

## Preferential Schemes: a Reappraisal (\*)

In my paper on *New Proposals for The International Finance of Development* (number 59 in the Princeton series of Essays in International Finance), attention was directed to the lack of progress in flow of resources to the developing countries in the nineteen-sixties and the urgent need for a significant increase in the flow. It was pointed out that pleas for donations on compassionate grounds and demands for concessions by the trade-union approach on the part of the developing countries had been useful in mobilizing world opinion in the initial stages of a massive effort, but that these were in themselves insufficient to obtain concessions at the negotiating table. Indeed, when grave difficulties had been encountered in obtaining key concessions from the developed countries, a new look was called for to deal with the impasse. Proposals were thus advanced for launching a new initiative for a significant increase in development finance. It was suggested that the various channels of development finance should be reappraised to distinguish, in particular, what was realistically feasible from what was likely to be a wild goose chase. It was also suggested that new fronts of attack which had so far been neglected should be explored. A new foundation is thus required at the intellectual level, and a new strategy is called for at the practical level.

The purpose of the present paper is to elaborate further the theme of the previous essay. Attention will be concentrated on one of the key demands by the developing countries: namely, the granting of preferential tariffs on manufactures and semi-manufac-

---

(\*) It is always difficult to enumerate the large number of economists and statesmen who have influenced my thought through their theories or actual intervention in the course of world events. I wish, however, to record my personal indebtedness to Messrs. W. Beckerman, A. Brown, H. C. Georgiadis, M. G. Mathur, J. L. Mosak, H. Pilvin, Raul Prebisch, M. Rom, N. Sarkar and Constant Shih for stimulating discussions on various aspects of the preference issue. The views expressed are those of the author alone, and do not necessarily reflect those of the organization with which he is associated.

tures by the developed countries to the developing countries (hereafter referred to simply as "preferential tariffs" where convenient). It will be shown that the lack of major progress on this score may be traced to the intellectual foundation of the preferential schemes and the way in which the preference issue has been debated by proponents and opponents alike. If this issue is to move from the debating stage to the negotiating stage, the arguments have to be reappraised and the schemes have to be redesigned.

## I. The Case for Preferences

### *The Trade Argument*

The preference issue has been identified as one of the key issues in trade and development (1). The argument starts with the postulate that if the developing countries are to achieve a certain rate of economic growth, say 5 per cent per annum, as envisaged in the "Development Decade" of the nineteen-sixties, imports required will have to grow at a somewhat faster rate. But world demand for primary commodities from the developing countries as a group is unlikely to grow at a satisfactory rate, owing to a tendency toward increased degree of fabrication in output and a

(1) The preference issue was raised at the March 1963 meeting of Committee III of the General Agreement on Tariffs and Trade (GATT). The Ministerial Meeting two months later concluded that a working group should be established to study the proposal of preferential treatment. The question was also discussed at the second session of the Preparatory Committee of the United Nations Conference on Trade and Development (UNCTAD). It was a key question of the Committee on Manufactures at the 1st UNCTAD in 1964 and will again feature on the agenda of the 2nd UNCTAD in 1968. In addition, other international organizations, such as the Organization for Economic Co-operation and Development and the European Economic Community, are currently engaged in a study of preferences. See General Agreement on Tariffs and Trade, *Measures for the Expansion of Trade of Developing Countries as a Means of Furthering Their Economic Development*, mimeographed document MIN (63) 7, 22 May 1963, p. 12; United Nations, *United Nations Conference on Trade and Development: Report of the Second Session*, mimeographed document E/CONF.46/PC/46, 5 July, 1963; *Proceedings of the United Nations Conference on Trade and Development*, Volume II, pp. 35-42 and Volume IV (New York, 1964); *Preferences: Review of Discussions*, Report by the Secretary-General of the Conference, mimeographed document TD/B/AC.1/1, 23 March 1965; *Preferences: Some Aspects for Further Consideration*, mimeographed document TD/B/C.2/AC.1/2/Rev. 1, 12 July 1966; *Draft Report of the Trade and Development Board on its Fourth Session: Chapter VII, Report of the Committee on Manufactures and Report of the Group on Preferences*, mimeographed document TD/B/L.93/Add. 7, 20 September 1966.

corresponding decline in the share of the value of raw materials embodied in the output of the developed countries, and owing to the development of substitutes, such as synthetic rubber and fibres, and to the generally low income elasticity of demand for primary products. Expansion of exports of manufactures is therefore crucial for meeting the trade or foreign exchange gap in the growth process of the developing countries.

Apart from the "gap" argument, the importance to developing countries of exports of manufactures, even in small quantities, has been emphasized for considerations of the strategy of development. It has been observed that the development propelled mainly by import-substituting industries in developing countries is rapidly running out of steam or reaching a ceiling. Such industries have typically been exclusively oriented toward the domestic market and are incapable of competing in the world market because of high costs under steep protective walls. Furthermore, in a majority of newly established countries with a typically low income level and a small population of a few million or less, the range of inward-looking industries that can reasonably be established is limited at an early stage of development. Under such circumstances, exports of manufactures are needed, not only because they provide scarce foreign exchange, but, more importantly, because they may provide an escape from a low-growth "structural trap". This does not mean that, in the strategy of development, emphasis should be uniformly shifted to export industries. Even where exports deserve top priority, it should be remembered that the choice is often not between import-substituting and export-oriented industries, pure and simple. For many industries, if only a small percentage of the output can be exported, the range of viable activities can be greatly expanded, and the cost structure can be altered.

At the same time, it is recognized that there are important obstacles to exports of manufactures by the developing countries. The infant industries of these countries would not be able to compete with the long-established ones of the developed countries. If protection is needed for their survival in the domestic market in their own countries, it is all the more necessary to obtain specially favourable treatment, such as preferential tariffs, in the foreign market — that is, in the developed countries. The infant industry argument is thus extended beyond the realm of tariff policy of the developing countries to justify preferential tariffs granted by the

developed countries. These industries are relatively high-cost producers, not necessarily because they are uneconomic, but because they are at the beginning of a long period of sliding along a declining cost function or "learning curve" or else because their pecuniary costs overstate the real social costs due to inadequate accounting of external economies generated by them or distortions in the price-wage structure in the "dual economy".

Moreover, it is contended that the granting of preferential tariffs to the developing countries does not necessarily conflict with trade liberalization and multilateralism. Even the conflict with the most-favoured-nation principle may be more apparent than real. In the first place, while preference inevitably presumes the existence of tariffs, it is not to be used as an argument for maintaining or raising existing levels of tariffs. Indeed, removal of existing barriers to trade by the developed countries is considered as a first step toward expansion of exports from the developing countries, although, for reasons given earlier, it is in itself considered inadequate. Preference is therefore to be viewed as a partial elimination or reduction of tariffs where an overall liberalization may not be possible. So long as preference is designed to facilitate exports of the developing countries and no new restrictions are placed on exports of other countries, the net impact may be considered liberalizing.

It is pointed out, further, that preference may be viewed as an offset against the existing tariff structure and trade obstacles since they are particularly burdensome to the developing countries. Indeed, postwar negotiations for tariff reductions primarily with the "principal supplier" meant that most of the developing countries have not been directly involved in the bargaining, and items of interest to them have frequently been by-passed. As a result, some of the import tariffs in the developed countries are levied on articles of light industry exported by the developing countries (2). Furthermore, the tariff structure varying according to the degree of processing, as is commonly found in most markets, has a high protective effect on semi-manufactures and manufactures, some of which are especially important to primary producers in the process of vertical industrialization. Moreover, quantitative restrictions,

(2) See United Nations, *Trade and Development: Trends, Needs and Policies: World Economic Survey, 1963*, (New York, 1964), pp. 219-220.

notably certain illegal restrictions in the so-called "negative list" of GATT, affect very largely the exports of the developing countries.

The argument that a preferential scheme is not necessarily in conflict with multilateralism is more involved. Obviously, preference, by definition, falls short of complete multilateralism. A preferential scheme may, however, be more multilateral than the prevailing situation or may indeed be used to offset existing discrimination. It is pointed out that, despite the general postwar trend towards multilateralism, the structure of trade is still characterized by compartmentalization. Quite apart from the division between East and West, a sizeable portion of world trade is in fact being conducted within preferential groupings. In addition to the long-established preferential arrangements explicitly allowed by GATT, such as the Commonwealth preferences and Franc Zone arrangements, recent formations of regional groupings, notably the European Economic Community (EEC) and the European Free Trade Area (EFTA), have been conspicuous. Many of these new arrangements have tended, in fact, to discriminate against exports from the developing countries. Furthermore, these arrangements are by no means limited to full-fledged customs unions or free trade areas, in the strict sense of article XXIV of GATT. Many forms of special arrangements have been made, ranging from loose associations with the customs unions to specific industry pacts as in the case of free trade in automobiles between the United States and Canada.

Furthermore, it should be realized that many quantitative restrictions already mentioned in effect imply some degree of discrimination against the developing countries. Such discrimination is explicit in the case of restrictions on imports of textiles into the developed countries, under the auspices of an international organization. Under such circumstances, preference in favour of the developing countries may be justified as an offset against the special obstacles to exports of these countries in the existing trade regime.

While the offsetting argument may justify a net increase in the degree of discrimination for the world trade regime, any increase from this source can hardly be expected to sway the overriding principle of non-discrimination. The most important consideration here is quantitative. It should be remembered that imports of manufactures from the developing countries into the developed

countries constitute no more than 4 per cent of such imports and even less in relation to total trade (table 1). Even if a preferential scheme should cover the entirety of such trade, there is no reason why the rest, and the major part, of world trade should not be governed by non-discriminatory rules.

DEVELOPED COUNTRIES: IMPORTS OF MANUFACTURES FROM DEVELOPING COUNTRIES, 1962  
(Millions of dollars and percentage)

TABLE I

Country	Amount	Percentage distribution by importing country	As a percentage of imports of manufactures from all sources
United States . . . . .	659.0	38.2	10.2
United Kingdom . . . . .	405.0	23.5	11.9
Germany, F.R. . . . .	155.0	9.0	3.3
France . . . . .	89.1	5.2	2.8
Japan . . . . .	62.7	3.6	4.6
Australia . . . . .	57.0	3.3	3.6
Canada . . . . .	56.1	3.3	1.4
Norway . . . . .	44.7	2.6	4.0
Belgium-Luxembourg . . . . .	33.0	1.9	1.4
Switzerland . . . . .	32.8	1.9	1.6
Netherlands . . . . .	30.8	1.8	1.0
Italy . . . . .	27.5	1.6	1.0
Sweden . . . . .	23.2	1.4	1.2
Denmark . . . . .	16.6	0.9	1.3
New Zealand . . . . .	15.4	0.9	3.0
Austria . . . . .	7.0	0.4	0.7
Finland . . . . .	3.3	0.2	0.4
Portugal . . . . .	2.7	0.2	0.8
Ireland . . . . .	2.5	0.1	0.6
Iceland . . . . .	0.2	—	0.4
Total . . . . .	1,723.6	100.0	4.1

Source: Based on data from United Nations Statistical Office, United Nations, *Commodity Trade Statistics*, Statistical Papers, Series D.

Note: Data refer to c.i.f. values for the following Standard International Trade Classification (SITC) codes: Chemicals (5); Machinery and transport equipment (7); Other manufactures excluding base metals (6 and 8, excluding 67 and 68 but including 681). Developing countries include countries other than developed countries (North America, Western Europe, Australia, Japan, New Zealand and South Africa), and centrally planned economies (Union of Soviet Socialist Republics, Eastern Europe, Yugoslavia, Mainland China, Mongolia, North Korea and North Vietnam).

Introduction of a new preferential regime does not, moreover, necessarily imply a net increase in discrimination.

To the extent that a new regime consolidates or generalizes the existing fragmented preferential regimes, especially in respect of trade between the developed and the developing countries, multilateralism is being promoted rather than being retarded, and the degree of discrimination in the system of international trade as a whole is diminished.

Evidently, the net outcome would depend on the particular preferential scheme as well as the criteria for measuring the degree of discrimination. It is not difficult to see that a scheme which accords preference to all developing countries may be as consistent with the most-favoured-nation principle as the existing regime or even more so, as a generalized preferential arrangement may very well eliminate the discrimination against non-Commonwealth developing countries in the developed Commonwealth markets, and similarly the discrimination against the ones not associated with the EEC in the European Common Market. These considerations may be sufficiently important to offset the new departure from the most-favoured-nation principle introduced in markets such as the United States.

It will be recognized that the main line of argument in favour of preference has benefited from the wide acceptance, even among free traders, of the need for protection of infant industries and from the development of the theory of the "second-best" in connection with general rules for world trade. At the same time, the dual emphasis placed on the infant industry argument and multilateral rules for world trade, especially the most-favoured-nation principle, has exercised a divisive influence on the development of preferential schemes.

#### *Divergent Implications of the Trade Argument*

While the arguments for preference have stimulated lively international discussions, little practical result has as yet been achieved. The basic difficulty stems from the divergent implications of the main arguments in favour of or in defence of preference.

Although the main arguments for preference have often been used together, when the emphasis is placed on the infant industry argument, a selective scheme becomes the logical solution; and when

the focus is on multilateralism in trade, a general scheme is insisted on.

The scheme favoured by most of the developing countries is an extremely general one. Preferential tariffs are to be granted by *all* developed countries to *all* developing countries. This reflects a general disapproval of the existing preferential schemes granted by certain developed countries to specially favoured developing countries reminiscent of pre-independence days. It also reflects the fear on the part of some developing countries of being left out of the picture and thus becoming "orphans" in the preferential scheme. Perhaps even more important is the desire to do as little violence as possible to the accepted principles of multilateral trade.

Events in recent years have amply demonstrated the difficulties in putting such a grandiose scheme into practice. In the first place, to the defenders of the multilateral principle, substitution of the preference principle for the most-favoured-nation principle, even when limited to trade relations between the developed and the developing countries, is considered incongruent with the accepted ideology. But the most damaging blow comes from those countries which have no difficulty in swallowing preference in principle, as it is in fact widely practiced by them in many areas of activity. To these countries a general preferential scheme granted by all developed countries to all developing countries is out of the question. It is agreed that every case should be examined on its own merits selectively. That means that individual developed countries should grant preference only as a result of specific negotiations, not only that different developed countries may take separate action on this score, but that different developing countries should be treated differently, since some countries and some industries need preference more than others.

This position has its roots in the existing preferential arrangements, which have been negotiated on a selective basis. There is considerable reluctance to upset laboriously negotiated schemes for something entirely alien. But the intellectual basis of the selective approach may be traced to the infant industry argument.

For the logical extension of the infant industry argument is that many industries in the developing countries are in their infancy. At the same time, it must also be admitted that some have reached adolescent stages or even adulthood. The latter industries may be fully competitive in world markets, not always because they may

have been established for a number of years, but in some cases precisely because they may enjoy the advantages of late-comers who benefit fully from the fruits of new technology, unencumbered with obsolete machinery and equipment. Consequently, there is no reason to accord preferential treatment to any industry which has outgrown its infancy, in relative terms. Curiously, the same argument is often also subscribed to by advocates of the general preferential scheme without realizing the latent contradictions. At the same time, it has also great appeal to the less industrialized group of developing countries as a justification for differential treatment among these countries.

The main difficulty with the selective approach in its extreme form is that the multilateral principle may be largely abrogated. Moreover, literally thousands of negotiations between pairs of countries for numerous commodity groups are not only extremely time-consuming and tedious but, as each negotiation is evidently inter-related with the rest, it is also extremely difficult to form a rational basis for any arrangement in an isolated case without effective consultation and co-ordination with the rest. The practical difficulties of effective co-ordination will be multiplied if the selection of industries is supposed to be based on the principle of viability and optimum allocation of world production.

The hardening of the positions of proponents of the general preferential scheme on the one hand and those of the selective scheme on the other, constitutes in itself a major difficulty, especially for the adoption of the general scheme. For, so long as important countries are firmly opposed to the general scheme, external pressure to induce a reversal of the position is likely to be ineffective, since there is no international obligation which would require any country to give preferential treatment to any particular country or group of countries, even if the general desirability of aid and preference is accepted. The intrinsic difficulty of gaining unanimous support for a general preferential scheme means that generality in all aspects is beyond practical reach.

Faced with the basic difficulty, international discussions have dragged on without a sense of direction. The pros and cons of isolated considerations have been repeated over and over again. Obviously, there are advantages and disadvantages in any general or selective approach; there are various criteria by which countries may be considered eligible for preferential treatment; there are

arguments and counter-arguments as to why certain commodities should be included in the scheme; there are considerations which favour or work against a temporary arrangement, or one of permanent duration; there are reasons for limited or unlimited quantities; there are arguments for high or low margins of preference. While such dialogue obviously has its place in the initial stages of debate, it is likely to become more and more arid and sterile since it can hardly be expected to yield a definitive conclusion.

### *The Aid Argument*

A first step toward resolving the basic conflict between the divergent schemes is to shift the intellectual foundations from trade considerations to aid considerations (3). That preference may be used as an instrument of aid is readily recognized by all concerned.

From the point of view of aid, tariff preference may be a more convenient vehicle than a straightforward resources transfer through budget appropriation. In the first place, it has the merit of built-in continuity. Once the system is accepted, it does not have to be reconsidered every year. At the same time, it is sufficiently flexible so that changes may be made when deemed desirable or necessary. In the second place, at least part of the real cost of preference is passed on to other developed countries because the primary aim is to give a competitive advantage to exports from the developing countries as contrasted with those from the developed countries. To the extent that preferential tariffs divert procurement from low-cost to high-cost producers, there is a real cost to the country granting the preference, borne largely by consumers. This is, however, not likely to be quantitatively important owing to the limited capacity of the developing countries to export manufactures even with the aid of preference. Moreover, as is well-known, the trade diversion effect is partly, or more than, offset by the trade expansion effect, since preference implies a partial liberalization of trade and a shift from submarginal domestic production to imports.

In any case, any real cost in terms of misallocation of world resources must be assessed by comparison with direct aid. In the context of aid, few people will maintain that a transfer of resources

(3) Cf. H. G. JOHNSON, "Trade Preferences and Developing Countries", *Lloyds Bank Review*, April, 1966, No. 80, pp. 1-18.

to the developing countries would encourage those countries to engage in uneconomic activities, but from the point of view of resource allocation, there is very little difference whether an industry is stimulated because it is benefited by preferential tariffs or by other aid, such as a low interest loan from an international agency.

But the chief advantage of the aid argument is to shift the emphasis, steering away from the basic conflict implied in the infant industry argument and the multilateral trade argument. For, as far as aid is concerned, there is no reason to assume that it should be distributed in a strictly multilateral fashion. It will be appreciated that distribution of aid, bilaterally or multilaterally, individually or collectively, may be, and has in fact been, extremely skewed and concentrated in a relatively few countries. While it will be useful to consider criteria of allocation of total available aid, the right of any particular country to disburse aid is unchallenged and the right of a particular country to receive aid cannot be assumed *a priori*.

Nor is it necessary to link preferential treatment, in the context of aid, to the infant industry argument. In fact, the infant industry argument is replaced by an "infant economy" argument which stresses the need for external resources in a developing economy. It is quite conceivable that countries in need of aid do have industries relatively well developed. India and Pakistan, which have been the main recipients of international aid, are cases in point.

### *Inadequacy of the Aid Argument*

While the aid argument provides a broad framework for a more flexible preferential scheme than is dictated either by the multilateral trade argument or the infant industry argument, it should not be assumed, as is sometimes done, that the basic difficulty of design of a preferential scheme is solved. For there is no escaping from the fact that preferential tariffs fall within the area of trade. The aid argument helps to direct attention to considerations other than trade, but does not remove the necessity of taking trade considerations into account.

The concern that a proliferation of preferential systems might exercise a divisive influence on the world trade system and create new spheres of influence cannot be ignored.

Nor can preferential tariffs avoid entirely the issue that certain industries in a number of developing countries have evidently passed the stage of infancy, as already noted, a fact which is further complicated by disparity among the developing countries.

The acceptance of the aid argument for preference is thus only a first step toward a more flexible approach than the extreme positions often advocated. At the same time, a flexible approach is basically indeterminate.

It is not difficult to see that an almost infinite number of intermediate positions are possible between the extremes of the general rule and the selective rule. Nor is it difficult to visualize compromise solutions that have their own difficulties. In order to point a way toward a practical design for a preferential scheme, it is necessary to narrow the area of alternative choices within which meaningful negotiation is possible. In doing so, various important policy considerations — commercial as well as industrial — must not be ignored but must be taken into account and appropriately weighed.

What has not been sufficiently appreciated from the implications of the aid argument is that the decision on aid-giving rests primarily with the donors. This is especially pertinent if the granting of preferential tariffs is to be made unilaterally without requiring reciprocal concessions or commitments by the developing countries. It follows that domestic considerations in the developed countries cannot be brushed aside. Since these considerations are by no means uniform in all developed countries, it is unrealistic to aim at a uniform arrangement acceptable to all these countries. The condition that all developed countries must participate should therefore be relaxed. In addition, the condition that there should be a single world preferential scheme should also be relaxed. Evidently, a preferential scheme which is applicable to developed market economies may not be pertinent to centrally planned economies. At the same time, not all developed market economies are likely to agree on an identical scheme. A further consideration, which is also consistent with the aid principle, is that a particular instrument of aid does not have to play a major role in the total aid picture. In fact, it is often good tactics to look into all possible instruments, including those whose impact may not be large. But when all the instruments are added together, the cumulative effect may be more than any single major instrument can hope to reach.

Viewed in this light, the current debate on the degree of effectiveness of preferential tariffs (4), is not central to the preferential issue but has only a limited relevance to it. Even if the argument that preferential tariffs are not likely to make a major contribution to the developing countries is accepted, it should not in itself be an argument against preference. By the same token, if the opposite argument is accepted, it has a double-edged effect since it may reduce the willingness of the developed countries to grant preference or necessitate the introduction of emasculating measures.

Moreover, the device of asking for a detailed examination of the precise effects of preferential tariffs — which can hardly be expected to be conclusive — may be used as a delaying tactic against any concrete action.

It is true that, if preferential tariffs are totally ineffective, or if there is completely free trade to start with, there is no basis for preference. The distinction, forcefully made in recent literature, between nominal tariffs and effective tariffs — based on value-added — helps to correct a common downward bias in rating the efficacy of preference. For example, a seemingly low structure of tariffs may in fact contain a powerful element of protectionism. At the same time, failure to relate tariff rates to value-added is not the only source of bias. As mentioned earlier, tariff rates on many items of interest to the developing countries tend to be much higher than the average. Inadequate disaggregation of tariff rates in the analysis thus results in a downward bias. Furthermore, attempts to assess the impact of preferential tariffs based on historical relationships also tend to understate the potential, since the past ineffectiveness may have been associated with a very low degree of industrialization as well as absence of other complementary conditions to take advantage of preference. Thus, the oft-cited case of ineffectiveness of the preferential arrangements for French territories in stimulating the development of industries in them, may be less applicable today

(4) See GARDNER PATTERSON, "Would Tariff Preferences Help Economic Development?", *Lloyds Bank Review*, April 1965, No. 76, pp. 18-30; *Discrimination in International Trade, The Policy Issues 1945-1965*, (Princeton, 1966), pp. 323-384; H. G. JOHNSON, "The Theory of Tariff Structure with Special Reference to World Trade, and Development", *Trade and Development*, l'Institut Universitaire des Hautes Etudes Internationales, (Geneva, 1965); B. BALASSA, "Tariff Protection in Industrial Countries: An Evaluation", *Journal of Political Economy*, December 1965, pp. 573-594; G. BASEVI, "The U.S. Tariff Structure: Estimate of Effective Rates of Protection of U.S. Industries and Industrial Labor", *Review of Economics and Statistics*, May 1966, pp. 147-160; W. M. CORDEN, "The Structure of a Tariff System and the Effective Protective Rate", *Journal of Political Economy*, June 1966, pp. 221-237.

and in future than in the past when the stage of development was at a very low level and protection of domestic industries was lacking.

This brings us to the difficult problem of evaluating the effectiveness of preferential tariffs, namely, the ability of manufacturers in the developing countries to take advantage of them. This relationship is not only a function of the basic economic structures, but also strongly influenced by domestic policy measures. The effective margin of preference has to be compared with the effective rates of protection and competitiveness of domestic industries in the developing countries, in the context of high tariffs, substantial subsidies, as well as unrealistic exchange rates under inflationary conditions. A general assessment of the effect of preference serves, therefore, no more than an illustrative purpose (5); and a detailed assessment of the impact on each particular industry and country, while unassailable as intellectual exercises, can hardly be expected to yield timely and meaningful results for international decision-making.

## II. Toward a Reconciliation of the General and Selective Schemes

### *Signs of Convergence*

As a matter of practical policy, the crucial question is whether a direction for concrete action can be found. The answer lies in a reconciliation of the general and selective schemes.

There are already some indications that the general and selective schemes tend to converge if approached realistically. Thus, if

(5) A number of estimates have been made to give an indication of the orders of magnitude involved under various assumptions. As a first approximation, if the average tariff on manufactures imported from the developing countries is 15 per cent, a 50 per cent linear reduction of tariffs on about \$2 billion of such imports would suggest a saving of about \$150 million of duty payments by the developing countries. The effect of a preferential tariff reduction on foreign exchange receipts is, however, not the same as a tariff refund. A tariff refund can yield a higher total receipt for the developing countries than an equal tariff reduction when demand is inelastic; on the other hand, it is entirely ineffective when the level of protection is prohibitive. A preferential tariff reduction affects exports of the developing countries not solely through the demand effect, but, more importantly, through the substitution effect by replacing some of the supplies from the developed countries. Varying assumptions of demand and supply elasticities have yielded an increase in export proceeds of the developing countries by \$1 billion to \$4 billion as a result of a 50 per cent linear preferential tariff reduction on manufactures. These estimates exhibit, however, a high degree of sensitivity to the particular models and assumptions used.

safeguards against market disruption in the developed countries are to be introduced within the framework of a general preferential scheme, exceptions for particular commodities and countries are obviously necessary. This is inevitable, because the process of tariff formation has almost always been the subject of detailed industry-by-industry consideration. The dramatic move toward an across-the-board approach has not, in practice, freed the Kennedy round negotiations from a commodity-by-commodity scrutiny. At the same time, the need to safeguard domestic interests in the developed countries granting preference does not mean that any industry in a particular developing country that has succeeded in passing the stage of infancy should be automatically excluded from preference. A practical solution lies between the extremes.

A significant step toward convergence of the selective and general approaches has in fact been taken by the acceptance of the Australian preferential scheme by GATT. It will be recalled that the Australian Government applied to GATT for a waiver for granting preferential tariffs to the developing countries in 1964 (6). The waiver was granted in March 1966. The main feature of the Australian scheme is that it was initiated, not by all the developed countries, but by a single developed country. Indeed, from many points of view, such as the degree of industrialization or the structure of trade, Australia may still be considered as a borderline country. As far as the developing countries are concerned, the scheme extends to virtually *all* of them. While the commodities concerned involve some sixty manufactured and semi-manufactured products, total imports of the selected items from all sources into Australia in 1963-1964 accounted for only 6 per cent of imports of all food and manufactures, as shown in table 2. Many items, including those largely imported from developing countries which enjoy Commonwealth preference, are excluded from the preferential list. Thus, imports of the selected items from the developing countries amounted to less than \$3 million and constituted a small fraction, 2 per cent, of total imports of the same items from all sources.

Moreover, in order to safeguard against injury to domestic producers, the margin of preference is not uniform but varies with products, averaging about 74 per cent as compared with the most-

(6) General Agreement on Tariffs and Trade, *Tariff Preferences for Less-developed Countries: Request for Waiver by Australia*, mimeographed document L/2442, 4 June 1965.



TABLE 2  
AUSTRALIA: VALUE OF IMPORTS: TOTAL AND PREFERENTIAL ITEMS  
(Thousands of dollars, f.o.b., and percentage)

Item	Total imports	Imports of items included in the preferential scheme from all sources		Imports of items included in the preferential scheme from developing countries	
	Amount	Amount	As a percentage of total imports	Amount	As a percentage of imports from all sources
Food . . . . .	102,618	835	0.8	9	1.1
Chemicals . . . . .	251,537	1,162	0.5	29	2.5
Manufactured goods classified by material . . . . .	580,844	75,204	12.9	1,751	2.3
Machinery . . . . .	928,323	38,154	4.1	38	0.1
Miscellaneous manufactured articles . . . . .	199,872	6,959	3.5	1,013	14.6
Total . . . . .	2,063,194	122,314	5.9	2,840	2.3

Source: Derived from data from General Agreement on Tariffs and Trade and United Nations, *Yearbook of International Trade, 1964* (New York, 1966).

Note: Items correspond to International Standard Trade Classification (SITC): Food (0) (which is not usually included in manufactures, but inasmuch as certain processed food items are included in the Australian scheme, it is listed here for the sake of comparison); Chemicals (5); Manufactured goods classified by material (6); Machinery (7); and Miscellaneous manufactured articles (8). Total imports refer to average of 1963-1964. Other imports refer to fiscal 1963/1964. The preferential scheme took effect in 1966. Items included in the preferential scheme classified by SITC, are: Food: chewing gum, sugar confectionery (excluding chocolate); Chemicals: wattle bark extract, soap (toilet, fancy or medicated), soap (other); Manufactured goods, classified by material: calf leather, other leather (less imitations and parings) and other leather manufactures; rubber thread (vulcanized); Portland cement; hosiery and other textile manufactures; machine made paper and paperboard, newsprint; hold utensils of wood, floats for fishing nets; machine made paper and paperboard, newsprint; silk yarns, cotton, linen, or ramie fabrics of huckaback or honeycomb weave, other woven fabrics of jute, hemp or other vegetable fibres, ropes, twines of coir, sisal and New Zealand hemp, other ropes (twines, etc.), fishing and rabbit nets, tents and sails, other textile articles, cotton shoe and corset laces, hand-made carpets, floor coverings of cotton, carpets and rugs of wool, other carpets and coir matting; butter knives, cruet sets, shakers, etc. of cut glass, other articles of cut glass, bottles, decanters, jars, tubes, etc. of glass, stationery (glassware), other glassware; cooks' and butchers' knives and blades, other kitchen or kitchen knives and blades, pocket knives and blades, razors and razor blades, scissors and blades; Machinery: machine tools for working metals and metallic carbide (specified machines, etc.), household washing machines, washing and dry-cleaning machines (commercial), gasket and similar joints, bottling machines, bagging machines, plastic processing machines, domestic sewing machine heads, wood-working machines and appliances (specified types), other wood-working machines and appliances (protected range and non-protected range), electric fans, office or household, military, band and orchestral musical instruments, musical instruments of the lute class (including strings) and other musical instruments; Miscellaneous manufactured articles: travel and other goods of leather, wooden chairs, chairs and loungers of wicker bamboo and cane, (with or without legs), other furniture, cricket bats and balls, and other sporting goods. In addition, numerous handmade traditional products of cottage industries of "less-developed" countries are granted free entry without quota limit. The precise value of such imports is not known.

favoured-nation rate, and about 36 per cent as compared with the Commonwealth preferential tariff. In addition, tariff quotas are set for each item specified, except for traditional handicrafts, which are without limit. The total value of these quotas amounts to \$30 million — about ten times the value of these imports into Australia from the developing countries. Yet, in terms of local production, while data are incomplete and not strictly comparable, it is evidently only a very small fraction (table 3).

TABLE 3  
AUSTRALIA: ANNUAL PREFERENTIAL QUOTAS FOR DEVELOPING COUNTRIES

Item	Amount (Thousands of dollars)	As a percentage of imports from all sources	As a percentage of imports from developing countries	As a percentage of local production
Food . . . . .	267	32	3,000	1
Chemicals . . . . .	445	38	1,538	2
Manufactured goods classified by material . . . . .	22,233	30	1,269	8
Machinery . . . . .	3,672	10	9,706	6
Miscellaneous manufactured articles . . . . .	3,027	43	299	4
Total . . . . .	29,644	24	1,044	6

Source: Derived from data from the Government of Australia, Customs and Excise Notice No. 66/73 of 12 April, 1966, General Agreement on Tariffs and Trade and United Nations, *Yearbook of International Trade, 1964*, (New York, 1966).

Note: For detailed explanations, see table 2. Estimates of local production are based on selected items for which data are available.

#### The Path Indicated by the Australian Scheme

Despite the limited quantitative importance of the Australian scheme, important principles have been established by it. It points to a new practical procedure by which preference may be introduced by a single developed country without waiting for every other developed country to agree on the same. It is sufficient that the rest of the developed countries acquiesce. This removes the most important obstacle, in contrast with a general preferential scheme, which requires all the developed countries to participate and agree. The example should, therefore, pave the way for other developed countries to introduce similar, although not necessarily identical, schemes.

That such a scheme can amply take into account the domestic needs of the developed countries granting preference is evident. In the first place, items which require special protection need not be included in the preferential scheme. Secondly, specific tariff quotas can limit the amount of preferential entry. In this connection, it should be made clear that there is a fundamental difference between a tariff quota and a quantitative restriction as such. A tariff quota does not in any way imply quantitative restrictions on imports; it only limits the amount eligible for favourable treatment. Beyond this limit, imports are still permitted at the general tariff rate. The introduction of tariff quotas would not, therefore, lead to a retrogression into quantitative restrictions, as is sometimes feared.

The individual action by the developed countries need, moreover, not be as fragmented as a simple counting of mathematical possibilities may indicate. For the really important markets for exports of manufactures from the developing countries are the United States, the European Economic Community, and the United Kingdom. These markets account for about four-fifths of all such exports (table 1). The fundamental trade policies of these giants, especially in their relation with one another, are not determined by preference to developing countries. On the contrary, any preferential scheme must take into account these policies. If trade moves toward Atlantic unity, preferential schemes of these countries may be readily harmonized; if separate ways are pursued, it is not likely that a uniform approach will emerge for preferential treatment of the developing countries.

### *The Position of the Pivotal Giants*

Although it is not the purpose of the present paper to assess the existing or prospective policies of the pivotal giants, an understanding of the considerations that these countries are concerned with is essential (7).

As far as the United Kingdom is concerned, the main consideration is what to do with existing preferential arrangements. Although Commonwealth preference has been considerably weakened in recent years through automatic reduction of the preferential

(7) For a statement of the official positions, see United Nations, *Report of the Special Committee on Preferences*, Annexes, mimeographed document TD/B/C.2/1/Add. 1, 8 June 1965.

margin on specific duties under creeping inflation, through diversification of trade as well as other preferential arrangements such as EFTA, a broadening of the Commonwealth preferential system to include other developing countries would imply further erosion of the existing preference. The granting of preferences to the developing countries as a whole by the United Kingdom is thus contingent on appropriate recommendation for the Commonwealth countries or adequate compensation for dilution of existing preference.

This dilution may be minimized by adopting the Australian solution of excluding a number of items of special interest to the Commonwealth countries, at least in the transitional stage before appropriate compensatory measures can be introduced.

The position of the European Economic Community is not entirely uniform. The momentum of movement of the Community points strongly in the direction of preferential treatment through association. Not only have the former African territories been brought under this special relation, but there is also increasing tendency to include other developing countries. This approach is more in line with the selective scheme than the general scheme. At the same time, it can be made sufficiently congruent with the Australian type of scheme, though it may cover a somewhat smaller list of developing countries and introduce larger country variations.

The attitude of the United States is crucial, not only in its own right but also as a factor in influencing the policies of other developed countries. Like other developed countries, it would seem to incur no great difficulty in adopting the Australian type of preference from the point of view of domestic considerations, since safeguards against possible disruption of markets for selected commodity groups can easily be introduced. Cotton textiles, for instance, may very well be excluded and governed by separate arrangements, as is already the case. The stumbling block to a preferential scheme remains uneasiness about its apparent conflict with the most-favoured-nation principle. There are, however, some indications that a more flexible attitude is possible.

Apart from exceptions which directly involve the interest of the United States, such as the arrangement for automobiles in free trade with Canada, rules and regulations with respect to the developing countries have in many cases been flexibly interpreted. This is the case with regional arrangements among the developing countries;

it is also the case with the granting of waivers to preferential arrangements in favour of certain developing countries by former metropolitan powers, and most obviously with the Australian case in GATT. Furthermore, there is a strong feeling that if some developing countries, such as the Commonwealth countries and associated states of EEC, are in fact enjoying a preference which leaves out many developing countries, notably in Latin America, the United States would be impelled to adopt some measures to redress such inequity. Indeed, a positive attitude by the United States toward preference could be instrumental in reducing the degree of discrimination among the developing countries. For the United States, with its preponderant importance in the world market, can induce the other countries to adopt a more multilateral scheme than otherwise might be the case. This might take the form, for example, of a conditional grant of preference to the Commonwealth, and the EEC associated countries, provided that the preferences of the latter are also generalized to include more developing countries. This proviso of conditional grants would give a strong incentive for the other developed countries to broaden their scope of preferences and give compensation for the loss of relative position to countries presently enjoying preference. At the same time, the possibility should not be ruled out that for political, cultural and other reasons, certain groups of countries prefer to have special arrangements among themselves. In such a case, the United States still has a choice between treating all developing countries uniformly or concentrating on those left out of the existing preferential schemes. Whatever the decision, there will be more than a single world preferential system, though lack of universality is not a result of United States policy but on account of inadequate support for it.

#### *Further Considerations and Measures*

The question remains as to how the interests of third countries may be protected. So far as the developed countries are concerned, the limiting of the preferential items to exports of interest to the developing countries and the exclusion of such items as textiles would minimize the possible scope of injury. In any case, the value of trade affected by such a preferential scheme is likely to be less than 5 per cent of the trade in manufactures and even less in relation to total trade (table 1). So long as the effect of preferences

on other developed countries is marginal in importance, the real cost involved may be readily absorbed as a part of aid. Where significant injury is evident, the technique of waiver, as illustrated by the Australian case, does permit recourse to procedures for ameliorating hardships.

As far as the developing countries are concerned, in addition to the procedure under GATT waiver, more concrete forms of compensatory payments might be worked out in connection with disbursement of aid. This is, in fact, the technique used by the EEC when existing preferential arrangements are being diluted. International mechanisms for compensatory payments similar to, but broader than, the EEC arrangements may be set up in the form of an "International Trade Adjustment Fund" to compensate for a demonstrable loss of advantages or proven injuries. On the whole, it must be remembered that most of the developing countries would undoubtedly stand to gain, the more so as the scheme is adopted by, and extended to, more countries.

A major instrument by which the interests of third countries may be protected as well as the interests of relatively weak countries enjoying preference is the setting of tariff quotas by country, on which the Australian scheme is silent. In fact, the global tariff quota for all developing countries in the Australian model may prove to be too small. In such a case, a first-come-first-served principle is not always the best procedure of allocation. Some other criteria of allocation may be considered. A number of suggestions made thus far would not, however, appear to be appropriate. One criterion would be the state of a particular industry in a particular country. This criterion could be made operational by such rules of thumb as the date of establishment of the industry or its export record. Preferential treatment would be accorded exclusively to newcomers. Such a criterion has obviously its origin in the infant industry argument and borders on a selective approach. It is, to a limited extent, also applied in the Australian model by the exclusion of certain developing countries (e.g. Hong Kong) for particular products (e.g. certain furnitures). An alternative suggestion is that the tariff quotas might be distributed according to some general criteria, such as population, or the inverse of per capita national income — criteria which reflect the size of the economy and the stage of development rather than the degree of competitiveness of particular industries.

The above procedures would imply significant deviations from the existing structure of trade because the distribution by origin of manufactures exports from the developing countries to the developed countries is extremely uneven. In the aggregate, six developing countries have accounted for about three-quarters of such exports. The degree of concentration is frequently more for the markets of individual countries and increases progressively as the individual commodities are disaggregated. This serves to illustrate that, even when the aid principle is accepted, a choice still has to be made as to whether a preferential scheme leans toward the infant industry argument or the avoidance of trade disruption.

The omission of country specification for tariff quotas in the Australian model implies that emphasis is placed on competition among the developing countries rather than special protection for the less industrialized among them. Had a country specification based on criteria drastically different from the existing trade pattern been adopted, it would have implied that few countries would actually be able to benefit from the scheme. Indeed, in that case those developing countries which have been leading exporters of manufactures would probably suffer a net disadvantage. On the other hand, in order to meet a frequent complaint of the less industrialized developing countries, as well as to forestall a chaotic scramble for a global tariff quota, individual maxima, based largely on the existing pattern of imports but adjusted to ensure that those countries with no export experience or small exports would have a share, might be introduced (8).

While the above considerations are far from a blueprint of a world preferential scheme, nor are they exhaustive, they should provide a basis for national and international action. Instead of debating the pros and cons of the extreme positions and the infinite

(8) This purpose might be achieved by allocating a basic quota and a trade related quota for each country. The former may be an absolute amount and the latter related to the past record of trade. To illustrate, the share of tariff quotas for each developing country may be  $\frac{(s+j)}{\Sigma(s+j)}$ , where  $s$  denotes the share of that country in the total imports of the commodity of the developed country in question,  $j$  is a constant. It will be noted that the smaller the value of  $j$ , the closer is the allocation to the existing pattern of trade and as the value of  $j$  increases, the solution approaches a flat rate for all developing countries. Inasmuch as many countries would not in fact be able to make use of the quotas, the aggregate value of individual quotas may be considerably larger than the target for a global quota.

variety of combinations of various elements that may conceivably enter into a preferential scheme, each developed nation could consider a scheme of the Australian variety and bring it to the international organizations for confrontation and harmonization.

### III. Beyond Tariff Preference

The approach suggested above is, moreover, not limited to preferential tariffs alone. Indeed, if, to start with, international efforts for aid had been obsessed with an ideal scheme of burden sharing and optimum distribution among countries and projects, it would not have been surprising if little had been accomplished. Nor should the extension of the principle of aid be limited to preferential tariffs. A broad application of preferential treatment to the developing countries is indicated. Even within the area of trade, special measures in favour of developing countries may apply to many non-tariff arrangements, including quantitative restrictions, subsidies, regional groupings, industry integration agreements, payments arrangements and the like. In addition, as has been emphasized elsewhere, whether in the setting of national targets in development planning, in the procurement policies of the public sector, in the shaping of fiscal and monetary policies, there is always some scope for preference to the developing countries. While the potentialities of these "preferential" policies have not been adequately and systematically explored, there have in fact been many instances of such practices. These practices have been little noticed, and no fundamental argument of principles has been raised against them, contrary to the world's experience with the tariff preference issue.

It is in this broad context that tariff preference should be considered. On the one hand, it should be admitted that tariff preference constitutes an exception to the general rule of trade; but, on the other hand, it is an exception which is similar to other exceptions favouring the developing countries.

This kind of exception was indeed explicitly allowed for in the Havana Charter in Article 15. (9). Although no specific mention of preference was made in the newly added part IV on Trade and Development to the General Agreement on Tariffs and Trade,

(9) United Nations, *United Nations Conference on Trade and Employment, Final Act and Related Documents*, (Havana, 1948), pp. 12-13.

the granting of waiver to the Australian application for preferential treatment of developing countries has established an important principle.

At the same time, the implication of the granting of waiver is that preference is an exception rather than the rule. The exception is admissible so long as the tail does not wag the dog. By the same token, it should not be expected that preferential tariffs should solve the major difficulties of exports of manufactures from the developing countries. Nor should it be expected that the incidence of benefit should be equal among all developing countries. But if preferential tariffs are neither adequate nor entirely equitable, they can and should be supplemented by many other instruments of preference, by direct aid for industrial development as well as reorientation of domestic policies in the developing countries, such as realignment of foreign exchange rates and provision of export incentives.

#### IV. Summary and Conclusion

Tariff preference in favour of the developing countries has been identified as a key issue in recent international discussions. The preferential scheme favoured by most of the developing countries is a global one to be granted by all developed countries to all developing countries on all manufactures and semi-manufactures. This is least inconsistent with the most-favoured-nation principle. At the same time, the case for preference is conceived as an extension of the infant industry argument, which implies an industry-by-industry and country-by-country approach. The basic conflict between these two approaches has resulted in lack of progress in practical implementation of the preference proposal. Indeed, international discussions have hardly moved into a negotiating stage but have mainly been confined to a discourse on principles and the pros and cons of various considerations. These discussions have tended to direct attention to the intrinsic conflict of principles as well as the multiplicity of possible choices, whether in respect of the definition of developing countries, the identification of products, the extent and duration of preference, or the design of safeguards.

Moreover, the widely held view that the basic solution of the preference issue lies in political will ignores the need for a definitive direction before the political will can be meaningfully mobilized.

On the other hand, pleas for more detailed and comprehensive studies for every commodity and country, while obviously attractive to the economic profession, must not be allowed to drown the basic issues in technicalities and minutia.

The present paper shows that the basic conflict of principles can be greatly lessened by advancing the aid argument rather than the infant industry argument. For the criteria of equitable granting of aid are much more flexible than those of equal treatment in accordance with the most-favoured-nation principle. On the other hand, this shift of emphasis does not in itself give a sufficient guide to the determination of the content of a preferential scheme. In order to move the preferential debate from an endless dialogue to business-like negotiation, it is necessary to point a way toward a workable scheme.

The first condition of a workable preferential scheme is acceptability from the point of view of the developed countries which are to grant preferences. Inasmuch as the initiative for preference originated with the developing countries, it is natural that the developed countries would like to know whether any scheme they adopt is acceptable to those who are supposed to benefit from it. The developing countries must, therefore, first indicate a flexible attitude, even though a scheme may not go as far as is desired. It should be emphasized that this does not mean a retreat on the part of the developing countries; it means, in fact, that the responsibility for implementing the preferential proposal is squarely placed on the developed countries. If a single developed country may grant preferences, others will not argue that a particular scheme is unacceptable, for every country can adjust the scheme to its complete satisfaction.

That such an approach is feasible has already been indicated by GATT's acceptance of the Australian preferential scheme. Other developed countries can very well introduce similar schemes, though not necessarily identical with respect to country and commodity coverage, extent and duration of preference, or the particular safeguards adopted. This means that many intractable problems, such as the definition of developing countries and of manufactures and semi-manufactures, the temporary or permanent nature of preference, the margin of preference, the disparity among the developing countries and the interests of third countries, can be solved without universal agreement. The decentralization of initiatives does not

mean that concerted efforts are unnecessary. It does mean that confrontation, co-ordination and harmonization should follow rather than precede the major movement for adoption of a scheme. A scheme must first be acceptable to the developed country granting preference, and then put to test by concerted international scrutiny, as in the waiver procedure, in order to minimize possible conflict with other basic international objectives, especially relating to multi-lateralism and the interests of third countries.

The international community is thus faced with a choice in a period of transition from the debating stage to the negotiating stage. Whether the transition will end with concrete achievements or with more debate will depend on the readiness of statesmen and economists alike to combine realism with vision and to accept limited objectives for a single instrument in a massive effort toward transformation of the developing countries.

N. T. WANG

*New York*