Bela Balassa
and Michael Sharpston

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by Developing Countries:
Issues of Policy

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Bela Balassa
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EXPORT SUBSIDIES BY DEVELOPING COUNTRIES: ISSUES OF POLICY

by Bela BALASSA and Michael SHARPSTON

INTRODUCTION

Following a policy of import substitution behind high protective barriers in the early postwar period, a number of developing countries have come to provide incentives to the exportation of manufactured goods. Exports have been encouraged by the use of various subsidy measures designed to offset the cost disadvantages of exports due to overvalued exchange rates, tariffs on imported inputs, and the high cost of domestically-produced inputs. These measures have reduced the bias against exports and in favor of import substitution in protected domestic markets.

Import protection and export subsidies are symmetrical in their economic effects: they favor domestic production at the expense of foreign industry that will be adversely affected in its export or in its own domestic markets. There are differences, however, in the international acceptability of these measures. While import protection is generally considered to be within the purview of every country, foreign nations may employ retaliatory measures in cases when export subsidies have been granted.

The possibility of retaliation to export subsidy measures raises questions as to the choice of appropriate policies by developing countries. Further questions arise concerning appropriateness of the treatment accorded to export subsidies by the developed nations. These questions will be considered in the framework of optimal trade policies on the part of both developing and developed countries. The discussion will be preceded by an analysis of existing international rules and attitudes in the developed nations towards export subsidies applied by the developing countries.
I. GATT Rules on Export Subsidies and their Practical Application

Export Subsidies and Countervailing Duties

Article XVI, Section A of the General Agreement on Tariffs and Trade\footnote{GATT, Basic Instruments and Selected Documents (to be cited as BISD), Volume IV, Text of the General Agreement, Geneva, 1969.} states the obligation of any country which provides subsidies that “directly or indirectly” increase exports to notify the Contracting Parties (i.e. the GATT Secretariat) as to “the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products ... exported from its territory and of the circumstances making the subsidization necessary.”\footnote{Article XVI, Section A deals in a parallel form with subsidies that adversely affect imports. A discussion of these subsidies, however, lies outside our subject. Nor will we consider the treatment of export subsidies to primary products.} Furthermore, “In any case in which it is determined that serious prejudice to the interest of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the Contracting Parties, the possibility of limiting the subsidization.”\footnote{It was subsequently agreed that the intent of this provision “is that consultations shall proceed upon the request of a contracting party when it considers that prejudice is caused or threatened and would not require a prior international determination” (BISD), Volume II, Geneva, 1952, page 44, para. 29 (b).}

Section B of Article XVI, added in 1955, imposes a more stringent obligation on exporting countries than does Section A of the same article. Paragraph 4 contains the provision that “contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product”. But this provision has not been subscribed to by developing countries, and is thus not applicable to them. Accordingly, developing countries have an obligation to notify and to discuss but not to eliminate an export subsidy.

Under Article VI, however, importing countries may offset export subsidies by countervailing duties. Such duties may be imposed in
an amount not exceeding the estimated subsidies, and they are subject
to the condition that the subsidies “cause or threaten material injury
to an established domestic industry, or ... retard materially the estab-
lishment of a domestic industry.”

The Meaning of Export Subsidies

In view of the threat of countervailing action to export subsidiza-
tion by developing countries, one needs to examine what is meant by
export subsidies under GATT rules. Section A of Article XVI is said
to apply to “any subsidy, including any form of income or price sup-
sport, which operates directly or indirectly to increase exports of
any product ...” According to a later interpretation, “the phrase
‘increased exports’ was intended to include the concept of maintaining
exports at a level higher than would otherwise exist in the absence of
a subsidy.” The Panel of Experts, appointed by GATT to examine
the application of Article XVI, endorsed this interpretation while adding,
“it [is] fair to assume that a subsidy which provides an incentive to
increased production will, in the absence of offsetting measures, e.g., a
consumption subsidy, either increase exports or reduce imports.”

The conclusions of the Panel, whose report has been adopted by
the Contracting Parties, are consistent with Article VI:3 of the General
Agreement that empowers the governments of the importing countries
to apply countervailing duties to offset subsidies “granted, directly or
indirectly, on the manufacture, production or export of [a] product ...”
In turn, according to an addendum to Article VI, “multiple currency
practices can in certain circumstances constitute a subsidy to exports
which may be met by countervailing duties” without, however, specifying what these circumstances are. And, finally, GATT regulations
do not exclude the use of export taxes on raw materials, which makes

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4 At the same time, while it is recognized in Article XVI that third parties (e.g. competing exporters) may be adversely affected by export subsidization, they do not have recourse to the application of countervailing duties under Article VI.
7 Notes and Supplementary Provisions BISD, Annex 4.
it possible to indirectly subsidize the exportation of processed goods using such materials. 8

In addressing itself to the notification of subsidies to exports, the Panel of Experts further stated that “the question of notifying levy/subsidy arrangements depends upon the source of the funds and the extent of government action, if any, in their collection” (page 192, para 12). In particular, “there was no doubt that there was an obligation to notify all schemes of levy/subsidy affecting imports or exports in which the government took a part either by making payments into the common fund or by entrusting to a private body the functions of taxation and subsidization with the result that the practice would in no real sense differ from those normally followed by governments” (ibid.). This is contrasted with the case when “a group of producers voluntarily taxed themselves in order to subsidize exports of a product” (ibid.).

The criterion of loss to the government includes the loss of revenue through e.g. rebates of income taxes or exemptions from such taxes payable on exports. However, in Notes and Supplementary Provisions relating to Article XVI, it is specified that “The exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy”. This provision has been interpreted as applying to duties and indirect taxes levied on products both at the final stages of fabrication and at the earlier stages. 9

There are further a number of measures involving loss of government revenue on which there is no agreed interpretation of GATT rules as to whether they are to be considered export subsidies. They include: 10

(i) The deferral of direct taxes in respect of exported goods.
(ii) The allowance of special deductions related to exports in the calculation of the base on which direct taxes are charged:

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8 Also, as noted below, imposing taxes on export products for which foreign demand is less than infinitely elastic, without however its elasticity being less than unity, entails the indirect subsidization of all other exports.

9 On this point, see the report of the Working Party cited above.

10 General Agreement on Tariffs and Trade, Working Group on Export Subsidies, Background Note by the Secretariat, COM/IND/W/73, 21 April 1973, p. 3.
— accelerated depreciation allowances on capital goods used in the production of exports;
— deduction of special reserves set aside to cover risks connected with export sales on medium-term credit;
— deduction of export promotion or market development expenses.

(iii) The accordance by governments of special advantages to exporters in obtaining credit.

(iv) The government bearing all or part of the costs incurred by exporters in obtaining insurance cover.

(v) Transport and freight subsidies on export shipments.

The Practical Application of GATT Rules on Export Subsidies to Developing Countries

We have seen that under GATT rules notification is required and importers may take countervailing action in regard to subsidies involving loss of government revenue which benefit the production of export commodities. Exemptions or rebates of indirect taxes and duties on the export product and its inputs provide the principal exceptions to this rule. Such exemptions and rebates are in fact regularly granted by a number of countries, including those of the European Common Market.

The next question concerns the application of GATT rules to export subsidies granted by the developing countries. Despite the proliferation of export subsidies over the last decade, there are few instances when these subsidies have been notified to GATT. At the same time, in the revision of the original Agreement, GATT has recognized the need for developing countries to apply measures of industrial promotion that are not consistent with the Agreement. Also, GATT has exhorted developed nations to improve market access for the developing countries' products and to refrain from the application of countervailing duties to offset export subsidies granted by the developing countries.

To begin with, Article XVIII added in 1955 recognizes that it may be necessary for developing countries “to take protective or other measures affecting imports” (para. 2) and “to grant the governmental assistance required to promote the establishment of particular indus-
tries” (para. 3). Thus, after appropriate consultations, developing countries can modify and withdraw tariff concessions, impose quantitative restrictions, and employ other measures not consistent with the Agreement.

Furthermore, Article XXXVI, added in 1965, takes note of the need “for a rapid and sustained expansion of the export earnings of the less-developed contracting parties” and “for positive efforts designed to ensure that less-developed contracting parties secure a share in the growth in international trade commensurate with the needs of their economic development” (Article XXXVI:2 and 3). In particular, the Agreement calls on developed nations to provide “increased access in the largest possible measure to markets under favorable conditions for processed and manufactured products currently or potentially of particular export interest to less-developed contracting parties” (para. 5).

To this end, the Agreement accords “high priority to the reduction and elimination of barriers to products currently or potentially of particular export interest to less-developed contracting parties” (Article XXXVII:1) and it states that “The developed contracting parties shall . . .

(c) have special regard to the trade interests of less-developed contracting parties when considering the application of other measures permitted under this Agreement to meet particular problems and explore all possibilities of constructive remedies before applying such measures where they would affect essential interests of those contracting parties” (XXXVII:3).

As noted in an interpretative note of the GATT Secretariat, “it is clear from the drafting history of Part IV that countervailing duties are among the measures permitted . . . to meet particular problems” referred to in Article XXXVII:3 (c). 11

The following sections of the paper will examine available evidence on the application of countervailing measures, as well as the prospective use of these measures, to developing country exports by the developed nations. Section II will deal with the United States experience. In turn, Section III will consider the policies followed by the major European countries and Japan.

11 General Agreement on Tariffs and Trade, Incentives for Industrial Exports from Developing Countries, COM/TD/72, March 17, 1970, page 2, para. 7.
II. Countervailing Actions by the United States

Applications of Countervailing Duties

In the United States, GATT has only the status of an Executive Agreement and actions taken by governmental bodies and the courts are guided by U.S. law and legal practice. In particular, on the basis of the "grandfather clause" in GATT, under the Tariff Act of 1897 the imposition of countervailing duties does not require the finding of injury to U.S. industry. Moreover, the imposition of such duties by the Treasury is mandatory, once it has been found that the foreign exporter has received a subsidy.

Nevertheless, until recently, countervailing action was taken in a few instances only; there were no such cases between 1959 and 1967. In turn, there has been an increasing volume of petitions for the application of countervailing duties since 1967, which have led to a number of positive findings.

The rarity of positive findings before 1967 reflected the U.S. Treasury's apparent desire to avoid, whenever possible, the application of countervailing duties for international political reasons. Some petitions were dismissed on the grounds that they were de minimis in the sense that the rate of the subsidy was small; others encountered considerable delay, or decisions were postponed sine die, as the Treasury was not subject to a time limit on reaching a decision. The application of this clause benefited in particular developing countries.

The situation changed in the second half of the sixties when import competition intensified as a result of multilateral tariff reductions and the increasing overvaluation of the dollar. The newly-assumed protectionist stance of labor further contributed to this change. At the same time, a "learning process" took place on the part of firms that were informed of successful petitions for countervailing duties on the part of others. As a result, there was increasing political pressure on the Treasury from sectoral interests and from Congress to levy countervailing duties, irrespective of whether these concerned imports from developed or from developing countries.

These considerations may explain that, between 1967 and 1974, countervailing duties were imposed in altogether seventeen cases, of which four involved developing countries (tomato products from
Greece, shoes from Brazil and from Spain, and bottled olives from Spain). There were also several instances, such as cut flowers from Colombia, where countervailing action was dropped in exchange for the discontinuation of export subsidies.

A greater number of decisions were reached in 1975, as the Trade Act of 1974 required the Treasury to take action within one year on petitions for the application of countervailing duties. Among the twenty decisions, there were nine positive findings. Countervailing duties were imposed in four instances while the duty was temporarily waived in five cases on the grounds that steps had been taken to eliminate or to substantially reduce the adverse effects of the subsidy. Exports of developing countries affected by these decisions include footwear from Korea and Taiwan and leather handbags from Brazil in the first group and carbon steel plates from Mexico in the second. Negative findings were reached in regard to cotton textiles, man-made fibers, and cast iron soil pipe from India, asparagus from Mexico and non-rubber footwear from Argentina. There are a number of additional cases pending, of which four involve developing countries (glazed ceramic wall tile exported by the Philippines and castor oil products, cotton yarn and scissors and shears exported by Brazil).

The Definition of Export Subsidies under U.S. Law

Section 303 of the Tariff Act of 1930, which replaced earlier legislation on countervailing duties, provides that “Whenever any country, dependency, colony, province, or other political subdivision of government, person, partnership, association, cartel or corporation shall pay or bestow, directly or indirectly, any bounty or grant upon the manufacture or production or export of any article or merchandise manufactured or produced in such country . . . and such article or merchandise is dutiable under the provision of this act . . . there shall be levied and paid, . . . an additional duty equal to the net amount of such bounty or grant . . .”

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12 An additional fourteen cases were otherwise disposed of as not requiring the imposition of countervailing duties.
This provision of the Tariff Act is akin to the interpretation of export subsidies under GATT, the major difference being that the U.S. formulation also extends to subsidies provided from non-governmental sources. At the same time, similar to GATT, U.S. legislation fails to provide an exhaustive list of subsidy measures. Accordingly, one needs to rely on Treasury decisions and the interpretation of legislation by the courts to which Treasury decisions have been appealed.

On the basis of Treasury decisions and legal interpretations, it would appear that governmental export subsidy measures subject to countervailing action include direct cost subsidies, indemnification for loss incurred in exporting, rebates of direct taxes, overrebates of indirect taxes, preferential financing and transport rates, as well as indirect government assistance in the form of price support and regional development assistance whenever these benefit firms whose output is in large part exported to the United States. In turn, the only instances where countervailing action was taken in response to private practices concerned cartel arrangements in regard to the exportation of German rolling-mill products (1926) and Australian butter (1928). In the latter case, however, there was also some government support.

Rebates of indirect taxes require special attention since these are permitted under GATT rules as noted above. It has been suggested that two Supreme Court dicta in the early part of this century considered all rebates of indirect taxes as export subsidies for the purpose of levying countervailing duties (Downs v. United States, 1903 and Nicholas and Co. v. United States, 1919). However, in court decisions countervailing duties have been applied only to overrebates of indirect taxes, consistent with the manner in which indirect taxes are treated under GATT rules.

Decisions by the Treasury on rebates of indirect taxes and customs duties have also conformed to GATT rules. On October 20, 1975, the Treasury put an end to the long controversy concerning the rebate of the value added tax in the European Common Market by ruling on a complaint from the U.S. Steel Corporation that these rebates are in line with international trading practices accepted under GATT and are thus not subject to countervailing action.

Exceptions to this rule have been made for indirect taxes levied on overhead expenditures, such as transportation and electricity, and for para-fiscal taxes, such as governmental inspection fees and customs charges other than tariffs. Rebates of these types of taxes were countervailed in the Italian transmission tower case (April 21, 1967) and in several subsequent cases based on the same ruling. Finally, over rebates of indirect taxes of both the cascade type (imports of olives from Spain) and the value added type (nonrubber footwear from Brazil) have been countervailed.

Although the Tariff Act defines export subsidization to include production subsidies, such subsidies have been countervailed only if the output is predominantly exported and exports are directed to the United States. Thus, in the case of Michelin Tire whose production in Nova Scotia benefited from regional development assistance, the Treasury imposed countervailing duties (January 8, 1973) largely on the grounds that 80 per cent of output was exported to the United States. Also, direct payments to tomato producers by the Greek Government were countervailed (March 28, 1972), on the basis that 90 per cent of production was exported, predominantly to the United States. However, the Treasury reached a negative decision in cases involving Belgium, Germany, and the United Kingdom, where the share of exports to the U.S. in output was small. 

Finally, there was only a single case (wool tops in Uruguay) during the postwar period when a positive determination was made on the basis of the application of multiple exchange rates. In May 1953, the Treasury ruled that the difference between the exchange rate applied in the particular case and the average exchange rate on all import and export transactions was considered an export subsidy. However, differential export taxation in the form of export taxes on the raw material (lead) but not on the processed export product (lithage) was not considered an export subsidy in the Hammond Lead Products Case (1969) although from the economic point of view they are equivalent to multiple exchange rates.

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15 Treasury decision in this case was reversed by the Customs Court whose decision was subsequently overruled on the grounds that U.S. manufacturers had no standing to contest Treasury countervailing duty rulings. This conclusion no longer holds since the 1974 Trade Act came into effect.
Countervailing Action Under the 1974 Trade Act

The Trade Act of 1974 grants new authority to the President with respect to multilateral negotiations on reductions in trade barriers and amends existing legislation concerning various forms of import relief, including countervailing action. As regards the latter, the Trade Act provides for changes in procedures and in the scope of application of countervailing duties and opens possibilities for international negotiations on the introduction of the injury clause.

The procedural changes make it mandatory for the Treasury to reach a preliminary decision on applications for countervailing action within six months and a final decision within twelve months. But, the Trade Act does not limit the Treasury's discretion to judge whether a particular practice is considered a subsidy, to estimate the extent of the subsidy and that of the countervailing duty, and to decide on the dismissal of applications on grounds that the cases are "de minimis".

The Trade Act further extends the scope of countervailing action to duty-free items, including those entering free of duty from developing countries under the General Preference scheme. The imposition of countervailing duties on duty-free items is, however, made contingent on the finding of injury. A finding of injury must be made by the International Trade Commission within a period of three months following the determination by Treasury that a subsidy is being paid and, in the event of a positive finding, countervailing duties will apply from the beginning of this period.

Apart from including an injury provision as a condition for countervailing action on duty-free imports, the Trade Act has opened the possibility for international negotiations on instituting an injury provision in regard to all imports that receive subsidies abroad:

"It is the sense of the Congress that the President, to the extent practicable and consistent with United States interests, seek through negotiations the establishment of internationally agreed rules and procedures governing the use of subsidies (and other export incentives) and the application of countervailing duties."

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\(^{16}\) For an excellent discussion of the relevant provisions of the Trade Act and of the preceding Congressional resolutions, see Matthew J. Marks and Harold B. Malmgren, "Negotiating Nontariff Distortions to Trade", Law and Policy in International Business, 1975 (2), pp. 327-411.
In order to ease the task of negotiations on the introduction of the injury clause, Congress has also allowed the Treasury some flexibility in the imposition of countervailing duties. Thus, for the four year period commencing with the enactment of the Trade Act while multilateral trade negotiations are in progress, the Treasury may waive countervailing duties if the following conditions are met:

"(a) adequate steps had been taken to reduce substantially or eliminate the adverse effects of the bounty or grant;
(b) there was reasonable prospect that successful trade agreements would be entered into, . . . , with foreign countries or instrumentalities providing for the reduction or elimination of barriers to, or other distortions of international trade; and
(c) the imposition of countervailing duties would be likely to severely jeopardize the satisfactory completion of such negotiations."

The U.S. Proposal on International Rules for Export Subsidies

By this time, the Treasury has used its authority to waive the imposition of countervailing duties in ten cases, all of which required the fulfilment of condition (a). In turn, as a preliminary step to negotiate introducing an injury provision in the application of countervailing duties, the U.S. Government has proposed that agreement be reached on grouping subsidy practices into three categories as to whether they are prohibited, conditional, or permitted. Countries would be allowed to take countervailing action against prohibited practices without any conditions; the injury test would be applicable in the event that measures were determined to be in the second category; and permissible measures would not be subject to countervailing action.

Under the proposed rules, “benefits directly or indirectly conferred upon exports that are not conferred at least equally upon goods produced domestically and destined for the domestic market, and benefits conditioned on export performance would be prohibited”. In turn, “benefits whose application and use equally affect all production, whether destined for the domestic market or for exports, would be conditional and would be subject to offsetting measures only under certain conditions, such as an injury test”. Finally “the permitted category would consist of practices that are considered to have minimal impact on international trade".
The U.S. proposal makes a clear distinction between subsidy measures affecting exports and those affecting domestic production. It would also resurrect the prohibition of export subsidies under Section B of Article XVI, which has been honored in its breach, as developed countries have continued to provide various forms of export subsidies. They include preferential export credit (practically all major exporters), preferential tax treatment of incomes derived from export (the U.S. DISC scheme), and indemnification for cost increases on fixed-price contracts (Britain and France). Moreover, the U.S. proposal calls for new regulations to safeguard the interests of third country exporters in the event of subsidization.

The U.S. proposal further expresses the view that “it will prove feasible and appropriate to negotiate provision for differential treatment under prescribed conditions for developing countries in certain areas of subsidies and countervailing duty rules”. It is added that “such treatment should be geared to the particular situations of developing countries and to periods linked to achieving particular development objectives”. The modalities of granting such exceptions and the conditions of their application have not been defined, however. This issue will be taken up in Section IV below.

Alternative Measures of Import Relief

Apart from the imposition of countervailing duties, there are several measures available to the U.S. Government for granting import relief to domestic producers. They include the application of anti-dumping duties, increases in tariffs, the imposition of quotas, and adjustment assistance. Contrary to the case of countervailing duties, the use of these measures presupposes a finding of injury to domestic industry resulting from increased imports. In turn, they do not require the existence of a foreign subsidy nor are they limited to imposing duties in the amount equivalent to the subsidy as in the case of countervailing action.

The application of anti-dumping duties is subject to the double requirement that sales take place at less than the comparable price of the product when destined for home consumption in the exporting country and that domestic industry has been injured as a result. Apart from the imposition of countervailing duties and anti-dumping duties, the Trade Act of 1974 empowers the President to retaliate against
various unfair trade practices, which are said to include unreasonable, unjustifiable or discriminatory foreign trade restrictions which burden or restrict U.S. commerce; foreign export subsidies which affect U.S. sales in third country markets; and restrictions on access to supplies. In such cases, the President may suspend or withdraw trade agreement concessions, impose duties or other restrictions on foreign goods, and impose fees or restrictions on foreign services.\(^1\) Finally, measures may be taken in the event of injury to domestic industry even in the absence of unfair foreign trade practices.

In amending earlier legislation, the Trade Act of 1974 makes it the responsibility of the International Trade Commission to determine on petition from the adversely affected party, "whether an article is being imported into the United States in such increased quantities as to be a substantial cause of serious injury, or the threat thereof, to the domestic industry producing an article like or directly competitive with the imported article". In the event of a positive determination, the Commission can make recommendations for increasing tariffs, imposing quotas, or providing adjustment assistance. Under the Act, the President is also empowered to "negotiate orderly marketing arrangements"—a euphemism for agreement on export quotas. Furthermore, he can reject the Commission's recommendations if the provision of import relief is not considered to be in the national interest; he may however be over-ruled by Congress if the recommendation was supported by the majority of the Commission.

Following a finding of injury in respect of speciality steel by the International Trade Commission in March 1976, the President invited foreign exporters of this product to negotiate export quotas. In turn, in April 1976, he did not follow the Commission's recommendations for import restraints on non-rubber shoes but decided in favor of adjustment assistance instead. Furthermore, he declined to continue the recommended tariff quota on stainless steel flatware and terminated tariffs imposed at higher rates on ceramic kitchenware and tableware while continuing higher duties on some related items until 1979. Finally, the President did not take action on asparagus, in the case of which the Commission split on the finding of injury, but he did provide adjustment assistance for the domestic zipper industry.

These decisions are of importance to developing countries since the President did not impose import restraints on products they at present export (speciality steels are exported by European countries and Japan). But, the United States played an important role in the establishment of the International Cotton Textiles Agreement, subsequently transformed into the International Multifiber Agreement, that limits textile imports from developing countries. It should be noted, however, that these limitations have been imposed without regard to the existence of export subsidies. Nor is the existence of subsidies a precondition to petitioning the International Trade Commission for import relief.

Finally, under the Trade Expansion Act of 1962, adjustment assistance can be provided to workers as well as to firms. And, while adjustment assistance was rarely granted during the following decade, the conditions for granting assistance have been liberalized to a considerable extent under the 1974 Trade Act. This, in turn, may conceivably reduce the need for applying measures of import restraint, including countervailing duties.

Nevertheless, protectionist pressures in favor of import restraint continue. As not earlier, during the last decade labor has turned protectionist, thus joining forces with industrial interests in import-competing industries. The end to the overvaluation of the dollar and increased access to adjustment assistance may however temper protectionist demands on the part of labor in the future.

Moreover, in judging the case of non-rubber shoes, the President for the first time gave attention to consumer interest and to the effects of import restraints on inflation. International political considerations, too, militate in favor of a liberal trade policy. This has been apparent in the Treasury's May 1976 decision to discontinue the antidumping investigation on passenger automobiles imported from Canada, Japan and six European countries as well as in the promise made by the Secretary of State at the May 1976 UNCTAD Conference in Nairobi to provide favorable treatment to developing countries in imposing import restraints in the future.

The question remains how far the U.S. Administration is willing and able to go in overruling labor and industrial interests on the grounds of international political considerations, anti-inflationary objectives, and benefits to the consumer. At the same time, it should be emphasized that, apart from the waiver applicable over a four-year
period if certain conditions are not met, the imposition of counter-
vailing duties remains mandatory once the subsidization of exports by
foreign countries has been established.

III. Countervailing Actions in Western Europe and Japan

The Application of Countervailing and Anti-Dumping Duties

European countries conform to GATT rules in requiring a finding
of injury for the imposition of countervailing duties. For example,
Regulation No. 459/68 of 5 April 1968 by the Commission of the
European Economic Community concerning the application of anti-
dumping and countervailing duties closely follows Article VI of GATT.
In practice, there has not been a single case where countervailing
duties might have been imposed by Common Market countries. How-
ever, in the EEC the distinction between countervailing and anti-
dumping duty cases is somewhat blurred. In both cases, proof of
injury is required; also, governmental subsidies resulting in export
prices lower than domestic prices may be prosecuted under anti-dump-
ing legislation as well.

There have been altogether eighteen anti-dumping cases in the
European Common Market since Regulation No. 459/68 came into
effect. A few exceptions aside, these have been settled out of court,
with the exporter agreeing to raise the price. None of the cases
involved developing countries, however, unless Yugoslavia is put in
this category.

Other European nations, too, follow GATT rules in requiring a
finding of injury for the application of countervailing duties and none
of them have imposed such duties on the exports of developing coun-
tries. And, in the case of Japan, there is not even legislation on coun-
tervailing action in the event that export subsidies are applied by
foreign countries.

However, European countries and Japan have taken action other
than the imposition of countervailing duties in several instances where
imports threatened domestic industry. In Western Europe, such
action was mainly directed against Japan during the nineteen-sixties.
However, developing countries as well as Japan were involved in
negotiating export restraints in the framework of successive international textile agreements. Also, all foreign producers were affected indiscriminately by the imposition of quotas on shoe imports by Sweden in 1975.

With the exports of manufactured goods from developing countries rising at a rapid rate, the question needs to be raised if European countries and Japan may take measures to stem this inflow in the future. An additional question is whether the use of export subsidies by developing countries would increase the danger that European countries and Japan might impose limitations on their exports. Finally, the possibility of the differential treatment of export subsidies granted by developed and by developing countries and the potential trade-off between export subsidies and existing preferences benefiting the exports of developing countries both need to be examined.

*Attitudes to Structural Change and the Adjustment Problem*

To answer these questions, we have first to consider long-term changes in the pattern of comparative advantage and the short-term problems of adjustment in the importing countries. There is a considerable degree of acceptance in Western Europe and Japan of the need for structural change in manufacturing industry, entailing the increased concentration of domestic production in skill and research-intensive industries and the importation of a rising proportion of unskilled labor-intensive and material-intensive products from developing countries. This is the most apparent in Germany, the Scandinavian countries and Japan and less so in France, Italy and the United Kingdom.

In Germany, it is envisaged that the transfer of certain industrial activities to developing countries would increasingly take the place of the importation of workers. Also, in accordance with their tradition to participate in the international division of labor to the fullest extent possible, Scandinavian countries expect to further increase their reliance on manufactured goods imported from developing countries.

In Japan, the Ministry for International Trade and Industry has published a plan under which the Japanese industrial structure would be transformed to make room for labor-intensive imports from developing countries and to encourage the transfer of basic steel and petrochemical industries to these countries. In turn, Keidanren, the Japa-
nese Industrial Federation, has proposed that shifts take place mainly within rather than between industries, with Japan concentrating on high-quality products and on labor and material-saving technological process within each industry. While the discussion on these proposals continues, imports from developing countries would increase in either case. Moreover, developing countries would replace Japanese products in labor-intensive industries in the markets of the United States and Western Europe.

At the same time, the transformation of the industrial structure in European countries and Japan is constrained by national security considerations, which call for maintaining capacities in principal manufacturing industries, as well as by social considerations which in part explain the continuing protection of agriculture. National security considerations have been involved in including the phrase “minimum viable production” in the International Multifiber Agreement and imposing quotas on shoes by Sweden.

In the short run, there is further the problem of adjustment that determines the speed at which changes in the industrial structure are allowed to take place. This, in turn, creates a potential conflict between the desire of the importing countries to slow down the process of adjustment in order to limit the risk of dislocation and the desire of the developing countries to accelerate the expansion of their exports by the use of subsidy measures.

Reactions to Export Subsidies Granted by Developing Countries

As noted above, European countries and Japan have made use of quantitative restrictions in several instances when manufactured goods threatened serious injury to domestic industry. A case in point is the International Cotton Textiles Agreement, signed in the early sixties, under which exports of cotton textiles from developing countries and from Japan were made subject to quantitative limitations. In turn, under the new multifiber agreement, the EEC has negotiated, or is in the process of negotiating, bilateral agreements with Brazil, Egypt, Hong Kong, India, Japan, Korea, Malaysia, Pakistan, Portugal, Singapore, and Yugoslavia. There is no evidence that these negotiations, or the past imposition of quantitative restrictions, would have been affected in any way by the existence of export subsidy measures by the developing countries. The question remains, however, if the use of
export subsidies may increase the possibility of the use of quantitative measures in the future.

Discussions with government officials indicate that European countries and Japan take a pragmatic attitude in the sense of using quantitative measures in cases of serious injury to domestic industry done without inquiring into the causes of the expansion of imports. Decision-makers appear to focus on the injury itself rather than on the policies of other countries which, at any rate, are often difficult to evaluate.

Also, in the event of injury, the use of quantitative measures is considered preferable to applying countervailing duties by reason of the fact that these measures have immediate effects that can be foreseen with confidence. Nevertheless, the future application of countervailing duties could not be excluded, in part because export subsidization offers a convenient rationale for imposing measures that favor domestic industry, and in part because of the international disapprobation of the use of quantitative measures to limit trade. If countervailing duties are indeed to be employed, the question arises whether developing countries would receive special treatment. In this connection, the proposal by Brazil submitted in the form of a Working Paper to the preparatory session for ongoing multilateral trade negotiations deserves attention.

The Brazilian Proposal

The Brazilian proposal has sought to establish that, since developing countries did not subscribe to the 1960 Declaration giving effect to the provision of Section B of Article XVI banning export subsidies, "it follows that no countervailing action should be taken against legitimately subsidized exports by developing countries". This position is hardly tenable, however, since as we have seen, Part A of Article XVI and Article VI apply to developing countries as well. This may explain the further statement by the Brazilian delegation, according to which, "in spite of the interpretation referred to in paragraph 3 above, the Brazilian Delegation is willing to explore with developed countries a further refining of the existing GATT rules, and is prepared to consider: (a) defining in more specific terms export incentive measures, which, through differentiated treatment, would be explicitly
allowed to developing countries, and (b) the possibility of countervailing action against subsidized exports from developing countries, under exceptional and objectively defined circumstances" (para. 6).

Following in the footsteps of an earlier Indian proposal submitted to GATT, the Brazilian delegation has suggested drawing up a "positive list" of export subsidy measures to be applied by developing countries that would not be subject to countervailing action by developed nations. It has further been proposed to institute a procedure of consultation, subject to arbitration by the GATT Secretariat, for the event that measures not included on the list cause injury to the industries of developed countries.

The Brazilian proposal has been endorsed by a number of developing countries. However, reactions by developed countries have been negative. According to a document submitted by the EEC Delegation, "the relevant provisions of the GATT did not give developing countries 'carte blanche' in the field of subsidies". And, "when there was proof of injury, there could not be any question of exempting altogether imports from developing countries from the levying of a countervailing duty". These sentiments have been echoed by other European countries, Japan, and the United States as well.

*Export Subsidies and Preferences*

The negative response to the Brazilian proposal reflects a variety of factors. In Western Europe, the feeling has been repeatedly expressed that export subsidies by developing countries should not exceed certain (unspecified) limits. For one thing, subsidies are said to distort international competition; for another, it is alleged that subsidy measures may be ill-advised from the point of view of the particular developing country or groups of developing countries. In this connection, reference has been made to the budgetary cost of subsidization, the transfer element involved in reducing prices to developed country consumers, and the possibility of competition through the granting of export subsidies by several developing countries. It has also been pointed out that developing countries already enjoy preferential treatment as far as export subsidization is concerned, in view of the fact that they have not subscribed to Section B of Article XVI
which bans export subsidies. Nevertheless, European countries and Japan appear to be willing to make exceptions for developing countries in the framework of the agreement on export subsidies to be negotiated with the United States. Such exceptions would be made on a temporary basis and they would not apply to those export industries of the developing countries which are considered to be competitive without an export subsidy.

There is finally the question whether export subsidization by developing countries would adversely affect their access to preferences, whether in the framework of the Lomé Convention or in the form of so-called general preferences. Such does not appear to be the case in regard to the free entry of manufactured goods to the Common Market countries under the Lomé Convention. Given the small size of the manufacturing sector of the developing partner countries, there is little danger of injury to European industry, even if a rapid expansion of exports were to take place. In fact, at their present level of economic development, these countries cannot fully exploit the advantages of their duty-free entry status. This explains that the EEC Commission is engaged in promotional activities to encourage the exports of manufactured goods from the countries in question. Promotional efforts in favor of developing country exporters in general are also made by the individual member countries of the Common Market as well as by the smaller European countries outside the EEC.

Different considerations may pertain to the application of the Generalized Preference Scheme by the Common Market. According to a communication from the EEC Commission to the Council,

"it will need to be appreciated on both sides that a policy of cooperation which provides advantages to the beneficiary countries implies as well both rights and obligations. Juridically, the preferences remain autonomous; and they bear no requirement for reciprocity. But they must be fitted into an international economic framework which permits the beneficiary countries to use the preferences to the full while respecting a certain number of economic and trade disciplines."  

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18 This expression has replaced the term "associated countries" used in the past.
This statement has been interpreted to relate, among other things, to the application of export subsidies by developing countries which export to the Common Market under the Generalized Preference Scheme. It thus raises the possibility that duty-free treatment under GPS may be limited in cases when the application of subsidy measures has led to the rapid expansion of the exports of particular commodities. Thus, the view has been expressed that excessive subsidization would conflict with the privilege accorded under the GSP scheme.

It should be noted, however, that the duty-free entry of manufactured goods under the Lomé Convention and in the framework of agreements negotiated with Mediterranean countries reduces the value of preferences to competing producers in other developing countries. As this form of discrimination has come under increased criticism, the EEC countries may not wish to further limit the scope of preferences in response to export subsidies by developing countries.

In turn, countervailing duty legislation applies to imports under the Generalized Preference Scheme in the United States. However, there is no evidence of a trade-off between this scheme and the granting of export subsidies by developing countries, in the sense that export subsidization might have affected legislative provisions on preferences.

IV. Optimal Policies on the Manufactured Exports of Developing Countries

The Case for Preferential Treatment of the Manufacturing Sector in Developing Countries

The first step towards devising optimal policy rules as regards manufactured exports from developing countries is to define optimal policies on trade between developed and developing countries. This will be done below excluding for the time being cases where developing countries can affect the world market price of particular commodities.

On economic grounds, deviations from worldwide free trade can be justified by externalities in production. The production externalities relevant for trade policy include the creation of new skills as well as technological improvements, the benefits of which are not fully captured by the entrepreneur.
Apart from the case when a country is behind in the development of technically-sophisticated industries, such as computers and electronics, externalities will not warrant supplying protective measures in developed countries. These countries may claim the need for protection only on the grounds that the continuance of certain industries is necessary for defense (e.g. steel) or for social (e.g. agriculture) reasons and, on a temporary basis, in order to avoid disruptions in the process of adjustment to free trade.

In developing countries, however, production externalities exist in the manufacturing sector, necessitating the preferential treatment of this sector. This is because manufacturing activities provide social benefits, not fully captured in the entrepreneur's profit calculations in the form of the "production" of skilled labor and technological change. There is a difference in this regard between manufacturing and agricultural activities as the latter generally use less skilled labor and technological changes are promoted chiefly by agricultural stations rather than by individual firms. Such external economies may operate within as well as between industries.

Ideally, preferential treatment to the manufacturing sector should be provided by production subsidies that do not distort the pattern of consumption and provide the same incentives to sales in domestic and in foreign markets. However, production subsidies are not practicable in most developing countries because of their limited capacity to raise taxes.

With production subsidies being excluded in the large majority of cases for budgetary reasons, joint use may be made of tariffs and export subsidies. While export subsidies would need to be financed from general tax revenue, their financing needs are much smaller than in the case of production subsidies. They may be covered by increasing indirect tax rates, for example.

The application of tariffs and export subsidies at equal rates would provide the same treatment to sales in domestic and in foreign markets. Their combined application would thus have the same effect as production subsidies, except for the fact that the higher prices paid by the domestic consumer would distort consumption patterns. However, the magnitude of the welfare loss resulting from such distortions is

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20 An additional condition is that the discounted value of future benefits should exceed the (discounted) economic cost of the measures applied.
difficult to gauge and, apart from countries with substantial oil revenue, it has to be accepted in view of the existence of budgetary constraints.

It follows that policies for optimal resource allocation on the world level would call for developed nations to provide duty-free treatment to the imports of manufactured goods from developing countries and for developing countries to grant tariff protection and export subsidies to manufactured goods subject to production externalities. And, since such externalities will obtain irrespective of whether sales take place in domestic or in foreign markets, tariffs and export subsidies should be applied at equal rates.

**Export Subsidies in the Developing Countries**

The use of export subsidies by developing countries serves efficient resource allocation on the world level by contributing to international specialization according to long-term comparative advantage. It thus benefits developing as well as developed countries by permitting them to specialize in industries where they possess relative advantages.

An additional consideration is that, in the absence of export subsidies, developing countries tend to impose high tariffs and quantitative restrictions in order to ensure their industrial development. As a result, industries are established that do not conform to the comparative advantage of the developing countries and replace imports from the developed nations at a high cost.

Industrial development could be furthered at a lower cost if developing countries reduced their often excessive levels of import protection and relied instead on a tariff-export subsidy scheme to promote their manufacturing industries. Thus, while the limitations of domestic markets lead to the establishment of industries at increasingly higher cost as import substitution proceeds, the application of export subsidies would permit expanding low-cost industries through increased exports. Again, benefits would accrue both to the developing and to the developed countries as discrimination against the export industries of the latter is reduced.

It has been suggested that tariff rates in developing countries should exceed export subsidy rates by reason of the need to contain dumping. However, the anti-dumping argument often becomes an excuse for raising tariffs on all commodities, including those not subject to dumping. Correspondingly, in order to avoid disincentives to exports and
the inefficiencies associated with high tariffs, one should use anti-dumping measures in cases where the existence of dumping can be proven. Also, developing countries would be well-advised to forego the use of quantitative import restrictions that tend to favor import substitution over exporting to an extent that cannot be easily ascertained.

In turn, rates of export subsidies may exceed tariff rates on a temporary basis in order to provide additional subsidies to new exports, should externalities be obtained in exporting through learning-by-doing in activities such as quality control, packaging and marketing. But this may be accomplished more directly through tax preferences for expenditures abroad or by institutional measures to be discussed below.

We have briefly examined here ideal trade policies on the part of developed and developing countries. In actual practice, the policies applied are constrained by political and institutional factors. We will next consider desirable policies by developing countries, given the constraints due to the trade policies followed in the developed nations (Section V). Subsequently, recommendations will be made for policy changes in the developed nations and for modifications in international rules affecting subsidies to the manufactured exports of the developing countries that would ease these constraints (Section VI).

V. Trade Policies by Developing Countries

Policy Making Under the Threat of Retaliation

It has been suggested above that, temporary exceptions aside, developing countries should ideally apply import tariffs and export subsidies on manufactured products at identical rates. Unless there is evidence that some industries generate more production externalities than others, equal rates of tariffs and export subsidies should be applied to all manufactured goods, since the growth contribution of the manufacturing sector will be maximized as a result.²¹

²¹ For proof, see Trent J. Bertrand, "Decision rules for Effective Protection in Less Developed Economies, American Economic Review, September 1972.
Providing equal incentives to all manufacturing industries will ensure that more efficient activities will expand at the expense of less efficient ones. At the same time, exceptions may be made in the case of new industries in order to offset their initial cost disadvantage. Such infant industry protection should be provided for a limited period and on a declining scale in order to encourage improvements in production methods.\textsuperscript{22}

Under existing rules on international trade, however, tariffs and other restrictions on imports are acceptable while export subsidies are subject to retaliation. As noted earlier, such retaliation is made mandatory by law in the United States once the complainant furnishes evidence that export subsidy measures were applied whereas in Western Europe and Japan it requires proof of injury. And, the latter group of countries has not yet taken countervailing action against export subsidies by developing countries, while this has been done on several occasions in the United States.

It follows that the chance of retaliation will depend, first of all, on the market for which exports are destined. It will further depend on the level of development of the country in question, its size, and its ties with the importing nations. The countries associated with the Common Market are favored in all these respects as far as their exports to the EEC are concerned. They are small countries at a low level of development and are recipients of special privileges by reason of the association.

Countries at lower levels of development apparently also received more favorable treatment in the past in the United States, although this is now circumscribed under the new legislation. Still, the U.S. Treasury continues to reject the imposition of countervailing duties on \textit{de minimis} grounds, which tends to favor developing countries whose exports tend to be smaller than those of developed countries.

Small exporters to the U.S. also benefit by reason of the fact that there is less of a tendency on the part of domestic producers to initiate countervailing action if the amount in question is small. For one thing, the impact of imports on their activities will be small; for another, countervailing action involves an administrative cost as well as uncertainty since the outcome is by no means sure, especially in cases where the \textit{de minimis} clause may be applicable.

\textsuperscript{22} For a detailed discussion, see Bela Balassa, "Reforming the System of Incentives in Developing Countries", \textit{World Development}, June 1975, pp. 374-76.
These considerations indicate that the danger of retaliation tends to be less for countries at lower levels of development as well as for small countries. They also point to the desirability of export diversification on the part of large developing countries.

In cases when the danger of retaliation does exist, it is in the interest of developing countries to minimize the danger. This in turn requires replacing direct export subsidies by indirect subsidization through appropriate exchange rate and tax arrangements and using only such direct subsidy measures that are less open to retaliation. Alternative possibilities of providing incentives to manufacturing activities will be considered below for the case when actions taken by developing countries affect the world market prices of some of their primary exports.

**Alternative Incentive Schemes**

Thus far, we considered the need for differential incentives to primary and to manufactured activities. Additional considerations are introduced when some of a country's export products are subject to less than infinitely elastic foreign demand, so that the country can affect world market prices by its own actions. In the following we will assume that this will be the case for traditional primary exports but not for non-traditional primary and manufactured exports.

In the event of less than infinitely elastic foreign demand for traditional exports, the optimal tariff argument will apply. Thus, in favoring non-traditional primary and manufactured goods over traditional primary products, the imposition of optimal tariffs will permit maximizing the advantages a country derives from international trade.\(^2\)

The optimal system of incentives can now be implemented in various ways. Under Alternative A, differential incentives are provided by applying the official exchange rate to traditional exports subject to less than infinitely elastic foreign demand (e.g. copper), and imposing tariffs and export subsidies at rates of 25 per cent on non-traditional primary products and at rates of 40 per cent on manufactured goods. Domestic prices and relative incentives, and thus the

allocation of resources and the effects on the government budget, will be identical but the exchange rate will be 25 per cent higher if, instead, a 12 per cent tariff-export subsidy scheme is applied to manufactured goods, a 20 per cent export tax is levied on copper whereas other primary commodities are not subject to a tariff or subsidy (Alternative B).

While the two schemes have identical economic effects, under the second scheme the chances of retaliation are reduced by relying in part on the exchange rate to provide incentives to exports. One can go a step further and replace tariffs and export subsidies on manufactured goods by taxes on all primary products. In the preceding example, relative prices, incentives, resource allocation, and budgetary effects will again be the same, but the danger of retaliation will be minimized if the following scheme is applied: a 28.6 per cent tax is levied on primary exports facing less than infinitely elastic demand, a 10.7 per cent export tax on other primary exports, and no tariffs or export subsidies on manufactured goods while imports of primary goods competing with domestic production receive a 10.7 per cent import subsidy (Alternative C).

Foreign demand may be less than infinitely elastic also for some manufactured goods exported by developing countries. This will be the situation if manufactured exports are subject to quotas or to voluntary export restraints, such as textiles. Now, an export subsidy may need to be foregone or, under the last-mentioned alternative, an export tax may need to be imposed to skim off monopolistic profits for producers who export under the quota (export limitation) and to avoid subsidizing the consumer in developed countries if domestic competition leads to lower export prices. Similar considerations apply to cases when developing countries affect the world market price of a manufactured product by their actions. Possible examples are shirts, wigs, and artificial flowers.

*Multiple Exchange Rates, Tariffs, and Export Subsidies*

As it is well known, multiple exchange rates are equivalent to an import tariff-export subsidy scheme. Thus, relative prices, incentives, resource allocation, and budgetary effects will be the same, irrespective of whether a 12 per cent tariff-subsidy scheme applies to manufactured products or such products are subject to an exchange rate 12 per cent
higher than the basic rate. The same conclusion applies to the use of multiple exchange rates in the place of the tariff-tax-subsidy schemes described above.

The use of multiple exchange rates has been recommended before, most prominently by Nicholas Kaldor, but they have fallen into disuse since the early postwar period. This has been explained by the negative attitude towards such measures on the part of the International Monetary Fund. Such attitudes reflected the preoccupation of the IMF with the removal of distortions in trade and in foreign exchange markets. However, with the increased recognition of the need for differential treatment of developing countries, this attitude has been changing in the IMF as well. Thus, the IMF now appears amenable to accept multiple exchange rates if their application is accompanied by reductions in tariff protection. In fact, in at least one case, the IMF has proposed introducing multiple exchange rates.

In regard to the ban on certain kinds of export subsidies under Section B of Article XVI in GATT, it is explicitly stated that “Nothing in Section B shall preclude the use by a contracting part of multiple rate of exchange in accordance with the Articles of Agreement of the International Monetary Fund”.

And while, according to the same source, “multiple currency practices can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties” under Article VI these circumstances have not been specified; nor have multiple exchange rates been considered in recent discussions on export subsidies.

Thus, as far as the application of GATT rules is concerned, there appears to be less of a chance for retaliation if multiple exchange rates rather than explicit export subsidies are used. The situation is less clear in regard to U.S. legislation as there have been no cases relating to multiple rates since the Treasury’s 1953 decision on wool tops imported from Uruguay. At the same time, under this decision, multiple exchange rates are subject to more favorable treatment than explicit export subsidies since the subsidy element is measured as the difference between the exchange rate applied to the commodity in question and the average exchange rate on all transactions, including the subsidized exports, while the rate of an explicit export subsidy is calculated at the official exchange rate.

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25 Ibid.
Note, however, that the simplicity of the proposed scheme may disappear if primary products are used as inputs in manufacturing industries. If such is the case for several primary commodities that face different world market conditions, optimality may require a complicated system of taxes and subsidies inasmuch as equal incentives should be provided to processing activities rather than to the products. Thus, instead of setting equal tariffs and export subsidies throughout the manufacturing sector, the effective protection of manufactured goods (i.e. the protection of value added) would need to be equalized.\footnote{Cf. Bela Balassa, "Reforming the System of Incentives in Developing Countries", \textit{op. cit.}}

In such a situation, the use of multiple exchange rates would encounter administrative difficulties and applying a number of different exchange rates would also be objected to by the IMF. Correspondingly, it would be preferable to use differentiated taxes and subsidies in the place of multiple exchange rates.

The conclusion remains, however, that in order to minimize the chances of retaliation, to the extent possible one should provide incentives to manufactured exports by the use of export taxes on primary products rather than by explicit export subsidies on manufactured goods. The implications for policy making of internal political constraints to devaluation and to import subsidies will be considered following a discussion of transitional measures.

\textit{Reforming the System of Incentives}

We have examined so far alternative ways of implementing optimal policies in developing countries, with account taken of the need to minimize the extent of retaliation on the part of developed nations. Optimality means that incentives are provided at rates commensurate with the expected benefits, and thus excessive protection is avoided.

In practice, however, one starts with a situation when the system of incentive is nonoptimal and the question is raised what changes can be made to effect improvements. This is a problem of the "second best" in the sense that the effects of measures taken have to be considered in the light of the other policies that are being applied. Thus, a particular measure which would have beneficial effects if other
policies were optimal may have an adverse impact under nonoptimal policies.

While it is not possible to consider individual cases which show variations from country to country, some general comments can be made on the case characteristic of many developing countries that have established an industrial base. By and large, these countries apply tariffs on manufactured goods at high and diverse rates, provide subsidies at rates lower than the protection provided by tariffs, do not levy export taxes, while indirect taxes are imposed on imports but are often not rebated to exports.

To begin with the last point, one should modify the system of indirect taxes by introducing rebates on exports. In removing the tax element in the export price, the introduction of the rebate will complete the application of the so-called destination principle that involves levying indirect taxes at equal rates on domestically consumed goods, irrespective of whether they are of domestic or foreign origin and rebating indirect taxes paid on exports and their inputs. In this way, tax neutrality is established by equalizing the tax burden on sales in domestic and foreign markets, and incentives to exports are improved without inviting retaliation, since the application of the destination principle is sanctioned by GATT and has recently been accepted in a U.S. Treasury decision.

Developing countries should also levy optimal export taxes on commodities facing less than infinitely elastic foreign demand. Apart from maximizing the advantages a country derives from international trade through the differential treatment of primary exports subject to disparate market conditions, this would permit increasing incentives to manufactured exports without recourse to an explicit export subsidy.

Such will be the case since imposing export taxes on primary products facing less than infinitely elastic foreign demand permits balance-of-payments equilibrium to be reached at a higher exchange rate,\(^7\) thus increasing the amount of domestic currency exporters of other primary products and manufactured goods receive per dollar earned. With a more favorable exchange rate, then, incentives to

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\(^7\) This conclusion does not hold if the elasticity of foreign demand is equal to, or less than, unity. This is, however, a very exceptional case which can be neglected.

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manufactured exports can be provided at a lower rate of explicit subsidy.

The imposition of export taxes should further be accompanied by a (partially) compensated devaluation. A fully compensated devaluation would involve reductions in import tariffs and export subsidies at rates commensurate with the devaluation so as to maintain domestic prices unchanged. However, in order to increase incentives to manufactured exports and reduce protection in domestic markets, differences between incentives to domestic and foreign sales of manufactured goods would need to be reduced. This could be accomplished if import tariffs are reduced to a greater extent than the devaluation.

At the same time, as a step towards equalizing incentives to various manufacturing activities, intercommodity differences in tariff and subsidy rates should be reduced. In effecting these changes, account should be taken of the fact that incentives to processing activities rather than to products would need to be equalized.

Reductions in import tariffs cannot be accomplished overnight. Rather, in order to provide firms time for adjustment, the reform of the system of protection should be carried out by stages. At the same time, the prospective changes to be carried out during, say, a five-year period should be announced in advance so as to provide certainty for the firms as regards future changes in the incentive system.

Export Subsidization Under Domestic and Foreign Constraints

The described reform of incentives would permit approaching, and eventually reaching, the scheme described under Alternative B. In order to fully eliminate export subsidies, one would also need to apply taxes on all primary exports and to grant import subsidies to primary products competing with domestic output (Alternative C). This, preferred, alternative would also necessitate a larger devaluation than Alternative B.

However, devaluation, the imposition of taxes on all primary exports, and the subsidization of the imports of primary products may not be practicable for internal political reasons. Should devaluation be excluded, increased incentives to manufactured exports could be provided only by applying or increasing export subsidies. Alterna-
tively, if the extent of a possible devaluation is limited or import subsidies are not feasible for political reasons, one could lower tariffs without necessarily reducing export subsidies.

In cases where political constraints make explicit export subsidization necessary and this is open to retaliation, developing countries should minimize the danger by relying on subsidy measures which conform to any of the following characteristics: they have not traditionally been considered export subsidies; they are subject to conflicting interpretations; or they have been used by the developed nations themselves.

The first category includes duty rebates on imported inputs used in export production that are admissible under GATT. While this measure discriminates against the use of domestically produced inputs and is superfluous if the described general incentive scheme is applied, its use may be recommended in the event that the application of this scheme is not practicable.

Also, there are various institutional measures of export promotion that have been widely employed without inviting retaliation. They include services to exporters provided by governmental or quasi-governmental bodies in the form of the collection of information on export markets, the organization of trade fairs, export marketing institutions, quality control, labor training, etc. Furthermore, for a number of export subsidy measures listed earlier, there is no agreed interpretation in GATT.

Finally, the danger of retaliation is reduced if the developing countries utilize subsidy measures which have been employed by the developed nations, such as preferential export credits, credit insurance schemes, and income tax deferrals. The application of such measures could not be recommended, however, on exports to the United States which has countervailed preferential export financing and schemes involving a delay of taxes payable on incomes derived from exports, although they are provided to U.S. exports.

We have examined here the subsidy measures that may be used to minimize the threat of retaliation in the event that indirect subsidies to the exports of manufactured goods through exchange rate and tax arrangements encounter difficulties. It should be emphasized, however, that the latter alternative is preferable on efficiency grounds and also because the introduction of various forms of export subsidies will create special interests that make subsequent reforms in the system of incentives difficult.
VI. Policies of Developed Nations Towards Manufactured Exports from Developing Countries

Tariffs on the Imports of Manufactured Goods

Notwithstanding the tariff reductions undertaken during the post-war period, manufactured goods remain subject to varying levels of duties in the developed countries. According to one estimate, following the completion of the Kennedy Round of tariff negotiations, tariffs on the imports of manufactured goods average 6.8 per cent in the United States, 6.6 per cent in the European Common Market, and 9.4 per cent in Japan. With tariffs rising from lower to higher levels of fabrication, effective rates of protection on value added are even higher, averaging 11.6 per cent in the United States, 11.1 per cent in the European Common Market, and 16.4 per cent in Japan.

At the same time, reductions in tariffs undertaken during the post-war period have been greater on commodities such as machinery, equipment, and capital-intensive intermediate products, which are of interest chiefly to the developed nations themselves, than on products of export interest to the developing countries. This explains why average tariffs on the manufactured goods imported from developing countries are substantially higher than the average for the total manufactured imports of the developed nations.

Thus, post-Kennedy Round tariffs on the imports of manufactures from developing countries have been estimated to average 12.4 per cent in the United States, 9.4 per cent in the European Common Market, and 11.7 per cent in Japan. Effective rates of protection are again higher, averaging 23.9 per cent in the United States, 16.8 per cent in the EEC, and 20.2 per cent in Japan.

In this connection, it should be recalled that an effective rate of, say, 20 per cent means that devel-

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29 Bela Balassa, "The Structure of Protection in Industrial Countries and Its Effects on the Exports of Processed Goods from Developing Countries", op. cit.
oping countries could export only if they were able to operate with processing costs 17 per cent lower than their competitors in the importing country.

It may be suggested, then, that lowering tariffs on the imports of the developed nations and subsidizing the manufactured exports of the developing countries are substitutes in their effects to improve the competitiveness of these exports vis-à-vis domestic production in the importing countries. But, while the fiscal cost of tariff reductions burdens the developed nations in the first case, it is borne by the developing countries in the second.

At the same time, removing discrimination against imports from the developing countries inherent in the protection of domestic industries is also in the interest of the developed nations. For one thing, specialization according to comparative advantage will improve the allocation of resources; for another, consumers will benefit from lower prices. It would seem appropriate, therefore, that the developed nations bear the fiscal cost of removing such discrimination through the elimination of tariffs on the imports of manufactured goods.

The described objectives could be attained by unilateral free trade on the part of the developed nations. Accordingly, efforts should be concentrated on tariff reductions to be undertaken in the framework of the Multilateral Trade Negotiations presently under way in Geneva. Offers made by the developing countries to reduce their often excessive levels of protection as suggested in Part V may contribute to the success of the negotiations.

The timing of reductions in, and the elimination of, tariffs on manufactured goods is however affected by the problems encountered in adjusting to free trade. Adjustment has a human cost in the form of unemployment and the depreciation of acquired skills. This cost decreases over time as new employment opportunities and skills are created and attrition takes place.

Adjustment problems can be dealt with through protective measures or by providing adjustment assistance. It is the former measures that have been chiefly employed in the developed countries; in the United States, for example, legislation on adjustment assistance had been on the books for over a decade but it has come to be applied only in recent
years. At the same time, the incidence of protection and of adjustment measures differ: in the first case, it burdens the foreign exporter, in the second, the Treasury of the importing country.

Considerations of equity would dictate that the developing countries should not be asked to bear the burden of adjustment in the developed nations. This could be accomplished by increased reliance on adjustment assistance in lieu of protective measures.

**Modifying International Rules on Export Subsidies**

It would further be desirable to modify international rules on export subsidies. From the point of view of the developing countries, the first priority is the introduction of an injury clause in U.S. legislation on countervailing action. The lack of an injury clause has unfairly burdened these countries by imposing countervailing duties on their producers although there may not have been injury to domestic industry. In the event that exports continue, the application of countervailing duties thus represents a financial transfer from the governments of the exporting countries to the U.S. Treasury.

But even apart from the commodities against which countervailing action has been taken, potential exporters in developing countries are discouraged by the threat of application of countervailing duties. Thus, the adverse impact of U.S. legislation transcends the cases when countervailing duties have actually been levied as it hampers the exports of manufactured goods from developing countries through increased uncertainty. Given the lack of clarity in legislation on countervailing duties, uncertainty is created also in regard to forms of export promotion that have not been subject to countervailing action.

The injury clause may be introduced in the framework of an international agreement on export subsidies referred to earlier. Such agreement should also call on the developed nations to observe the ban on export subsidies under Section B of Article XVI that has been part of GATT rules for over two decades. There are no economic reasons for export subsidies by the developed countries and such subsidization creates competitive pressures that hurt the exports of developing countries.

The ban on export subsidies would not extend to developing countries where such subsidization is required to capture production exter-
nalities, thereby contributing to international specialization according to comparative advantage. It would be desirable, however, to limit the extent of such subsidization, so as to assure that developing countries do not apply excessive subsidies that distort competition and involve an economic cost to them.

A possible way to limit subsidization is to agree that the rate of export subsidy should not exceed either the tariff on the commodity in question or the average tariff on the imports of manufactured goods in the exporting country. Through the use of this double criterion one could avoid the possibility that developing countries raise tariffs on imported goods in order to be able to provide large subsidies on exported goods, even though such tariffs are redundant. Furthermore, this proposal represents the application of the "market principle" by providing equal incentives to various industrial activities, irrespective of the market destination of sales.

Stricter rules would apply, however, to cases when particular developing countries have showed evidence of their superior competitiveness through large exports without reliance on subsidies. The existence of such cases would necessitate establishing lists of products and countries that come into this category, with the list being revised periodically.

In regard to export subsidies by developing countries that would not be allowed under the proposed scheme, it would be desirable to make claims for injury subject to internationally agreed rules, with international surveillance of the manner in which it is administered. This would ensure uniformity in the administration of the injury clause, and would also make it easier for national administrations to resist domestic political pressures for restrictions.  

The application of the proposed rules would call for GATT playing a much more important role than heretofore. It is suggested here that one should determine in the framework of GATT (a) the permissible extent of export subsidization in the individual countries, (b) the exceptions made for products and countries where export subsidization would be subject to countervailing action, and (c) the administration of the rules on determining injury in the event of export subsidization in regard to the products and countries listed under (b). As conditions change over time, performing these tasks would necessitate periodic reviews by GATT.

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*We are indebted to Isaiah Frank on this point.*
Instituting the described scheme would accelerate the transformation of the industrial structure of developed and developing countries and contribute to the efficient industrial development in the latter. By admitting export subsidization on the part of developing countries, it would also reduce pressures for inward-looking policies in these countries that have a high economic cost. At the same time, offers by developing countries to reduce protection would contribute to the acceptability of the scheme on the part of the developed countries.
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