tulloch, *The Seven Outside. Commonwealth Asia's Trade with the Enlarged EEC*, Overseas Development Institute, 1973, pp. 16–17. The loss of Commonwealth preference has been broadly recognised as calling for compensatory adjustment.

(37) For example, the UK regional employment premium may have this effect. See W. M. Corden and G. Fels, eds, *Public Assistance to Industry. Protection and Subsidies in Britain and Germany*, Macmillan for the Trade Policy Research Centre, London and the Institut für Weltwirtschaft, Kiel, 1976.

(38) Jan Tinbergen, *Shaping the World Economy. Suggestions for an International Policy*, Twentieth Century Fund, New York, 1962.

on a restoration to the disadvantaged country of the level of export earnings prevailing previously. He argues that where tariff barriers on imports from a previous 'outsider' are lowered, thus affecting the preferential access of a previous 'insider': "···compensation must be offered. The most appropriate form which compensation can take seems to us to be an additional amount of financial assistance for development purposes. More precisely, this amount should correspond to the reduction in export values to be expected from the reduction in outer tariffs applied to outsiders."(39)

There may, of course, be a countervailing 'trade creation' effect when developed countries liberalise trading relationships amongst themselves. Such liberalisation may, by stimulating developed country economic activity, generate spillover effects, calling forth a larger demand for developing country exports. Moreover, since such a process would release resources which could be relocated in the field of the developed country's comparative advantage, the willingness to substitute developing country imports for domestic production may receive a fillip, as the process of trade liberalisation will have increased the opportunities for the developed country to exploit its comparative advantage. In so far as this occurs, the developed countries may be more prepared to assist in the 'gearing up' of export industries in the developing countries (see Section II above) and to finance the movement of additional factors into these export industries. Thus, assistance designed to reorientate productive activity in the developing countries towards their export industries, may well complement a process of trade liberalisation amongst the developed countries.(40)

To summarise this section: Two principles are operative in the claim that developed countries should accord assistance to developing countries to enable them to adjust to a new situation in which trade liberalisation has occurred amongst the developed countries themselves. On the one hand, there is the principle of compensation where the developing country exporters are now relatively disadvantaged and, in particular, where they

(39) *Ibid.*, p. 147. Tinbergen develops the idea in more detail on pages 147-149. He is referring here to EEC policy in respect of outer tariffs and the preferences granted to associated countries.

(40) David Wall makes the same point, arguing that, in addition, cheaper developing country imports may *help* the developed countries to adjust to the liberalisation of trade amongst themselves: see "Developing Countries in the Liberalisation of World Trade," in McFadzean *et al.*, *Towards an Open World Economy*, Trade Policy Research Centre, London, 1972.

now face competition from the exports of a developed country which are subsidised—directly, or indirectly—by the State. (The sudsidy policy itself should, of course, also be on the agenda for change.) On the other hand, such trade liberalisation can in some cases generate increased demand for developing country exports; Firstly, by aiding general economic activity in the developed countries, and secondly, by allowing developed countries to exploit their comparative advantage more effectively, thus facilitating the movement of factors of production in those countries into the sectors in which they enjoy such comparative advantage. In this situation, assistance to the developing countries could take the form of 'gearing up' their export industries (provided this can be safely done under the guarantees discussed in Section II above), whereas in the first situation, assistance might well take the form of moving factors in the developing country out of the affected export sector, or at least helping towards its diversification.

V. Adjustment Assistance as a Means of Compensating Developing Countries Against 'Emergency' Import Restraints Imposed by Developed Countries

It has generally been maintained by the developed countries that, due to the difficulties of internal adjustment involved, the relaxation of tariffs and other protective devices will have to be a slow process.[41] However, developed countries which have acted so as to reduce protection for domestic industries from developing country imports, may still face dislocations to their economies so instantaneous and of such magnitude that their own adjustment assistance mechanisms are inadequate to deal with the short-term problems involved.

Article 19 of the GATT authorises emergency import restraints when the extent of market disruption is acute and not caused by 'dumping'. Under this article, emergency action must be across the board and non-discriminatory, and this has tended to discourage signatories from using it.[42] However, the article is inherently unsatisfactory since governments are not

(41) See, for example, R.B.M. King, "Criteria for Europe's Development Policy to the Third World," *Journal of Administration Overseas*, Vol. XIII, No. 3, July 1974.

(42) But see above, p. 207.

committed to any time period for the ending of such emergency action, opening up the prospect of 'emergency' action becoming permanent. Article 6 of the GATT is the only other authorisation of emergency import restraints, but this relates to the case of 'dumping'. UNCTAD, too, has expressly recognised that there may be cases where an industry in a developed country requires a degree of protection to ease the process of adjustment.(43) Again, such measures can only be regarded as temporary: "these safeguard measures should be accompanied by action designed to bring about rapid domestic adjustment, and this adjustment programme and its progress would be *the subject* of consultations with the country whose trade was restricted and of international review under multilateral procedures."(44)

In such a situation, we argue that mere consultation is not sufficient in so far as the developing countries are concerned. This was recognised as early as 1962 by Tinbergen, who claimed that "in cases where quick action on trade policy is necessary, measures such as ··· increased financial aid may be used to compensate the groups or countries adversely affected. It does seem desirable to act quickly in some cases."(45)

Moreover, the strength of the export multiplier effect in developing countries is widely acknowledged,(46) and thus even temporary contractions in export earnings are likely to have wide-ranging ramifications in the developing country economy in terms of employment and income distribution. The adverse effects on Net Capital Formation, particularly within a manufacturing sector, may have long-term effects on productivity in that sector, and the adverse effects may be transferred to the developed countries in the form of increased prices for their imports. Frequently, the so-called problem of 'market-disruption' is solved by the developed countries having recourse to Non-Tariff Barriers (NTBs), in addition to, and sometimes in place of, tariffs. Particularly important in this regard are import quotas.(47)

(43) See "Policy Perspectives for International Trade and Economic Relations," Report by the High Level Group on Trade and Related Problems to the Secretary-General of the OECD, August 1972.
(44) See UNCTAD, Trade and Development Board, Committee on Manufactures, August 1973, *Liberalisation of Non-Tariff Barriers: Adjustment Assistance Measures*, p. 12.
(45) Tinbergen, *op. cit.*, p. 140.
(46) See, particularly, H.W. Singer *et al.*, "Trade Liberalisation, Employment and Income Distribution: A First Approach," *op, cit.*, for a detailed discussion of the issue.
(47) See, for example, Charles R. Frank *et al.*, *Assisting Developing Countries. Problems of Debts, Burden Sharing, Jobs & Trade*, Overseas Development Council Studies—1, New York, Praeger, 1972, particularly p. 405.

NTBs tend to discriminate against the developing countries and frequently encompass products of direct interest to them. Again, as in the case of tariffs, their incidence tends to increase with the level of fabrication.[48] Any attempt, therefore, to tackle the problem of protection against 'market-disruption' must deal with NTBs and particularly import quotas.

One writer has suggested that the GATT should tackle this problem of emergency protection and derive adequate criteria for the assessment of 'market-disruption' in addition to providing safeguards, to ensure that 'international regulations' are carried out.[49] Three major principles are proposed:

1. Emergency protection (with protection defined to include non-tariff barriers) should be for a limited time period and be progressively reduced over this period.
2. Emergency protection must be accompanied by genuine efforts on behalf of the importing country to reorientate or adjust its economy to the new situation.
3. A multilateral body should supervise such adjustment schemes.

What makes these proposals particularly interesting, from the point of view of adjustment assistance, is that there is an explicit recognition that such programmes, although differing in their mechanisms nationally, should be subject to some form of international regulation. However, these proposals are still oriented towards adjustment problems in the importing countries, and this is only one half of the problem.

Each case should be assessed on its merits. However, developing countries would seem to have a good case, *prima facie,* for arguing that they are entitled to some form of assistance to allow their economies to adjust to the curtailment in export growth and to reassume such growth once the temporary restrictions are lifted. Moreover, the form of such assistance could be mutually beneficial to developed and developing countries. For example, if Net Capital Formation in the developing country export sector

(48) C. Pestieau and J. Henry, "Non-Tariff Barriers as a Problem in International Development," Private Planning Association of Canada, 1972, particularly pp. 84-89. Also, UNCTAD, *Liberalisation of Tariff and Non-Tariff Barriers,* TD/B/C2/83, Part I, Geneva, 1970.

(49) J. Tumlir, "Proposals for Emergency Protection Against Sharp Increases in Imports," Guest Paper No. 1, Trade Policy Research Centre, London, 1973, p. 16. Kathryn Morton, *op. cit.*, p. 38.

is the magnitude likely to be badly affected, assistance of the developed country could well take the form of supplying the requisite capital equipment at reduced cost when conditions are once again ripe for a resumption of growth in the export sector. Moreover, such a policy would create an increased demand for the outputs of the capital goods sector, which is likely to be the sector of comparative advantage to the developed country.

Such assistance is necessarily temporary and should be negotiated with the proviso that such measures are required only while the underlying situation lasts, i.e. transition to a new production structure in the developing countries affected, whether towards a contracted or expanded export sector.

VI. Conclusion

The focus of this paper has been upon adjustment and transformation assistance measures in their relation to the promotion of trade expansion between developed and developing countries. Although we are not primarily concerned with the 'mechanics' of such a scheme, some preliminary indications would not be out of place.

Firstly, definite criteria would have to be laid down for the administration of such measures. Adjustment and transformation assistance should complement trade liberalisation and quite clearly encourage factor relocation with this aim in view. Where, however, adjustment is rendered necessary by the *rupture* of previous trading relations a second-best solution is the only possibility, and a country should be helped to adjust to the new situation by relocating factors in sectors where it enjoys a comparative advantage in the new conditions. In short, the concept of effectiveness in adjustment assistance should relate precisely to its role as facilitating trade expansion, or guarding against its risks.

Secondly, the relationship between such a programme and what is conventionally called 'foreign aid' requires more clarification. In the long debate of 'trade versus aid', some writers have argued for the one and some for the other. John white has argued that trade concessions to developing countries are a form of aid since they are a type of 'concessional subsidy'.[(50)]

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(50) John White, *The Politics of Foreign Aid*, The Bodley Head, 1974.

We have argued, in respect of preference schemes, that they should *NOT* be regarded as concessions to developing countries, since such 'concessions' are frequently in the interests of the developed countries themselves, particularly as a complement to trade liberalisation amongst themselves.[51]

Following on from this, adjustment assistance schemes should *NOT* be regarded as *substitutes* for assistance in the form of aid. Where they are paid to developing countries with a view to liberalising their trade policies, developed countries stand to gain substantially. In cases of trade disruption, such as a 'temporary' hike in tariffs to protect developed country producers or to prevent the export prospects of developing countries from being jeopardised by the lowering of tariffs among the developed countries themselves, the justification for the payment of adjustment by the developed countries is essentially on grounds of compensation to recompense those that have suffered as a result of contemporary developed country policies, and to some extent as a deterrent against unreasonable action. The justification, moral or otherwise, behind foreign assistance or aid programmes is surely very different.

Thirdly, not all 'affected' parties need qualify for assistance. Since the multinational corporations are responsible for a large and increasing percentage of developing country exports,[52] care will have to be taken to decide to what extent adjustment assistance would in fact serve, directly or indirectly, to aid the MNCs.[53] Payment to the MNCs would primarily benefit non-residents and possibly fail to restore the balance of payments. In any case, as international companies, they are in a position to switch production from one country to another and so are protected from many of the risks and vicissitudes of international trading patterns, and have their own 'built-in' compensation system.

Several other complications will undoubtedly arise were such a scheme to be implemented, and precisely what these would be and how they might

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(51) See Wall, *op. cit.*

(52) See, for example, Raymond Vernon, *Sovereignty at Bay. The Multinational Spread of US Enterprise*, 1971, p. 102. and L.G. Franko, 'Multinational Enterprise, the International Division of Labour in Manufactures, and the Developing Countries," ILO, World Employment Programme Research, Working Paper WEP2-28/WP4, Geneva, October 1975.

(53) See UNCTAD Secretariat, "Export Incentives," *Development Digest*, Vol. X, No. 2, April 1972, p. 119.

be overcome could form topics for further research. The main thrust of this paper has been to argue that adjustment assistance programmes, sponsored by the developed countries to effect the relocation of factors in the developing countries, are a potentially important element in the promotion of trade liberalisation.