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The political economy *of protection after the* Uruguay Round

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This paper discusses the interplay between domestic policies and foreign interests under the institutional framework to be administered by the World Trade Organization (WTO). It presents a theoretical model that treats the WTO as the forum for an overlapping game which provides the rules for the maintenance of an open trading system among economies that are periodically submitted to protectionist pressures. Overlapping games occur when a particular player is engaged at the same time in games against distinct opponents, and when the strategy pursued in one game limits strategies available in the other. The basic rule provided by the model is that protection costs should be kept entirely within national borders, and the proper instrument to enforce this rule is the Agreement on Safeguards. Two main points are argued here. First, the effort to keep protection costs inside national borders improves the consistency of domestic policies. Second, although developing economies are expected to play an active part in the new trading system, most Latin American countries are not yet prepared for playing that role.

I

Introduction

The conclusion of the Uruguay Round of Multilateral Trade Negotiations signified a watershed in the history of the General Agreement on Tariffs and Trade (GATT), now transformed into the World Trade Organization (WTO). This new institution is expected to enforce the appropriate framework for reconciling conflicts between domestic policies and foreign interests stemming from competition in a globalized economy. The WTO will be able to deal with a series of themes that remained beyond GATT's control, such as agricultural protectionism, the Multifibre Arrangement, voluntary export restraints, the abuse of anti-dumping measures, services, intellectual property rights, and investment rules.

During the GATT era, the main negotiating issues were easily settled whenever the United States, the European Community and Japan had convergent views. Under the WTO regime, the rules of the game include active participation by the developing countries, since the basic issue is no longer trade liberalization among the OECD countries, but the establishment of a normative framework for the global competition process.

This paper discusses a topic of special concern for all of the WTO's members: the forms of protection that will be sanctioned by the new trading system. The WTO will have several instruments to monitor selective protection. For instance, the legislation on intellectual property rights (IPR) is a protectionist mechanism for innovative industries. It plays exactly the same role that conventional instruments like tariffs, quotas and subsidies play for infant or senile industries, since all of them create special conditions for capital accumulation. The only difference is that IPRs seldom imply explicit barriers to merchandise trade, but merely extend the period during which

innovating firms can extract Schumpeterian rents from their new technologies. It is thus an impediment to potential competition in frontier technology industries. In this case, the WTO's main role would be keeping up to date the norms that protect the interests of those who create technical progress, but without artificially raising the entry barriers into high-technology industries.

A key instrument for monitoring protectionism will be the Agreement on Safeguards, a major innovation produced by the Uruguay Round. This agreement admits the possibility of allocating export quotas among supplier countries, which was the trait common to all managed trade practices invented by OECD countries in recent decades: the so-called "gray-area" measures. Export quotas have an interesting peculiarity: the rents they generate are shared between the domestic industry and the foreign suppliers. Depending upon the characteristics of the products concerned and the criteria used in the distribution of the protection rents, it is possible to reach a situation where all costs of protection are exclusively paid by local consumers, without any harmful impact on international interests. This outcome can also be produced by other means. For instance, a subsidy that equalizes domestic prices with international price levels will do the same. What is important, however, is that measures of this kind have two virtues: i) they do not create trade disputes, and ii) they leave the government with an instrument –i.e., the explicit and segregative burden on local society– for shrinking the power of the protected industries and enforcing a reasonable expiration term for the benefits.

The interplay between domestic policies and foreign interests implies two interdependent bargaining processes, as many analysts have already noted. According to Robert Putnam, for instance, it should be conceived as a two-level game: "At the national level, domestic groups pursue their interests by pressuring the government to adopt favorable policies, and politicians seek power by constructing coalitions among those groups. At the international level, national governments seek to maximize their own

□ I am grateful to Sheila Najberg for sharing with me her expertise on game theory, and to Richard Blackhurst, Eliana Cardoso, Robert Devlin, José Alfredo Graça Lima, Daniel Robinson, Diana Tussie and Sergio Werlang for helpful criticism and advice.

ability to satisfy domestic pressures, while minimizing the adverse consequences of foreign developments. Neither of the two games can be ignored by central decision-makers, so long as their countries remain interdependent, yet sovereign" (Putnam, 1988, p. 434). In a similar vein, James Alt and Barry Eichengreen use the notion of *overlapping games*: "Overlapping games arise when a particular player is engaged at the same time in games against distinct opponents, and when the strategy pursued in one game limits strategies available in the other" (Alt and Eichengreen, 1990, p. 76).

II

Free trade and protection: an overlapping game

In the following pages, we assume that all governments are implementing sound macroeconomic policies and that the international monetary system is able to keep steady exchange rates. Thus, there will be no protectionist pressures arising from macroeconomic disturbances such as recessions or exchange rate appreciation, but only those generated by technical progress or industrial policies, which can be classified into three stylized cases: import substitution industrialization, restructuring of declining industries, and promotion of high-technology industries.

Each of these policies creates a vector of local and foreign interests that can be identified by answering four questions:

i) *Who are the losers?* In other words, how are the costs of protection distributed among domestic consumers and exporters from the rest of the world?

ii) *Who are the winners?* How are protection rents shared between domestic industry and foreign suppliers?

iii) *Should any additional compensation be paid to the trading partners?*

iv) *From the national interest viewpoint, is it worthwhile to provoke all these distortions?*

This paper uses the above concepts to introduce a new approach that could be adopted by the WTO for controlling protectionism. Section II below presents a theoretical model that treats the WTO as the forum for an overlapping game which provides the rules for the maintenance of an open trading system among economies that are periodically submitted to protectionist pressures. Section III shows how the Agreement on Safeguards can enforce those rules, while section IV argues that Latin American countries are not prepared for taking part in this game. Finally, section V summarizes the main conclusions.

1. Import substitution

Let us imagine that during the period [0,n] the government of the home country enacts a tariff (t_i) in order to establish a new industry through import substitution. This measure will have the following consequences.

Equation [1] indicates the welfare losses (L) suffered by domestic consumers during the period.¹ They result from the difference between domestic (P_i) and international prices (P_{wi}), plus the additional amount of local demand (D_i) that would exist if domestic and international prices were the same.

$$[1] \quad L = \sum_0^n [(P_i - P_{wi}) \cdot D_i + P_{wi} \cdot \Delta \cdot D_i]$$

The amount of rents (R) received by domestic producers is described by equation [2], where V^i is the value added per unit made possible by protection, V_i is the value added per unit in absence of protection, and α is the share of local firms in domestic production (Q).

¹The domestic consumption includes both intermediate and final goods. The welfare losses (L) therefore contain the anti-exporting bias created by the tariff.

$$[2] \quad R = \sum_0^n (V^i - V_i) \alpha Q_i$$

The government's revenues (G) originated by the tariff (t_i) will depend on the amount of imports (M_i), as equation [3] shows.

$$[3] \quad G = \sum_0^n t_i M_i$$

The amount of rents (F) received by foreign firms is described by equation [4], where M^i are the potential imports in absence of protection, and β is the share of foreign subsidiaries in domestic production.

$$[4] \quad F = \sum_0^n [(M^i - M_i) + (V^i - V_i) \beta Q_i]$$

By definition, $\alpha + \beta = 1$ and $D_i = Q_i + M_i$

If $F \geq 0$, no additional compensation to the rest of the world is needed. In the home country, the government should gradually reduce the tariff to zero as soon as the learning process in the import substituting industry allows convergence between domestic and international prices. In this case, the only pressure to stop protectionism comes from consumers, since the government, domestic producers and the rest of the world have non-negative payoffs. However, this is just a temporary situation that can be changed by the policies implemented by the rest of the world, as we will see later.

From the perspective of the national interest, the above policy is rational if the amount of domestic production created by protection compensates the losses inflicted on consumers. In other words, when the economy returns to free trade at the moment n , condition [5] should hold.

$$[5] \quad L \leq \sum_0^n Q_i$$

2. Declining industries

If $F < 0$, the government may use its revenue to pay additional compensation to the rest of the world, in order to avoid trade disputes and possible retaliation.

This situation is frequent when protection is being used to promote the restructuring of declining industries. Such payment can be made by transforming the tariff into a Voluntary Export Restraint Agreement (VER) to be signed with the trading partners.

Figure 1 describes the mechanism for the transfer of protection rents to foreign firms.² MM' is the home country's demand for imports. The VER will

FIGURE 1

Protection rents transferred to the rest of the world

raise domestic prices from oc to oa . The exporters from the rest of the world will lose the amount equivalent to the rectangle $edfg$, but will receive new rents equivalent to $abdc$. Thus, as equation [6] and condition [7] demonstrate, if the demand elasticity for imports does not exceed unity, the rents captured by the rest of the world ($abdc$) are superior to their forgone sales ($edfg$), and no additional compensation is needed.

$$[6] \quad \eta = \frac{dM/M}{dP/P} = \frac{dM}{dP} \cdot \frac{P}{M} = \frac{df \cdot fg}{ac \cdot ca}$$

$$[7] \quad \eta \leq 1 \therefore df \cdot fg \leq ac \cdot cd$$

3. High-tech industries

The promotion of high-technology industries creates a vector of interests which is rather different from the two preceding cases, but the interplay between domestic and foreign interests remains essentially the same. Table 1 presents a partial list of the costs and benefits involved. It shows that, even when only one

² For a careful analysis of the general effects of VERs, including the transfer of protection rents to foreign firms, see Melo and Tarr (1992).

country is protecting this type of industry, there is room for conflict and convergence at home and abroad. As Laura Tyson commented: "Technology-intensive industries violate the assumptions of free trade theory and static economic concepts that are the traditional basis for U.S. trade policy. In such industries, costs fall and product quality improves as the scale of production increases, the returns to technological advance create beneficial spillovers for other economic activities, and barriers to entry generate market structures rife with first-mover advantages and strategic behavior. A nation's competitive position in industries with these characteristics is less a function of its national factor endowments and more a function of strategic interactions between its firms and government, and between them and the firms and governments of other nations" (Tyson, 1992, p. 3).

TABLE 1
Costs and benefits of promoting high-technology industries

	Costs	Benefits
Home Country	Tax expenditures on R&D	Productivity growth
	Technological unemployment	New goods and services New professions
Rest of the world	Possible loss of market share in certain industries	New trade flows Secondary innovations Productivity growth, etc.

4. The overlapping game

In the foregoing description of domestic policies, the assessment of the national interest was made without considering the policies being followed by the country's trading partners. However, the net benefits any country can extract from its governmental actions are obviously constrained by the contemporary international circumstances. If free trade conditions are dominant in the world trading system, most governments will refrain from being the first to erode them, unless the expected gains are truly rewarding. On the other hand, if several other countries are already protecting a certain industry, the domestic country may prefer to ignore the free trade fashion and just collect the protection rents from its trading partners.

The effort of adjusting domestic objectives to international conditions can be described as a game between two players, the "home country" and the "rest of the world", that may use two strategies, "free trade" (F) or "protection" (P), and receive the following matrix of payoffs (table 2):

TABLE 2
Matrix of payoffs

		Rest of the world	
		Free trade	Protection
Home country	Free trade	0 , 0	0 , Br
	Protection	Bh , 0	Bh* , Br*

If both players choose free trade, they get nothing but the standard outcomes of that strategy. Consumers will enjoy unrestricted access to goods and services, paying just the international prices, and only global competitors will survive in each economy. If one player chooses protection, his payoff is B (Bh for the home country and Br for the rest of the world), which is the net benefit he is expecting from his industrial policy, and the other player gets nothing, since all adverse effects on his economy will be duly repaired by the trading partner. If both players prefer protection, each one gets B*, which is, in principle, smaller than B, due to the greater number of distortions introduced in the economic system and the corresponding compensations to be paid.

The game repeats infinitely and overlaps another one that is played domestically, among the government, local firms and consumers. Suppose that the international game starts just after the first round of the domestic game, when protectionist strategies have been approved in both countries and ratified by multilateral negotiations. So, the initial Nash equilibrium is PP. But the payoffs B and B* depend on the duration of the domestic policies, since longer protection periods imply costly reparations. Moreover, the difference between B and B* may be large and, eventually, the rationale for protection may disappear.³ Hence, at each round of the domestic game, the players take notice of the new restrictions imposed by the international situation and review their

³ The Nash equilibrium is FF whenever B and B* are negative. If only B* is negative, one player will choose protection and the other free trade.

strategies. Similarly, each round of the international game has a transitory Nash equilibrium that reflects the momentary values of B and B^* . And so on. The international game fulfills two functions. The first is to ensure the correct payoff to every player. Someone

may be applying protection without paying due reparations to the partner, or claiming excessive compensation. The second function is to indicate the correct amounts of costs and benefits generated by national policies.

III

The Agreement on Safeguards

The basic rule of the overlapping game presented in section II is that protection costs should be kept entirely inside national borders. The WTO will have a special instrument to enforce this rule, namely, the Agreement on Safeguards, which states that: "A Member proposing to apply a safeguard measure (...) shall endeavour to maintain a substantially equivalent level of concessions and other obligations to that existing between it and the exporting Members which would be affected by such a measure (...). To achieve this objective, the Members concerned may agree on any adequate means of trade compensation for the adverse effects of the measure on their trade" (paragraph 16). Moreover, it admits that: "In cases in which a quota is allocated among supplying countries, the Member applying the restrictions may seek agreement with respect to the allocation of shares in the quota with all other Members having a substantial interest in supplying the product concerned" (paragraph 9).

To improve the transparency of these procedures, two minor amendments should be introduced in the Agreement. First, it should be clarified that export quotas have been legitimized precisely because they facilitate the payment of compensations and that this form of protection may provide fair compensation to all trading partners when the products under safeguard have an import-demand elasticity that does not exceed unity. Since this characteristic is not exceptional, as table 2 shows, a number of trade disputes could be avoided. Second, it should be mandatory that every country applying a safeguard measure publish a report on the protection costs created by that measure, indicating the distribution of such costs at home and abroad. The report should also include all protection rents that might be transferred to the rest of the world by other recent

domestic policies that did not provoke trade disputes.⁴ These rents should be credited as partial compensations to be used in cases when the products concerned have an import-demand elasticity higher than unity.

Since the agreement allows "any adequate means of trade compensation", one obvious possibility is simply to pay cash for the damages inflicted on the trading partners. This idea was submitted to GATT in the 1960s by the Uruguay-Brazil Plan.⁵ In many cases, this is the least expensive solution. According to Melo and Tarr (1992, p. 193), "the United States could achieve the same degree of protection as under the current system of quantitative restrictions at about one-third the cost by shifting to a system that transfers the quota rights to domestic firms". Indeed, as we have seen in section II above, whenever the import-demand elasticity is strictly inferior to unity, the use of export quotas is a bad policy, due to the excessive amount of rents transferred to the rest of the world.

The payment of financial compensation has another merit: it improves the fairness of domestic policies. Our discussion of the three stylized cases of industrial policies showed that, from the national interest viewpoint, protectionist strategies may be rational under certain circumstances. But the historical evidence shows that, in the absence of political pressure, those circumstances are seldom obeyed and superfluous protection is rather frequent. By making

⁴ The WTO can easily define a standard methodology for these reports, since there is an extensive literature on the measurement of protection costs. See, *inter alia*, Cline (1987), Corden (1957), Dinopoulos and Kreinin (1988), Feenstra (1985), Hufbauer and Elliott (1994), Melo and Tarr (1992), and OECD (1985).

⁵ For a discussion of this plan, see Dam (1970) and Abreu (1990).

entirely explicit the international component of the protection costs, financial compensation becomes a political issue that helps the government to reduce the power of protected industries and extinguish their privileges when necessary.

Despite these virtues, the Uruguay-Brazil Plan was not approved by the GATT members. As Kenneth Dam (1970, p. 371) well explained: "Whatever may be one's views on the relative superiority of the financial-liability and private-compensation systems, one is led to suspect that the determinative argument leading the GATT to reject the Uruguay-Brazil Plan was the traditionalist argument that financial liability was an 'entirely new concept' which was out of harmony with the traditional GATT system. To adopt a financial liability system would require a revolution in attitudes toward the function of the GATT, a revolution that would be unacceptable to those contracting parties—a clear majority—that have preferred to pursue their national interest in trade matters without too many scruples concerning the effects on other contracting parties".

The Agreement on Safeguards caused such a revolution.

TABLE 3
United States: Estimated price elasticities of import demand for selected industries, 1962/1978

Industry	Demand elasticity
Food products	-0.21
Beverages	-0.70
Textiles	-1.41
Wearing apparel	-0.52
Footwear	-2.42
Paper products	-1.80
Petroleum refineries	-0.79
Rubber products	-1.32
Pottery	-1.37
Glass	-2.86
Iron and steel	-2.28
Non-ferrous metals	-0.67
Metal products (excluding machinery)	-0.94
Machinery (excluding electric)	-0.88
Electrical machinery	-3.08
Transport equipment	-1.26
Optical and photographic	-0.44

Source: Shiells, Stern and Deardorff (1986), p. 515.

IV

The role of the developing countries

It is generally agreed that the developing countries have played a marginal role in the GATT system (Tussie, 1987; Abreu, 1990). But it is unlikely that the same will happen under the WTO system. To begin with, governments no longer have the "partial membership" option available after the Tokyo Round that allowed selective adoption of the Round's results. Furthermore, the participation of developing countries as *demandeurs* will improve the scope of the new set of instruments to regulate services, investments and intellectual property rights. For instance, the agreement on TRIPS (trade-related aspects of intellectual property rights) is fairly comprehensive (Low, 1993; UNCTAD, 1994), since it covers such areas as copyright, trade marks, geographical indications, industrial designs, patents, layouts of integrated circuits, confidential information, and anti-competitive practices in contractual licenses. The agreement also attempts to avoid the creation of artificial barriers to entry into high-technology industries, with their

corresponding adverse effects on the diffusion of innovations (see articles 40 and 41). However, the achievement of this goal may depend on the pressures exerted by the developing countries, because the interests of the OECD countries are often biased toward the supply side of innovations.

Paradoxically, an active presence in the WTO implies a major *domestic* challenge for most developing countries. In the overlapping game described in section II, one standard assumption is that players act in their own best interest under all circumstances. Since our "players" are, in fact, governments, they must fulfill three basic requirements before entering that game. First, the country's trade regime must include a coherent tariff structure and transparent procedures. Second, the domestic legislation, at least in the areas of foreign investment, subsidies, labour market and intellectual property rights, should be in line with the WTO's rules. Third, national institutions must have sufficient capacity to administer the above instruments.

The current situation in Latin America well illustrates that challenge. In the 1980s, the region passed through a radical experience of trade liberalization which is only comparable to the shift made in the 1930s, when many countries initiated their import substitution strategies. In 1986, Chile was the only open economy in the region, but by 1993 only Panama had an average tariff above 20%. The idea of regional integration, which had remained a rhetorical project for decades, suddenly became a serious priority. Nevertheless, in most countries, the coherence of the trade regime and the enforcement capabilities of national institutions are still distant targets that are yet to be attained.

One very common flaw is tariff escalation: a mechanism that has been remarkably popular in Latin America during the last 30 years. It consists of establishing low import duties for raw materials and other inputs, and high duties for final goods. In Colombia, for example, that procedure survived as an explicit policy instrument even after the 1991 trade reform (Gómez, Moreira and Santa María, 1994). The lasting appeal of tariff escalation has a well-known origin: Albert Hirschman's 1958 classic *The strategy of economic development*, which contains the seminal ideas on "linkage effects" and "key sectors". In the 1960s and 1970s, these ideas were overwhelmingly dominant, not only among academics but also –and especially– among politicians and entrepreneurs. In the 1980s, they were served up once again under the concept of industrial targeting, which stresses the point that promoting a key sector may be a relevant step towards building up a new industrial system. Despite the undeniable merits of these concepts, they are useless when the problem is not to establish new industries, but to correct the disequilibria of economies which have been subjected to decades of inconsistent policies and superfluous protectionism.

Although not always officially endorsed, tariff escalation is quite widespread in the region. Let us take one revealing case: Ecuador. Until 1990, its trade policy still had all the typical mechanisms of indiscriminate protection: high and redundant tariffs ranging up to 290%, generalized administrative controls, ad-hoc tax exceptions, quotas, and the like. These trade barriers began to be demolished in June 1990. Nowadays, the average tariff is only 9.3%, the import procedures have been simplified, and the country is about to join GAITT.

Ecuador is a textbook example of a small developing economy that exports food and raw materials, imports manufactured goods, and has an industrial structure centered on light consumer goods. Despite the ambitions created by the oil boom of the 1970s, there was no significant diversification of the export profile, the composition of imports remained essentially unchanged from 1970 to 1990, and the share of foreign trade in GDP has been over 50% for several years (Tavares de Araujo, 1994). After the trade reform, most industries that compete with imported goods are receiving an effective protection rate of approximately 20%. Automobiles, however, receive very different treatment: an effective rate of 247%.⁶ It is hard to find any reasonable explanation for this privilege, considering that the transport equipment industry, which includes other activities besides automobile assembly, generated less than 2% of total employment in the Ecuadorian manufacturing sector during the last 20 years.

Let us now take Brazil, a successful story of import substitution industrialization from 1930 to 1979, and a radical case of useless protectionism in the 1980s. Its trade reform, started in 1987 and concluded in 1993, was not far removed from the regional pattern. Quantitative import controls were abolished, most sectors now have 20% of effective protection, some basic and intermediate goods have less, and a few privileged sectors, like cars, fine chemicals and electronics, have more. Here again, the first prize went to the automobile industry: 62.5% (Carvalho and Machado, 1994).

Besides tariff escalation, the Brazilian trade policy has another deficiency that is frequent in Latin America: the lack of explicit rules for future changes in the tariff structure, which leaves the door open for new forms of disguised protectionism such as the abuse of antidumping and countervailing actions. As Nora Lustig and Primo Braga (1994) documented, such protection is already fashionable in the region. These distortions do not imply a return to inward-oriented policies: they merely doom Latin American governments to recurrent poor performances at both levels of the overlapping game between free trade and protection.

⁶ The tariff rate for assembled vehicles is 37%, and for CKD vehicles, 0%. Assuming that the value added per unit in the automobile assembly industry is 15%, the conventional Corden's formula indicates that $G = 37/0.15 = 247$.

V

Conclusions

At first sight, the maintenance of an open trading system among economies that are periodically under protectionist pressures is a contradiction in terms. This paper has shown, however, that the WTO will be able to fulfill this task by enforcing the rule that all protection costs should be kept entirely inside national borders. As we have seen, this is a feasible rule that improves the consistency of domestic policies. It is interesting to compare this rule with other approaches to protectionism, such as those advocated by Jan Tumlir and Jagdish Bhagwati.

Tumlir (1985) does not use the concept of overlapping games but starts from the same idea: "A moment's reflection on the nature of international trade policy conflicts leads to the realization that they are mere epiphenomena, overflows, of domestic politics in the main countries (p. 13). [...] Negotiations concerned with preventing the recurrence of conflicts should therefore try to articulate or reaffirm trade rules that will have a chance of reforming not just the conduct of trade policy but also the domestic politics that determine that conduct" (pp. 61-62).

In order to achieve this goal he recommends the strengthening of the unconditional most-favoured-nation principle: "We now understand enough about the political dynamics of protectionism to see that its expansion cannot be arrested unless the legal force of the nondiscrimination clause is restored. The countries concerned with and mainly responsible for the state of the international trading order could simply agree to make the unconditional most-favoured-nation principle a requirement of national law, bind-

ing on themselves. The main virtues of this proposal are simplicity and flexibility" (p. 63).

In practical terms, Tumlir suggests the substitution of auction quotas for voluntary export restrictions: "If quantitative restrictions had to be administered in a strictly nondiscriminatory manner, that is, by public auctioning of import licenses, the margin of protection afforded would become clearly visible in the auction prices, and that could be counted on to reduce the demand for this form of protection. At the same time the protection rents would become public revenue, a fact that could not but increase political opposition to quantitative restrictions by the importers. The public discussion about protection would become better balanced and thus better informed" (Tumlir, 1985, p. 65).

Bhagwati's proposal is more conventional: "(1) Instead of voluntary export restrictions, the safeguard action would use the nondiscriminatory tariff as contemplated in Article XIX. (2) The revenues generated by the tariff would be used to finance adjustment assistance, possibly through a common fund receiving all such tariff revenues. (3) The protective tariff would be explicitly set on a declining time-bound schedule" (Bhagwati, 1988, p. 119).

When applied to small countries, both proposals are equivalent to the rule discussed here, since the international effects of protectionism are negligible in this case. However, the rule of full compensation not only preserves the unconditional most-favoured-nation principle but also keeps the world trading system away from conflicts among large countries.

(Original: English)

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