Moral Hazard and GATT Article XVIII(B)

Hartley Furtan

GATT Research Paper 90-GATT 12
June 1992

Center for Agricultural and Rural Development
Iowa State University
Ames, Iowa 50011

H. Furtan is a professor, Department of Agricultural Economics, The University of Saskatchewan, Saskatoon, Saskatchewan, Canada.

The author acknowledges, without implication, the generous help from R.S. Gray.

This material is based upon work supported by the Cooperative State Research Service, U.S. Department of Agriculture, under Agreement No. 89-38812-4480.

Any opinions, findings, conclusions, or recommendations expressed in this publication are those of the author and do not necessarily reflect the view of the U.S. Department of Agriculture.

CONTENTS

Abstract v

Introduction 1

Review of Literature 2

Theoretical Model 11

New Directions for Article XVIII(B) 17

Conclusions 21

References 22

FIGURES

1. Balance-of-payments in a general equilibrium model 12

2. Optimal tariff in a general equilibrium model 13

3. Quota rents in a partial equilibrium model 15

4. Impact of lobbying in a general equilibrium model 16

TABLES

1. Percentage of commodity groups covered by quantitative restrictions for balance-of-payments reasons under GATT, Article XVIII(B) 4

2. Consultations under Articles XII and XVIII(B) of the GATT committee on balance-of-payments restrictions 5

3. Elements of a GATT temporary-measures code 8

ABSTRACT

Article XVIII(B) of the GATT code allows developing countries to use tariffs to reduce imports when their balance-of-payments problems result in a low foreign currency reserve. While the intent of this GATT provision is sound, it has led to moral hazard problems. This chapter reviews the history and safeguards of Article XVIII(B) and identifies some of its specific moral hazard problems. A model addressing these problems is then presented, and alternative policies are suggested to reform the Article.

MORAL HAZARD AND GATT ARTICLE XVIII(B)

Introduction

GATT has continued to allow for the protection of domestic economies through tariff and nontariff barriers, despite its primary goal of encouraging an outward-looking, export-oriented view of economic development. The rationale given for this position by the Contracting Parties to GATT reflects the fact that all countries were not starting from an equal base when the GATT was first put in place in 1947. Some countries, such as the United States, had a highly developed economy at the end of World War II; other economies were destroyed in the war, e.g., West Germany and Japan, while others were simply under developed. (For an excellent review of the political, legal, and economic history of the GATT, see J. H. Jackson, 1990). In addition, all countries did not have the same experience with international trade at the end of World War II. For example, the financial and legal institutions required for trade were not well developed in most countries. Many countries also lacked knowledge of the role that the balance-of-payments and exchange rates would play in maintaining acceptable trading conditions.

A number of articles in the GATT code deal with exemptions countries can use to prevent the liberalization of their domestic markets. For example, Article XI(C) allows all countries to restrict imports to near historic levels if they also control domestic production through the use of quotas. This Article is used to support the current Canadian Supply Management scheme for dairy, poultry, eggs, and turkey. By controlling domestic production,

the GATT presumed countries would only produce for their domestic markets instead of dumping commodities on the world market in order to depress world prices for other producers. Similarly, Article XVIII(B) allows developing countries to place quantitative restrictions on imports, due to balance-of-payments problems, while Article XVIII(C) allows for quantitative restrictions to protect infant industries. Article XVIII was designed to assist developing countries in their entry into the world of international trade. The provisions provided in the Article were to be used only in the case of clearly defined need, and then only temporarily. However, a number of economists now question the validity of the conclusion that protection, in whatever form, leads to economic development.

The purpose of this chapter is to examine Article XVIII(B). To begin the discussion, we will review the Article and assess how well its objectives have been achieved. Next, we will suggest how the Article could be evaluated in a political economy context. To date, little or no analysis has been done on the link between special interest groups in developing countries and the imposition of tariff and nontariff barriers to trade. We will then suggest how the Article could be modified to achieve its original objectives. This requires a policy design that is not subject to problems of moral hazard.

Review of Literature

The purpose of Article XVIII(B) is to allow developing countries to place restrictions on imports when balance-of-payments difficulties arise and cause problems with the country's domestic economic development program. It is not difficult to imagine how structural problems in a developing economy can cause balance-of-payments problems. The development of infrastructure, such as roads, etc., the inadequacy of institutional development, and a poor organizational structure all lead to lower productivity and, thus, lower export earnings. Developing countries often need to import capital intensive goods

while exporting labor intensive goods. It was thought by policymakers that this could cause a short-term problem in the balance-of-payments. As a solution, the GATT code includes Article XVIII(B), which allows for the imposition of temporary trade restrictions subject to consultation and monitoring. However, whether placing trade restrictions on imports is the best way to remedy these problems is now debatable.

Article XVIII(B) is currently used extensively, and use has increased in recent years due, in part, to large foreign debts accumulated by many developed countries. Some countries have used the foreign debt to finance consumption rather than investments, which only complicates repayment problems. As shown in Table 1, the percentage of commodity groups affected by Article XVIII(B) can be very large or very small, depending upon the country. What is not shown in this table is the duration of these "temporary measures." For many developing countries, the direction has clearly been toward more protection of domestic industry through the use of Article XVIII(B). However, some developing countries, such as South Korea, have liberalized trade and avoided the temptation to use trade protection as a means to solve economic problems.

One of the safeguards built into Article XVIII(B) is the consultation and monitoring process. Once countries implement the Article, the GATT is to be consulted over the severity of the balance-of-payments problems. Also, because the measures are temporary, and other trading countries will not retaliate, the GATT agreed to monitor use of the Article. However, the consultation and monitoring of Article XVIII(B) has been sporadic and inconsistent. In the case of Israel and Portugal, for example, a great deal of consultation occurred before, or at the time of, the implementation of trade restrictions (Table 2). In other countries, such as Egypt, only a simplified consultant process has occurred. Consultation is an expensive task; one reason countries have not consulted more reflects the high transaction costs of such a policy.

The consultation and monitoring of trade restrictions available under Article XVIII(B) results in principal agent problems. Because the consultation takes place after the balance-

Table 1. Percentage of Commodity Groups Covered by Quantitative Restrictions for Balance-of Payments Reasons under GATT, Article XVIII(B)

Country	Year	Percentage of Groups Affected
Argentina	1986	72
Bangladesh	1986	60
Brazil	1985	32
Colombia	1986	86
Egypt, A.R.	1985	5
Ghana	1985	60
India	1985	48
Korea, Rep.	1986	20
Nigeria	1983	18
Pakistan	1985	43
Peru	1985	50
Phillipines	1985	5
Sri Lanka	1986	14
Thailand	1983	0.2
Tunisia	1985	73
Turkey	1986	22
Yugoslavia	1984	19
Zimbabwe	1984	0.1

Note: Each quantitative restriction refers to an affected commodity, where a commodity is defined by one of 1,010 four-digit Customs Cooperation Council Nomenclature.

Source: GATT document NTM/W/17(9/1/86). Taken from S.J. Angaria. "Balance of Payments and Related Issues in the Uraguay Round of Trade Negotiations, *The World Bank Economic Review*, Vol. 1, No. 4 (1987), p. 680.

Table 2. Consultations under Articles XII and XVIII(B) of the GATT Committee on Balance-of-Payments Restrictions

Country	Year													Article
	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	
Argentina		S			S								F	XVIII(B)
Bangladesh	S		S		S		S		S		S		S	XVIII(B)
Brazil			F		SF		S	F		F		S		XVIII(B)
Chile	S	S			S									XVIII(B)
Colombia												F		XVIII(B)
Egypt, Arab Republic of				S		S	S		S		S	S		XVIII(B)
Finland		F	F	F	F									XII
Ghana	S		S		S		S		S	F		S		XVIII(B)
Greece	F		S		S		F	F					F	XVIII(B)/XII
Hungary										F	F			XII
India		S			SF		S		S		S		S	XVIII(B)
Indonesia		S		S		S								XVIII(B)
Israel	S	F	F		F		F		F	F	F			Not stated
Italy								F						XII
Korea, Republic of		S	F		S	F		S		S	F		S	XVIII(B)
Nigeria											F		S	XVIII(B)
Pakistan		S		S	F		S		S			S		XVIII(B)
Peru	S	F		S		S		S		S			S	XVIII(B)
Philippines							F		S		S			XVIII(B)
Portugal		F	F		F	F	F	F	F	F	F	F		Not stated
Sri Lanka		S		S		S		S		S		S		XVIII(B)
Tunisia	S		S		S	F		S		S		S		XVIII(B)
Turkey		F		S		F		S		S		S		XVIII(B)
Yugoslavia	F		F		S			SF			S		S	XVIII(B)

Notes: S= Simplified consultation; F= Full consultation.

Source: GATT Secretariat. Taken from S.J. Anjaria. "Balance of Payments and Related Issues in the Uruguay Round of Trade Negotiations", *The World Bank Economic Review*, Vol. 1, No. 4 (1987), p. 675.

of-payments have reached a crisis level, developing countries may have adverse incentives in maintaining foreign exchange at levels that do not cause a crisis when short-run problems arise in the economy. Politically powerful groups within developing countries have the incentive to lobby for the use of Article XVIII(B). Once the trade restrictions are imposed, these groups will pressure the government to maintain the restrictions. Thus, because the consultation and monitoring process occurs after the incentives have been put in place, they are more difficult to remove. As will be demonstrated later, a low level of foreign currency reserve can be the result of lobbying rather than structural problems in the economy.

Bergsten (1977) and Perez-Lopez (1989) have both reviewed Article XVIII(B) and suggested a number of reforms to the GATT code. Bergsten is particularly critical of the use of quotas as a mechanism to restrict trade. He applies this criticism to all countries and codes, not just to Article XVIII(B). He argues that all quotas should be replaced by tariffs. He further recommends that, over time, tariffs, themselves, should be lowered and a free-trade regime developed. While the Contracting Parties to the GATT supported free trade, it is not clear that they initially intended that all tariff barriers would ever be removed.

Bergsten does recognize that developing countries are in need of some protection; he also feels that such a radical change would never be acceptable to the GATT. He outlines four recommendations for a less radical change to Article XVIII(B):

i) No restrictions should be made among different types of trade measures used by developing countries to control for balance-of-payments problems;

ii) all measures would require prior authorization;

iii) internal measures which effect trade, e.g., border tax, would need similar prior authorization;

iv) the need for balance-of-payments protection would be approved by the IMF and the measure approved by the GATT.

Bergsten (1977), p. 20

Bergsten's proposal is clearly aimed at mechanisms designed to overcome the moral hazard issues discussed earlier. Monitoring would be done by external agents prior to enactment of the tariffs. By requiring all decisions to be approved prior to implementation, the lobbying of internal groups would be mitigated. To remove this process from the domestic political economy, actual approval of trade restrictions would be made by authorities outside the country proposing the restrictions. Bergsten's proposal, however, fundamentally recognizes that developing countries need economic protection in order to deal with short-run balance-of-payments problems.

More than ten years later, Perez-Lopez (1989) reviewed the same GATT article for the Uruguay Round of trade talks. He noted that, at the Uruguay Round, developed countries were not interested in opening up discussion on Articles XVIII(B) and XVIII(C). While he does not provide a reason for this, it is likely many developing countries consider the use of quotas and tariffs to be a domestic issue. Perez-Lopez suggests a less radical modification of the temporary measure than did Bergsten: His proposals are summarized in Table 3. Basically, Perez-Lopez suggests few substantive changes to Article XVIII(B). He states the rules of his "suggested code" as if the imposition of trade restrictions were strictly a domestic issue. He sees no need to have consultations occur prior to implementation. As a result, his suggestions would not overcome the existing moral hazard problems that plague this Article.

Additional concerns over the usefulness of Article XVIII(B) have been raised by other economists in the literature [Elgin (1987), Wolf (1987), Anjaria (1987), and Abreu (1989)]. For example, when a developing country places a trade restriction on an imported good, there is no requirement for that country to make any macroeconomic adjustments to correct the structural situation that caused the balance-of-payments problem. Therefore, countries repeatedly invoke the Article to correct balance-of-payments problems without making any real progress in trade liberalization or in economic development. Some economists argue that the presence of GATT Article XVIII(B) actually encourages the type of behavior that the

Table 3. Elements of a GATT Temporary-Measures Code

	Temporary-Measures Code	Articles XII & XVIII(B)	Article XIX
Duration of measure	Two years, with one-year renewal	Temporary, but no time limit	Temporary, but no time limit
Type of measure	Tariff	Quantitative restriction	Quantitative restriction, tariff, tariff quota, OMA[a]
Multilateral surveillance	Annual	Annual or biannual	None
Compensation/ Retaliation	No	No	Yes
Notification/ Consultation	Ex ante	Ex ante/ Ex post	Ex ante
Coverage	MFN[b]	?MFN	?MFN
Degressivity	Yes	?Yes	?No

[a]Most Favored Nation
[b]Orderly Marketing Arrangements

Source: J.P. Perez-Lopez. "Case for a GATT Code on Temporary Measures", *The World Economy*, Vol. 12, No. 1 (1989), p. 57.

GATT is attempting to discourage in developing countries; i.e., trade restrictions, rather than trade liberalization, as a source of economic development and growth. As a result, this provision has slowed the export-led growth the GATT has tried to foster. It should be noted that all developing countries do not fit the same mold on this issue. Some of the least developed countries may well need some import protection before they are subjected to the forces of international competition. Other developing countries are able to compete, provided they have secured access to the markets in developed countries. For such countries, the use of Article XVIII(B) may be as much a bargaining position to gain market access as it is to correct balance-of-payments problems.

A second concern is the simultaneity of balance-of-payments problems and trade restrictions. Economies that grow through trade and specialization should earn sufficient exchange to accommodate imports (this does not necessarily include repayment on foreign debt that has been used for consumption). Introducing a trade restriction will cause more domestic resources to be used in the production of domestically consumed goods, thereby reducing exports and foreign exchange earnings. A circular situation may therefore occur, exacerbating the structural problem Article XVIII(B) is supposed to address. In addition, special interest groups within a country influence the decisions made by the government, and these decisions may not be conducive to free trade. If economic agents know that trade restrictions can be placed on imports if foreign reserves fall, then the government may hold a lower than equilibrium level of foreign exchange. If the level of foreign exchange is lowered through government action due to the availability of Article XVIII(B), then the possibility of practicing moral hazard exists.

The lack of retaliation possible by trading partners opposed to those countries using Article XVIII(B) is of less concern. If there is no mechanism for other trading countries to police the Article effectively, they will circumvent the restrictions by relying, for example, on bilateral trade agreements. This works against the best interests of developing countries and the intent of the GATT. The lack of retaliatory action or compensation to those foreign

producers who suffered economic injury has caused developed countries to be concerned over the present use of Article XVIII(B).

In a recent paper, Bhagwati (1989) points out that the United States has moved away from multilateral trade agreements and toward bilateral trade agreements. For example, the United States now maintains bilateral trade agreements with Israel and Canada. Passage of the Omnibus Trade and Competitiveness Act of 1988 suggests that the United States government will take retaliatory action against countries it considers unfair traders. These are unilateral actions by the major trading country and the country which initiated the GATT. This U.S. decision to make trade policy outside of the GATT, because of concerns over the GATT code, is a major blow to the idea of multilateral trade agreements.

The use of Article XVIII(B) allows special interest groups within countries to lobby for import restrictions. This is the mirror image of the problem discussed earlier by Anne Krueger (1974) [regarding the use of import quotas]. There is no specification in the Article detailing which import commodities can or cannot be placed under tariff or the level of tariff, given balance-of-payments problems. Politically powerful groups within developing countries can increase their own economic rent by having tariffs placed on commodities they produce. This is an important question in political economy that needs much more work and could provide an interesting test for some of the work on special interest theory [see Rausser (1989)].

In summary, Article XVIII(B), while well intended, has not achieved its goal of helping to incorporate developing countries into a liberalized world trading regime. The existing policy of GATT is subject to moral hazard; this adverse incentive should to be removed. A new direction is needed, as the Article has not solved the balance-of-payments problems; indeed, it may have made them worse.

Theoretical Model

Suppose we have a developing economy producing two goods, A and B. The production and consumption of both goods occurs with a technology function that is homogeneous of degree one. Both goods are produced with inputs that are mobile between sectors of the economy. Prices of the commodities are set in the international market, and domestic factor markets are assumed to be competitive.

The equilibrium in the economy is shown in Figure 1, where the utility function, U = U(A,B), is tangent to the price line, TT, at point Z. Because the budget line is not tangent to the production possibilities frontier, FF, the country accumulates a deficit of D. In this model, the economy imports $A_c - A_x$ of A, and exports $B_x - B_c$ of B. If we assume the economy runs a deficit in order to finance this level of consumption, then a balance-of-payments problem will arise. This is the type of problem Article XVIII(B) was intended to solve.

There is more than one solution to the deficit problem demonstrated in Figure 1. The country could try to shift the production possibilities curve out until it is tangential to TT. This may be viewed as an economic development or structural adjustment solution. Alternatively, the country could change its macroeconomic policies so that the budget line, TT, shifts to T'T' and the deficit is removed. Both of these solutions require specific domestic policy reforms.

Suppose the developing country employs Article XVIII(B), citing a balance-of-payments problem. In accordance with the code, it places a tariff on the imported good, A, equal to angle q, as shown in Figure 2. The consumers of the country suffer a loss, as shown by the shift of the utility function, U_1, to U_2. Production of the export good also declines from B_x to B_x'. The tariff has encouraged domestic production of the import good of amount $A_x' - A_x$, and the government receives the tariff revenue equal to $qA_c' - A_x'$. This is a second-best solution because domestic consumers and producers do not face world prices.

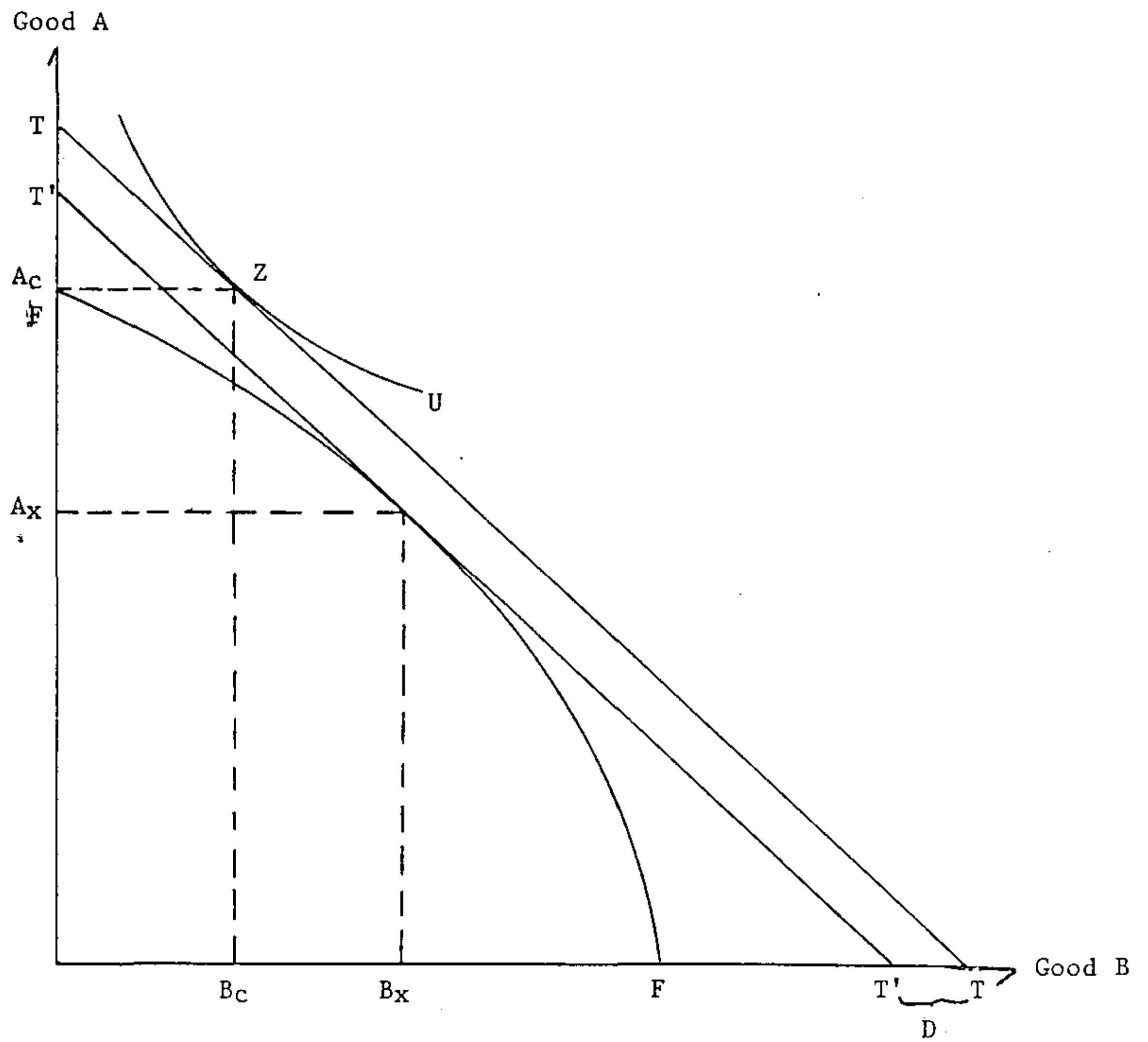

FIGURE 1: Balance-of-Payments in a General Equilibrium Model

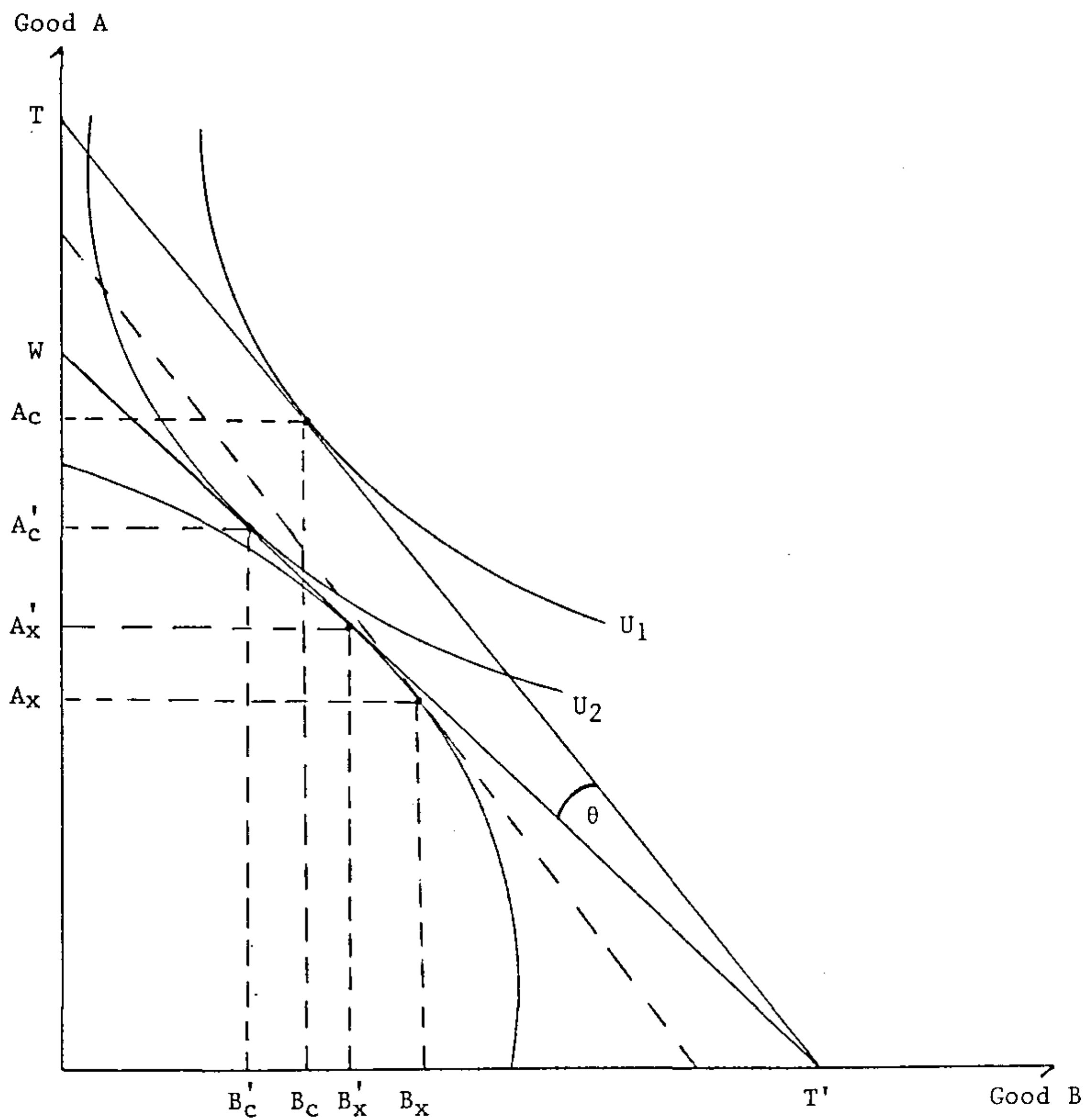

FIGURE 2: Optimal Tariff in a General Equilibrium Model

Reforms of domestic policy or economic growth represent first-best solutions to a deficit problem in the balance-of-payments.

An alternative policy for reducing the balance-of-payments problem is the imposition of a quota on the imported good. If the quota is set so that the deficit is just removed (i.e., the optimal quota), then the solution is identical to that in Figure 2. This can also be shown in a partial equilibrium framework (Figure 3). The optimal quota will shift S to S', such that the domestic price of A is equivalent to $P_A + q$ where q is the optimal tariff. Domestic consumers gain economic rents equivalent to area $P_A*C*D(P_A + q)$. The value of the import-quota rents are equivalent to area D*E*F*G. Imports, exports, and production of the import and export good, are identical to those identified in Figure 2, i.e., $A_c^{'} - A_x^{'}$ $B_x^{'} - B_c^{1}$, $A_x^{'}$, and $B_x^{'}$, respectively.

Domestic producers of good A have clearly benefited from the introduction of the quota policy. They could benefit further by an amount equivalent to area $(P_A + q)*D*H(P_A^{'} + q)$ if imports were reduced to zero. This may be either fully or partially achieved if these individuals are politically powerful. In developed countries, where agricultural quotas are used, lobby groups *have* achieved this. The supply management policy of the Canadian government is an example.

Import quota rents may be captured by individuals in the economy or auctioned off by the government. In either case, resources will come from both import- and export-producing sectors to pay for the lobbying effort. As shown in Figure 4, this lobbying activity will shift the production possibilities curve inward from FF to F'F', resulting in lower domestic commodity production as well as lower consumer utility, (i.e., $U_1 > U_2$). This lobbying activity is an unproductive expenditure of resources; therefore, the country will experience a GNP decline equal to K.

The moral hazard in this model is created by domestic producers lobbying for the use of tariffs or quotas in order to solve the balance-of-payments problem. Individuals in the economy are then able to capture economic rents which would not exist under a

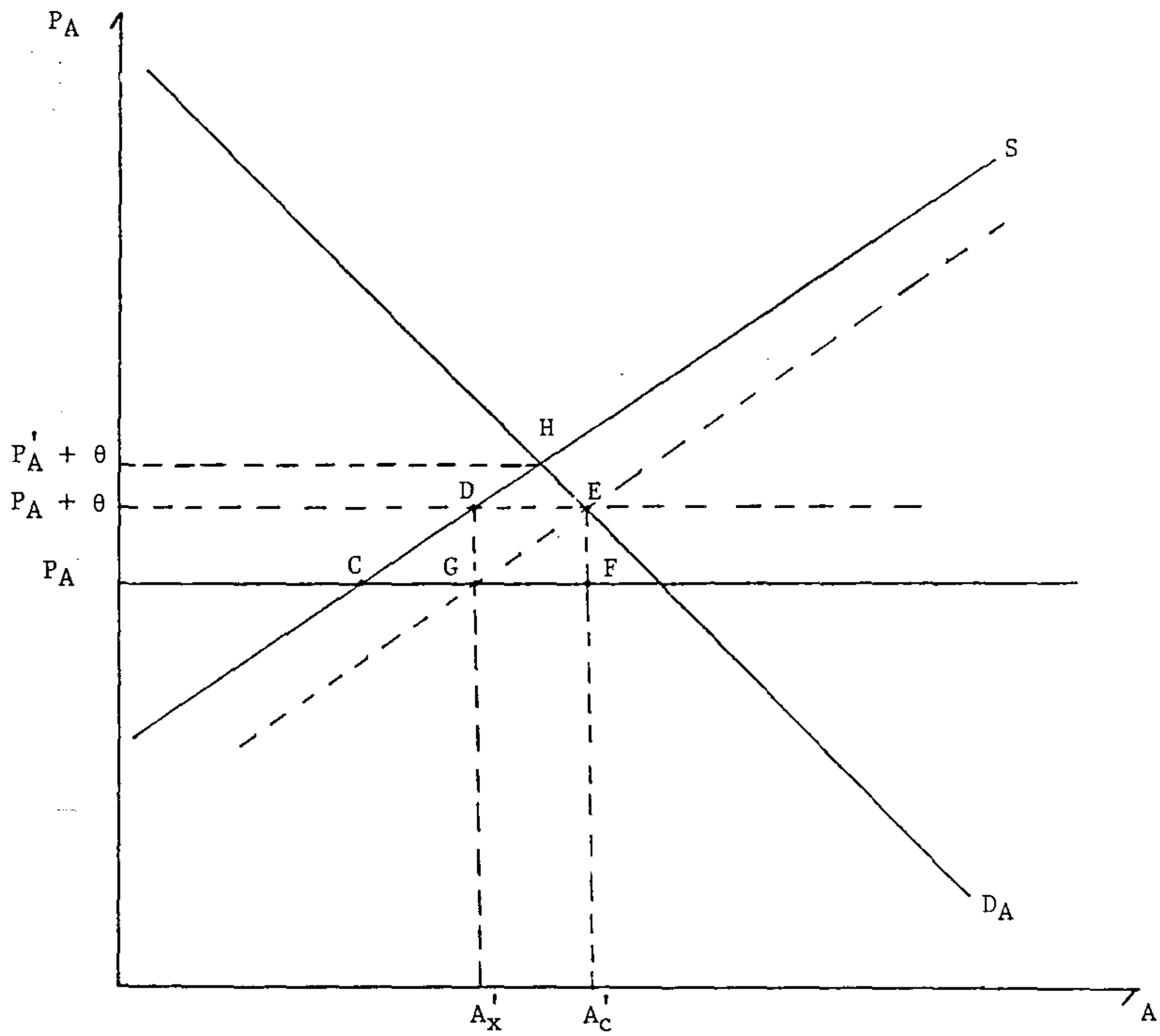

FIGURE 3: Quota Rents in a Partial Equilibrium Model

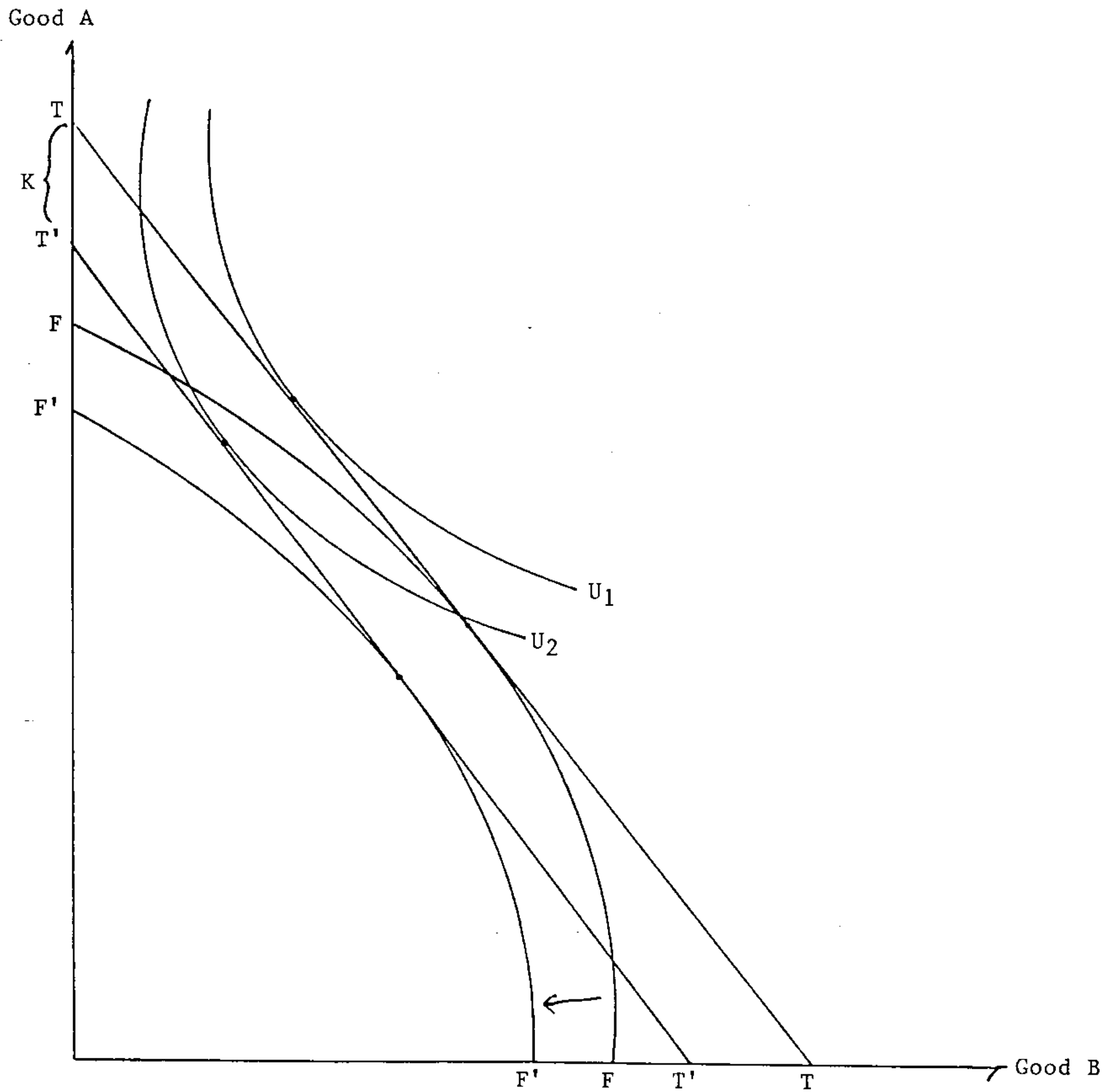

FIGURE 4: Impact of Lobbying in a General Equilibrium Model

macroeconomic solution to the deficit problem. Once quota or tariff rents are capitalized into the economy, they become a major obstacle to trade reform. Domestic political groups are, therefore, able to benefit from economic policies created through the enactment of Article XVIII(B).

New Directions for Article XVIII(B)

Article XVIII(B) is not designed to deal with the current magnitude of balance-of-payments problems caused, in part, by the recent build up of foreign debt. One of the most limiting assumptions of the model we present here is that we ignore the effects of foreign debt. Many developing countries face large foreign debt repayment commitments; interest payments often equal a country's total foreign exchange earnings. Without some resolution of the debt issue, any change to the GATT code will meet with resistance. While the foreign debt problem is clearly a related issue, we chose to set it aside.

Another limitation of the model presented here is that it assumes current domestic production of both commodities (i.e., import and export goods). This assumption could overstate the level of productivity in some developing countries. Many such countries produce a limited number of export goods while importing a much larger and more expensive array of import goods. Article XVIII(C), which deals with the infant industry argument and the GATT, is not addressed in this chapter. We chose not to discuss the relationship between import substitution and trade policy. However, we acknowledge that import substitution may, in some circumstances, make economic sense in developing countries.

It is reasonable to divide developing countries into at least two categories. The first category includes those countries which can and do produce products consumed in developed countries. The second category includes those countries which do not currently possess the resources, technology, or institutions to produce goods for developed-country markets. This

latter group is unable to respond to market forces; their economic development may be hindered by a radical movement toward free trade. The first category of developing countries has a higher GNP, and the resources in the economy tend to be more mobile. The changes suggested in this discussion focus on this first group.

There are two directions for change or reform possible for GATT Article XVIII(B). Before discussing these, it may be useful to restate the problem with the current code. The code currently allows for moral hazard, on the part of the importing country, in at least two ways. First, domestic groups can rent seek through the use of tariffs and quotas. Second, the government may increase short-run foreign exchange earnings through tariff revenues. This enhances the government's position at the expense of longer-run structural problems brought on by the trade restrictions. Any meaningful trade reform must deal with the issue of moral hazard.

The first reform would increase both consultation and monitoring of Article XVIII(B) along the lines suggested by Bergsten (1977). Any country using the Article to put tariffs or quotas on imported goods would be required to provide a complete plan, detailing how the structural problem would be addressed. Such a plan would include justification for the use of the Article, a time when the restrictions would be removed, and a plan for how the extra foreign exchange would be spent in the country. This plan would be evaluated by the World Bank and monitored by the World Bank/GATT. This reform would increase the cost of invoking Article XVIII(B), perhaps discouraging some countries from using it so readily. The World Bank might pay for a developing country's research and plan preparation, thereby reducing the transaction cost for the country. However, we anticipate that developing countries may object to such reforms, as they already find the consultation process burdensome. In addition, they might view such a proposal as an unnecessary infringement on their sovereignty.

A second reform would replace the current Article XVIII(B) code with a revised code, which would give developing countries facing balance-of-payments problems greater market

access, adjustment support (World Bank), and foreign exchange loans (IMF). Foreign exchange assistance here is limited to import needs in the economic development process and does not include a cover repayment of foreign debt. Assistance to cover repayment of debt should be handled, if at all, in a separate policy agreement. This change would partly remove the decision-making process from the developing country. Requiring all transactions to occur concurrently would result in parallel information being held by both the international community and the developing country.

Under this plan, if a developing country experienced a foreign deficit due to structural problems, it would appeal to GATT for an increase in access to markets in developed countries. The country would have to open its own economy through the lowering of tariffs and the elimination of some nontariff barriers. These revised tariffs would be binding and enforced by the GATT. Thus, to gain greater market access, a developing country would have to *give* greater market access. This should reduce the current moral hazard problem under Article XVIII(B). Eliminating nontariff barriers is essential, since they are often used as protectionist policy. In return, the developing country would receive additional concessions from developed countries.

The IMF and the World Bank would recognize the developing country as a trade liberalizing country, i.e., a "free trader," and would offer preferential treatment. For example, the IMF would provide additional foreign-exchange loans at preferential rates. This would enable the country to overcome the short-run problem of low foreign-exchange reserves. The World Bank would provide structural adjustment help aimed at reducing the domestic structural problems which lead to poor export performance. If the balance-of-payments problem is due to a macroeconomic policy, as shown in Figure 1, then the IMF may require domestic policy reform. This would be resisted by developing countries; however, problems such as an overvalued exchange rate cannot be solved with continuous foreign loans. Thus, by becoming a "free trader," the developing country has access to financial assistance not offered other nations.

Any reform of the GATT code dealing with quotas or tariffs will have to address the issue of special interests and rent seeking. As shown in Figure 3, imposition of quotas and tariffs on an imported good creates economic rents that can be captured by domestic producers or quota holders. These groups will not support the liberalization of trade; because they may be politically powerful, their economic interests need to addressed. It is likely that such groups will block any trade reform that might result in a loss to their economic interests.

This raises the question of international compensation. It is a well-known result in welfare economics that, if gainers can compensate losers and still achieve a greater economic welfare, the change is Pareto-improving (Just, Hueth, and Schmitz, 1982). This principle does not state that compensation need occur, just that the potential for compensation must exist. It would be possible for the GATT to determine the economic loss incurred in a move toward free trade when quotas or tariffs are removed. An international fund could be set up to, in effect, "buy off" those groups which would lose in exchange for their honoring a binding tariff agreement. This would reduce a major barrier to trade reform.

Australia has just completed such a reform program. The government purchased the dairy quota, then eliminated all dairy quotas. In this case, compensation did occur. Many developed countries may find this type of policy difficult to justify; however, it is one of the most important constraints to trade reform, which may contribute to its political unpalatability.

Such a change to Article XVIII(B) would lead to greater trade liberalization while still dealing with the problems of balance-of-payments and structural adjustments. The need to monitor such a code would be reduced; it would be easier to enforce than the current Article. There is no easy way to practice moral hazard in this model; and, from that perspective alone, it represents an improvement to the existing code.

Conclusions

The purpose of GATT Article XVIII(B) is to enable developing countries to overcome short-run problems with their balance-of-payments. In some cases, it has achieved this goal; however, it is currently used as a means of trade protection, something for which it was never intended. In this chapter, a reform package is proposed that incorporates three basic components. First, countries that experience balance-of-payments problems would be given greater access to markets in developed countries in exchange for use of tariffs and quotas under Article XVIII(B). Second, to finance the short-run problems related to balance-of-payments and structural adjustments, the World Bank and the IMF would provide preferential treatment for the developing country. Third, an international compensation fund would be set up to buy off domestic interests that would suffer economic losses under trade liberalization. Once compensation has been paid, the developing country could not appeal to Article XVIII(B).

Reform of the GATT code is difficult; however, if the multilateral trading rules are not reformed, developing countries stand to lose through the increased use of bilateral trade agreements. Given the current concern over economic growth, any reduction in the freer movement of commodities and services between countries is cause for concern.

REFERENCES

Abreu, M. de P. (1989), "Developing Countries and the Uruguay Round of Trade Negotiations", *The World Bank Economic Review*, Proceedings of the World Bank Annual Conference on Development Economies, pp. 21-46.

Anjaria, S. J. (1987), "Balance of Payments and Related Issues in the Uruguay Round of Trade Negotiations", *The World Bank Economic Review*, Vol. 1, No. 4, pp. 669-688.

Bhagwati, J. N. (1989), "United States Trade Policy at the Crossroads", *The World Economy*, Vol. 12, No. 4, pp. 439-480.

Bergsten, C. F. (1977), "Reforming the GATT: The Use of Trade Measure for Balance-of-Payments Purposes", *Journal of International Economics*, Vol. 15, No.1, pp. 1-19.

Elgin, R. (1987), " Surveillance of Balance-of Payments Measures in the GATT", *The World Economy*, Vol. 10, No. 1, pp. 1-26.

Jackson, J. H. (1990), *Restructuring The GATT System*, The Royal Institute of International Affairs, Council on Foreign Relations Press, New York, New York.

Krueger, A. O.(1974), "The Political Economy of Rent Seeking", *American Economic Review*, Vol. 69, No. 3, pp. 291-303.

Just, R., D. Heuth and A. Schmitz (1982), *Applied Welfare Economics*, Prentice-Hall, Englewood, New Jersey.

Perez-Lopez, J. P.(1989), "Case for a GATT Code on Temporary Measures", *The World Economy*, Vol. 12, No. 1, pp. 53-69.

Rausser, G. C. and D. A. Irwin (1989), "The Political Economy of Agricultural Policy Reform", *European Journal of Agricultural Economics*, Vol. 15, pp. 349-366.

Wolf, M. (1987), "Differential and More Favorable Treatment of Developing Countries and the International Trading System", *The World Bank Economic Review*, Vol. 1, No. 4, pp. 647-668.