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Imports from Developing Countries: Reasons for Protection and Proposals for Liberalization

by Dieter Schumacher, Berlin*

Protectionism in international trade, in particular with regard to imports from developing countries, has increased rapidly since the beginning of the 1970s. Dieter Schumacher analyses the reasons for this development and makes some proposals for a liberalization of trade which take the conflicts between domestic objectives in the industrialised countries and the international division of labour into account.

The advantages of the international division of labour arise from the more efficient exploitation of available worldwide resources. There are several reasons for this, irrespective of the type of economy: geographical factors (such as climate and geological conditions) as well as differences in the endowment with factors of production (characterized by different endowments in land, labour, capital and skills), in the production processes or in demand play a role. Moreover, a lack of domestic supply due to natural conditions or to a lack of production possibilities resulting from a low level of development are also significant determinants of international trade. According to the theory of the market economy, the above differences are reflected in different prices.¹ They are an expression of the opportunity costs of producing the various goods and depend on the endowment of resources, technology and consumer preferences. The price of a commodity indicates the amount of alternative production which must be foregone to produce an additional unit of the good in question. Through trade between countries with different relative prices it is possible that each country achieves a better supply of goods than under autarky. This is brought about by producing more and exporting goods with a low (domestic) opportunity cost while substituting imports for the production of goods with a high (domestic) opportunity cost. This means that real

income rises in each country and in the world as a whole although resources remain unchanged because international trade relaxes the limitation of consumption on given national production opportunities. Which goods are exported and imported in competitive trade is determined by the exchange rate which translates the relative differences in domestic and foreign prices into absolute advantages or disadvantages. It balances out the differences in the overall price and productivity levels and, taking capital movements into account, settles at a level at which a balance exists in the longer term between the value of imports and the value of exports.

Prices in a (closed) economy are, in addition, affected by government measures. A system of purely private-enterprise competitive prices leads, in an ideal economy, to an efficient allocation of resources in the sense of maximum production. This, however, includes only those costs and benefits which are considered in the calculation of individual private profitability, and it means that, in terms of purchasing power, the individual consumer's importance corresponds to the distribution of income which arises from the given distribution of the ownership of the factors of production. On the one hand, government measures serve to redistribute income, as far as the initial distribution of income is considered to be in need of change, and thus influence demand conditions. On the other hand, they take into account

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¹ This price system theoretically could also be computed in a centrally planned economy. Every efficient plan for production implies a system of competitive prices and vice versa as may be shown with the aid of the property of duality in mathematical optimization.

external effects on production and consumption: certain production or consumption activities are made more expensive by means of taxation or are promoted by means of subsidies and/or are subjected to government regulations.

Welfare Function

Such measures also influence international trade flows. However, they do not distort them but are in fact necessary in order to correctly determine the comparative advantages (and disadvantages) of different industries according to a more comprehensive welfare concept than that considering production maximization only. Aligning trade flows solely to purely private competitive prices can lead to maximum production on a world-wide scale but would neglect other relevant welfare factors. Conversely, if international trade were aligned to relative prices which represent actual social costs in terms of a more comprehensive welfare function as well as government regulations for this purpose, then each economy would gain according to its own welfare function.

The situation of free trade can now be defined as the international exchange of goods based on the comparative advantages as defined above and which is not influenced by additional measures. Protectionism is therefore measures which go beyond those taken in the (hypothetical) situation without trade. These measures would distort trade flows as compared with free trade and would therefore reduce the maximum attainable welfare gains.

New aspects arise in connection with foreign trade which can be relevant to social welfare but which are not taken into account in the above welfare function.² For example, protection against foreign competition may be necessary to establish new industries or to achieve industrial diversification. Besides, national security may require that demand be met to a minimum extent by domestic production. It could also be meaningful as a basis for further development of means of production to produce a minimum level domestically using those means of production. Furthermore, the introduction or expansion of foreign trade leads to adjustment processes. If resources are pulled out from the production replaced by imports and move into export production, then labour must be retrained and possibly move to a different place, factories must be demolished

or adapted and buildings must be altered or rebuilt. The resulting costs may be reduced by stretching adjustment over a long period of time and thus achieving it to a large extent through the natural reduction in capacity (workers' retirement, capital consumption) caused by abstaining from re-investment. Nevertheless, costs will arise to a certain extent because the "natural" life-cycle of individual factors of production differs.

Under these aspects – where not only the product but also production itself is of value – it may be sensible for a country to allow international division of labour only up to a certain limit or at least to increase it gradually. Advantages in the form of the possible establishment of new industries, satisfying security needs and avoiding structural adjustment costs can, however, be achieved only by sacrificing welfare in the sense of the above welfare function – as long as future comparative advantages do not develop as a result of temporary protective measures. In this case a national conflict of objectives arises which means that competing objectives must be weighed up in order to work out a compromise. This cannot be achieved by academic discussion, but only by political decision making. Economists can attempt to analyse the main determinants of this decision and, thus, the actual protection pattern, for example by examining the influence of different interest groups on government policy.³ Moreover, they can quantify, at least to a certain extent, the advantages of protection on the one hand and the possible welfare gains without protection on the other. If a political assessment of both aspects leads to a decision for a certain level of protection, then a reduction in that protection can be described as a sacrifice of national welfare in a broader sense, the extent of which cannot be measured objectively, however.

International Conflicts of Interest

Finding a compromise in the national conflict of objectives described above is, to begin with, a matter for the respective society, just as is the weighting of competing objectives in the national welfare function in a situation without trade. However, as protection in one country prevents other countries from realizing welfare gains through the international division of labour, there

² Apart from the arguments discussed here, other aspects such as foreign policy considerations also play a part (e.g. embargo and boycott measures, on the one hand, promoting trade for political purposes or creating mutual economic dependence, on the other), as do moral issues (e.g. a ban on exporting arms).

³ See the approaches of the political economy of protection which try to explain the extent of protection by the supply of, and demand for, protection on a political market. D. R. Nelson: *The Political Structure of the New Protectionism*, World Bank Staff Working Paper No. 471, Washington D. C., 1981, gives a summary with references. For empirical results see K. Anderson, R. E. Baldwin: *The Political Market for Protection in Industrial Countries: Empirical Evidence*, World Bank Staff Working Paper No. 492, Washington D. C., 1981.

is also an international conflict. In this case the solution implies an evaluation of the competing interests of different countries. The problem is that, as opposed to the situation at the national level, no binding mechanism exists at the international level which combines the diverging objectives to a compromise. Here, a compromise must be sought in multilateral negotiations if the result is not to be purely dependent on the individual strength of the countries involved.

In principle, the sovereignty of each country must be recognized to decide on the relevant arguments and their relative importance for its welfare. On the one hand this implies that it determines its comparative advantages and disadvantages according to its own national welfare function, i. e. it may also influence them to a varying degree by government action. On the other hand, each country must be entitled to limit the effects of the comparative advantages of other countries on its own economy. Consequently, protection would be basically permitted although the extent would be subject to international discussion. Firstly, therefore, protective measures must be transparent so that the extent of protection can be ascertained. In practice it is often difficult to draw the line suggested in the theory between measures to correctly determine comparative advantages – in terms of the respective welfare function without trade – and measures for protection in the real sense of the word. This is because no empirical comparisons of government behaviour with and without foreign trade are possible. As well as measures which obviously aim at discrimination between natives and foreigners, e. g. tariffs or quantitative restrictions, there are other measures where this is not simply the case, e. g. subsidies or various forms of government regulations.⁴ Secondly, discussion on the extent to which protection should be allowed in individual cases should consider not so much the reasons for price advantages but the effects of the induced supply in the importing country.⁵ Public discussion of conflicting objectives would make the problems more transparent and improve the position of the weaker countries.

The considerations outlined here leave it to a certain extent to international agreements to determine foreign

trade flows. No definite solution can be drawn from them but they certainly represent a more realistic approach as they take account of existing conflicts of interests. In contrast, it is true that the classical dogma of free trade offers a well-defined solution. In the recommendations that trade flows should be determined by private-sector price relationships on markets with as perfect competition as possible and with a minimum level of government intervention, the international division of labour is regulated only with the objective of maximising world-wide production. Other objectives and the resulting conflicts are neglected.

In the next section, some ideas concerning the liberalization of imports from developing countries are outlined, which take the competing objectives into account. They seek a compromise between the interests of the industries in industrialised countries under pressure from imports from developing countries, the interests of consumers and exporting industries in industrialised countries as well as the interests of the developing countries.⁶

Liberalization of Imports

An assessment of the trade barriers of the most important western industrialised countries shows – despite all the differences in details – particularly strong insulation against imports from developing countries. A large proportion of trade between the industrialised countries takes place without tariffs, whereas manufactures which come under strong competition from the developing countries – normally labour-intensive goods – are subject to the highest tariffs. For many of these products the tariff preferences granted under the General System of Preferences are restricted. The protection effect of tariffs – measured by the level of prevented imports – is particularly large in this case, as the demand for these goods has a relatively low income elasticity and a high price elasticity. Furthermore, the effective protection of domestic value added against competition from developing countries is considerably higher than the level of nominal tariffs, as a result of the tariff escalation which still prevails. More important than tariffs are non-tariff trade barriers which also concentrate on groups of products subject to competition from the developing countries. In many

⁴ Apart from discriminating against foreigners in the domestic market it is also possible to discriminate in third markets, e.g. by subsidizing exports (directly or by reducing the costs of financing) or by tying aid. Protectionist measures are usually undertaken by the government although similar effects arise due to restrictive business practices.

⁵ Consumers in the importing country have an advantage and domestic producers are at a disadvantage, e.g. when foreign goods are supplied more cheaply due to dumping or subsidies from the exporting country. This will only happen in the short run, though, if the foreign country achieves a monopoly status in this way and exploits the situation for later price increases.

⁶ The concept briefly presented below is extensively elaborated in: D. Schumacher, U. Möbius, S. Schultz: Ein internationaler Liberalisierungsplan. Handelshemmnisse gegenüber Industrieerzeugnissen aus Entwicklungsländern und Wege zu ihrem Abbau, Köln, 1984. For a summarizing presentation see S. Schultz, D. Schumacher (in collaboration with U. Möbius): Re-Liberalization of World Trade: Some Ideas for Reducing Trade Barriers against Industrial Products from Developing Countries, in: *Journal of World Trade Law*, Vol. 18, 1984, pp. 206-223.

cases such measures are exclusively used against Third World countries.

Even after the Tokyo Round the developing countries remain at a disadvantage compared to suppliers from the industrialised countries: they still have to overcome higher tariff barriers and the agreed codes for a series of non-tariff barriers to trade are often not binding while the hard-core non-tariff protection in the form of quantitative restrictions is not regulated at all. An international liberalization effort would have to reduce the present bias of protection to the disadvantage of developing countries and, in addition, should provide an advantage which is desirable from the point of view of development policy.

However, the liberalization of imports from developing countries now brings about greater problems than the earlier liberalization in trade among the industrialised countries: the structural change resulting from an extension of trade with developing countries is larger than one arising from an equal increase in trade between the industrialised countries. This is because trade with the Third World is characterized more by inter-industry division of labour and therefore leads to shifts among the branches of the economy. In addition, the marginal utility of additional real income falls at a high level of material welfare, whereas the preference to avoid adjustments increases, i. e. structural adjustment costs are felt more severely.⁷ This is even more the case now, since the current situation in the industrialised countries is characterized by high unemployment. Moreover, the prospect that an increase in imports will be accompanied by an increase in exports is uncertain. While liberalization among the industrialised countries was mutual and led to an increase in imports and exports in each country – broadly in the same sectors of the economy – the developing countries could use a proportion of the additional foreign exchange to pay for oil imports and debt servicing. Furthermore, they protect their own domestic markets more strongly than the industrialised countries. They are forced to do this to a certain extent because of their low level of development.

Need for Complex Regulations

Correspondingly, any realistic proposals to remove trade barriers against imports from developing countries must provide for complex regulations. They have to take into account differences between the countries involved, (i) between the industrialised countries as to

their capability and willingness to overcome the resulting structural changes, and (ii) between the developing countries as to their level of development. This holds, in particular, with regard to the treatment of the most advanced developing countries – the so-called newly industrialised countries. An international approach to liberalize imports from developing countries should comprise the following elements.

Liberalization must be long-term and provide for a reduction of trade barriers according to a *binding timetable* in several stages. The first step would be to agree not to introduce any new protectionist measures and to make the existing measures public. Thus, more transparency regarding the level and structure of existing protection should be achieved. As a second step, an agreement on the gradual reduction of trade barriers should be reached.

With respect to non-tariff barriers, which comprise many and complex measures, liberalization should at first concentrate on *quantitative restrictions*. They could be reduced by a gradual increase in supply quotas, which could be smaller the more labour-intensive the production of the goods in question. Thus, the loss of jobs in the most vulnerable industries of the developed countries could be limited. The disadvantage for developing countries of having to accept the smallest increase in the exports of their most competitive goods would be compensated for by the advantage that these increases would be obligatory. An alternative would be first of all to replace the quantitative restrictions by tariffs resulting in approximately the same protective effect and then to gradually reduce the tariffs.

The General System of Preferences offers a starting point for the reduction of *tariffs* by gradually extending the current preferences granted to the developing countries. This could be achieved by successively lifting the built-in restrictions, by the inclusion of further industrial products and the consideration of the few not-yet-favoured countries.

A *differentiation between countries* in terms of trade and development policy could also be made possible by corresponding regulations under the General System of Preferences. The quantitative limits to tariff preferences for many products according to the type of commodity and the supplier countries should be removed. Instead of this, the newly industrialising countries should be excluded from preferences in goods for which they exceed a certain share of supply. Supply from LLDCs should always be free of tariffs. Interim solutions should be found for countries at a medium stage of development, e.g. by implementing half the normal

⁷ This aspect is discussed in K. W. Rothschild: Außenhandelstheorie, Außenhandelspolitik und Anpassungsdruck, in: Kyklos, Vol. 32, 1979, pp. 47-58.

tariffs. The most advanced countries must also be considered in so far as, in their case, liberalization could be made dependent on the reduction of their own protection. This could improve the export opportunities of developed countries and, thus, reduce the resistance of these countries against liberalization. The difficulty is to formulate objective and commonly acceptable rules determining those countries which in trade policy should be treated more and more like industrialised countries. To this end a GATT committee on "graduation" might be established.⁸

Structural Adjustment

The mastering of the *structural changes* which arise from the increase in the division of labour with the Third World is probably the most important precondition in the developed countries for a liberalization of imports from developing countries. Various empirical studies show that the structural changes are small from the point of view of the economy as a whole as well as in relation to the overall shifts arising from changes in technology, domestic demand and foreign trade combined. However, labour market problems result from the fact that the job losses due to imports are concentrated on a few relatively small branches of the economy. Moreover, women workers and unskilled labour are affected particularly hard, i. e. groups of workers who are in any case disadvantaged. In many cases economically weak regions are affected. On the other hand, the positive effects on employment resulting from exports are more spread out in terms of sectors and regions and benefit qualified labour to a particularly large extent. The structural changes induced by increased division of labour with developing countries

thus imply a need for enhanced training of women in what are regarded as men's jobs and training to a higher level of qualification for the workforce in general.⁹

In a market economy, firms themselves are primarily responsible for structural adjustment. In addition, *government measures* to aid the adjustment process – especially for the workers – are necessary for reasons of the future efficiency of the economy and to make the changes acceptable and politically viable. No new instruments and institutions are basically needed for this as the sectors of society negatively affected by imports from the developing countries are essentially the same as those which are put at a disadvantage in the industrialised countries during their general process of development anyway and for which in principle supporting schemes exist. The measures must consistently be directed towards support for, and not – as is often the case today – towards the prevention of, adjustment processes. However, a temporary increase in funds alongside liberalization is probably necessary to master the need for adjustment which has built up as a result of many years of protection. The resulting advantages in terms of jobs in the exporting industries and an increase in real income as well as the funds spent on adjusting to imports from developing countries must be made clear to the public so as to reduce the political opposition to liberalization. The expenses could be listed in a new position alongside the transfer of

⁸ Cf. I. Frank: The "Graduation" Issue in Trade Policy toward LDCs, World Bank Staff Working Paper No. 334, Washington D.C., 1979.

⁹ For empirical evidence on the magnitude and direction of structural changes arising from trade with developing countries as well as differences between industrialised countries see D. Schumacher: North-South Trade and Shifts in Employment. A Comparative Analysis of Six European Community Countries, in: International Labour Review, Vol. 123, 1984, pp. 333-348. Differences between the impact from trade with the Third World and from trade with industrialised countries are documented in A. Sapir, D. Schumacher: The Employment Impact of Shifts in the Composition of Commodity and Services Trade, Paper presented at the Inter-Governmental Conference on Employment Growth in the Context of Structural Changes, OECD, Paris, 6-8 February 1984.

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resources to developing countries already recorded in the annual examinations of the OECD's Development Assistance Committee.

The *funds* required for adjustment measures could be raised by partially skimming off the advantages of an increased division of labour which accrue to consumers and exporting industries. Adjustment costs could possibly also be financed by increased tariff revenues if quantitative restrictions are replaced by their tariff equivalents. As the non-tariff barriers are more restrictive at present than tariffs for various goods from the Third World, tariff rates would have to be introduced selectively against developing countries which exceed the most-favoured-nation level. This would not be in line with the non-discrimination principle of GATT, but it should be possible by means of a "waiver" if the developed countries were in fact willing to pursue this path. At the same time, a timetable for the gradual reduction of additional tariffs would have to be set down.

When considering the idea of an international effort towards liberalization, it must be taken into account that disparities exist between the individual industrialised countries both with respect to the importance of the structural changes resulting from foreign trade and with respect to economic efficiency. Moreover, opinions differ considerably from country to country over the degree to which the contraction of threatened industries can be considered socially acceptable. In order to take these differences into account the setting-up of an *international transfer of finance* may be considered which would provide a suitable distribution of funds to finance structural adjustment measures among the participating industrialised countries. To this end existing financial instruments could be extended (at EEC level, e. g. EIB loans, Regional and Social Funds). In this case the funds would be increased and their use for adjustment to increased imports from the developing countries could be clearly shown by handling them separately. However, a specific international fund could also be established which would include the USA and Japan alongside the EEC countries and which could be placed at the World Bank. The proposed international transfer of finance might encourage the more cautious industrialised countries to participate in the liberalization of imports from developing countries.

Special regulations would have to provide for the case of serious disruptions in individual sectors of production as a result of a sudden – traceable – rise in supply pressure from abroad which cannot be met quickly enough by structural adjustment measures. In this regard, a *safeguard clause* might be considered which – as an "emergency break" – would allow a temporary

halt to the liberalization process under precisely defined circumstances. The problem is to define the conditions appropriately, i. e. not so narrowly that the clause would be eluded, and not so widely that the liberalization process could be stopped very easily.

Concluding Remarks

The concept of a liberalization initiative outlined above is based on the acknowledgement that limited protection may be basically justified. However, it should be transparent and tied to a timetable of gradual reduction. As the weight of competing objectives implied in such a compromise cannot be theoretically determined, it is possible only to elaborate the necessary elements and their basic characteristics. More exact quantitative assessments require political decisions.

An international effort to liberalize imports from developing countries could be an opportunity to approach the unfinished business of the Tokyo Round in a comprehensive way, i.e. the problems of quantitative restrictions, graduation of the more advanced developing countries and an agreement on an appropriate safeguard mechanism. A comprehensive liberalization concept would make the treatment of developing countries in terms of trade policy clearer and, in particular, would remove the juxtaposition of barriers and preferences relating to the same products supplied by the same countries.

A step-by-step reduction of trade barriers following a binding timetable would provide a solid basis for sensible investment decisions in the developing countries and in the industrialised countries, so that the risk of wrong investment decisions would be reduced. Structural change would be brought about in the industrialised countries and, at the same time, alleviated. This is because, if there is sufficient time, the necessary reduction in capacity in individual areas can, to a large extent, result from the retirement of labour and discontinuing reinvestment. Thus the need for import restrictions within the framework of safeguard clauses would be reduced.

The structural changes resulting from liberalization could certainly be coped with more easily if the general economic situation were a better one. Since the recovery from the recession in several of the main industrialised countries makes prospects appear brighter, an international initiative for liberalization might well have a chance of success. Decisive is, above all, that the most important participants in international trade show a strong enough political will to act.