ECONOMIC SOCIETY OF AUSTRALIA
Victorian branch

TARIFFS, THEN AND NOW

Delivered by:
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Lecture delivered on 19 March 1997 in memory of Mr Bert Kelly
Published under the auspices of the Stan Kelly Memorial Fund

Introduction:

"The desirability of maintaining free the channels of trade throughout the world".

The Stan Kelly Memorial Fund was established in 1977 in memory of William Stanley (Stan) Kelly, OBE, a South Australian farmer and life long champion of free trade. The theme of the fund and the lecture series, which is a key part of its activities, is quoted above.

Charles Robert (Bert) Kelly, Stan's son, continued to pursue his father's goal of exposing the real cost of protectionism. Bert Kelly became well known as the Federal member for Wakefield in South Australia, during which time he made many speeches on the topic and wrote the "Modest Member" and later "Modest Farmer" column for the Australian Financial Review.

This lecture was held in memory of Bert Kelly after his passing away on 17 January 1997.

The Society is grateful to Professor Richard Sharpe for his willingness to prepare and deliver the lecture. The Victorian branch of the Economic Society has decided to publish the lecture under the auspices of the Stan Kelly Memorial Fund to mark the passing of his son, Bert.

Phil Graham
President

Tariffs, Then and Now

Lecture in Honour of the late Bert Kelly*

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1. INTRODUCTION

It is a considerable honour to be asked to speak at this commemorative occasion, but rather daunting. In recent times others have spoken and written of Bert Kelly's great contributions — I think of Ray Evans' marvellous eulogy, reprinted in the latest issue of *Policy* (Evans, 1997), John Hyde in *The Australian* and John Stone in *The Financial Review*. Then last Thursday (13 March, 1997) there was a great occasion held to honour Bert Kelly under the auspices of the Centre for Independent Studies, chaired in an exemplary manner by Jim Carlton and with memorable contributions by Gough Whitlam, Paul Kelly, David Kemp, John Hyde and Ray Evans. And today Brian Parmenter has shared his reminiscences.

Many people have stated that Bert Kelly's position was fundamentally a moral one. Developing this, Ray Evans drew from *The Pilgrim's Progress* — painting Bert accurately as Mr Valiant for Truth. His enemy was privilege, the special favour, concealed benefits. He championed public scrutiny and was the best advocate the Tariff Board and its successors, the Industries Assistance Commission (IAC) and the Industry Commission (IC), ever had.

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* This is a revised version of a lecture delivered at a lunchtime meeting of the Economic Society of Australia (Victorian Branch) on Wednesday 19 March, 1997. I am grateful to Simon Corden, Robert Kerr, Ray Evans, Des Moore and John Cosgrove for comments: they are not to be blamed. The opinions expressed are those of the author and should not be attributed to, or taken as representing, the views of the institutions which employ him, or the Australian government.

Bert's main focus was on trade policy. A check on the collection of his "Modest Member" newspaper essays in his *Economics Made Easy* (Kelly, 1982) showed more than half to be on that subject; other favourite topics were rural affairs, labour and money. Much of what I shall address — alas, without the deft touch and homespun wisdom of Bert — will also be trade policy. Comparative advantage is not dead!

2. TRADE POLICY

Since Mr. Valiant for Truth started his journey there have been major shifts in trade policy thinking and practice. Max Corden noted in his 1995 Joseph Fisher lecture the magnitude of these changes which had occurred since he delivered an earlier Fisher lecture:

> In [the] 1967 lecture I aimed to sort out and explain the policy choices...
>
> What were my concluding recommendations? I should mention here that, while my writings on tariffs were quite widely read, many real-world practical down-to-earth people regarded me as a typical, somewhat unrealistic, academic and (dirty word) a free trader...
>
> In the 1967 lecture I proposed two benchmarks. There should be a benchmark in nominal rate terms of 30% for new activities and another benchmark of 45% for existing activities. ... Let me repeat these figures: 30% for new activities and 45% for existing activities. So these were this free trader's very radical recommendations.
>
> W. Max Corden "Protection and Liberalization in Australia and Abroad",
> Joseph Fisher Lecture, University of Adelaide, 1995.

Of course most tariffs are now 5% or lower: the only exceptions are Textiles, Clothing and Footwear (TCF) with rates up to 37% currently and Passenger Motor Vehicles (PMV) at 22.5%. Figure 1 presents the Industry Commission's estimates of effective rates of protection over a 30 year or so period. In manufacturing the average effective rate has fallen from 36% in 1968–69 to a projected 5% in 2000–01; in agriculture there have been some ups and downs, but in 1994–95 it was 11% against about 28% 1970–71.

In his penetrating questions on tariffs and somewhat lonely Parliamentary defence of the Tariff Board Bert Kelly annoyed Ministers of Trade greatly. But as he said: "I did have some lucky breaks. One was that the Minister for Trade, Mr McEwen couldn't help losing his temper with me." (Kelly, 1978, p.78) As an illustration of Mr McEwen's thinking on tariffs and the Tariff Board I quote from Hansard where he is speaking on the important 1967–68 *Annual Report* of

the Tariff Board in which, for the first time, industries were classified according to the degree of protection which they received.

> Tariffs have played a large part in the growth and development of Australia, but I am the first to admit that tariffs, in the broadest terms, can increase costs. We can have cheap motor cars by not having a motor vehicle industry. We can get cheap butter by not having a dairy industry. And the same applies to chemicals, footwear, television and a multitude of other items. Of course we can get these products cheaper from somewhere in the world if we have no industry at all. But I am bound to go on and say that if we are to seek lower costs simply for the sake of lower costs we must examine what this means in other fields. If seeking lower costs completely dominates our thinking, lower wages would be the most obvious area to turn to, with unemployment and a slower rate of development...
>
> The Tariff Board's recent decision to break new ground by classifying industries according to existing levels of protection, with all the implications that are contained in this, might be regarded as a departure from the traditional method of judging each industry's need for protection and whether the industry is economic and efficient...
>
> If the Government were to be powerfully influenced by recommendations [by the Tariff Board] on such critically important economic considerations, we would most certainly wish that advice to come from people of the highest standing and competence. We would, in that case, look to people with established reputations as economists or the men who have already achieved great eminence and leadership in their respective fields. When I say that the present members of the Board do not meet these criteria — and I am sure that they would not claim this themselves — I am in no way denigrating the members of the Board. In selecting members for the Board the Government has never looked for great eminence in economics or in other fields. Indeed, the conditions, including the emoluments, of Board members are not aimed at attracting such people...
>
> We will give adequate protection, where necessary, to Australian industries which are economic and efficient.
>
> Minister for Trade (Mr J McEwen), *Hansard*,
> House of Representatives, 28 November, 1968

The term "economic and efficient" used by Mr McEwen meant different things to different people. For Mr McEwen and most others, including the Tariff Board until that time, economic and efficient was judged simply in managerial and technical terms for an industry considered on its own. If an industry used appropriate technology and did not appear slack than it was judged economic and efficient and, as Mr McEwen said, it received whatever assistance was

required — what Max Corden termed "made to measure" assistance. In the late 1960's, however, the Tariff Board was attempting to give real economic meaning to economic and efficient in an economy wide context. It was moving away from just technical and managerial efficiency to include allocative efficiency — to consider what were the best uses of Australia's resources from an economy or community wide perspective.

A view very different from Mr McEwen's was expressed by Prime Minister Hawke in 1985:

> From Australian industry we seek acceptance of the need to reduce protective walls around the small domestic market. And in this we have had some success. It is enlightened self interest to recognise that protective measures impose a cost for the economy as a whole. They put upward pressure on prices in the protected market and through the rigidities and distortions which they introduce they will ultimately restrict employment and export opportunities...
>
> How can this vicious circle [of protection] be broken and the effectiveness of the international trading system restored? ...
>
> We have to break loose from the notion, inherent in the negotiation framework, that one's own trade liberalization is a concession granted to others...
>
> The educative process on the costs of protection must come, predominantly, from within. This is a process which has been carried out in Australia with some success over the past decade or so. Successive governments have been provided with detailed assessments of the costs and benefits of different industry policies...
>
> This has raised public awareness of the costs of protectionism, and has helped foster a more reasoned debate on industry policy. This debate is essential if trade and industry policies are to be successfully and rationally harmonised.
>
> Prime Minister, R.J.L. Hawke, Speech to the Centre for European Policy Studies, Brussels, 4 February 1985

Such a statement could not have been made by the leader of any major party in the 1960s, but it was the essence of the view being put forward — then alone in Federal Parliament — by Bert Kelly that economic and efficient must be judged in an economy wide context, and on economic criteria.

The views of the industry associations of those industries which received the highest assistance then, and still do so today, also have changed greatly. I quote from the submission from the Council of the Textile and Fashion Industry Association to the current Industry Commission Inquiry into TCF.

> Australia's TCF industries acknowledge the government's commitment to the APEC free trade environment. The industries accept the move to a true free trade regime within the region, provided it is equally adopted by our major trading partners. In the lead up to freer regional and perhaps world trade, local companies recognise the need to position themselves to capture all the opportunities likely to arise from the dismantling of the currently extensive international barriers to trade and investment flows in TCF and supporting industries.
>
> Council of Textile and Fashion Industries of Australia Ltd., *Submission to Industry Commission Inquiry into Textiles, Clothing and Footwear*, February, 1997.

This statement, albeit qualified by reciprocity, is of a substantially different nature from submissions by the industry association even a decade earlier.

3. OTHER ISSUES

Bert Kelly was a strong advocate of public scrutiny, of independence of the Tariff Board and of its successors. While as I have mentioned, his main focus was on trade policy, that did not exclude other issues. The issues detailed in the *Stocktake of Microeconomic Reform* (Productivity Commission, 1996)[1] are very much in the Bert Kelly mould. These are:

- Labour Markets and Industrial Relations
- Competition Policy
- Infrastructure
- Taxation
- Trade and Industry Assistance
- Resource Access and the Environment
- Regulatory Reform
- Government Performance — trading enterprises and service provision

The *Stocktake* details what needs to be done to further the Bert Kelly vision of the general good. Bert would have expected the reforms to be opposed by the holders of privileged positions and by those who can only see the immediate effects of policies and not those which are around the corner or over the

[1] The legislation to create the Productivity Commission had not been passed at this time On the instructions of the Treasurer the staff of the Industry Commission, Economic Planning Advisory Commission, and Bureau of Industry Economics had been amalgamated in anticipation of the formation of the Productivity Commission.

horizon. Economics *is* complicated and those who argue that there are effects and forces which are not immediately apparent have the same problems as Copernicus and Galileo in convincing those who see only the obvious.

To quote Bert:

> But it was Eccles [his economist] who made my cup of misery run over. He proudly proclaimed that economists were supposed to be unpopular, and to prove it he quoted the great economist, Alfred Marshall. "Students of social science must fear popular approval: evil is with them when all men speak well of them...
>
> It is almost impossible for a student to be a true patriot and to have the reputation of being one in his own time." From then on Mavis [his pseudonymous wife] regarded Eccles with deep suspicion.
>
> Bert Kelly, *Economics Made Easy*, p. 192.

4. SOME WRINKLES

In many quarters the position is taken that the job on trade policy is all but completed — that tariffs are so low that one can forget about them. Of course rates are still fairly high on TCF and PMV — with rates of up to 25% and 15% respectively in year 2000 — but even these are low compared with past levels for these industries.

There is also a view that trade policy is now quite straight-forward — there are now no complicated exemptions etc. Of course we know that there is the Tariff Concession Scheme under which importers pay 3% rather than the general tariff rate of 5% if there are no substitute products made in Australia, and that there are problems of interpretation and discretion in making this determination. But have all the other wrinkles been ironed out? My attention was caught at a TCF public hearing recently by the following:

> Mr. Cosgrove [Presiding Commissioner]: Do you import fabric?...
>
> Mr. S. Same [Gloweave Consolidated Pty Ltd]: Yes, apart from knitted fabric it's 100 per cent imported from different countries...
>
> Mr. Cosgrove: Are you paying a tariff duty?...
>
> Mr. S. Same: The only time we ever pay a tariff is if fabric has arrived and it's overweight, and that's accidental and normally we don't.
>
> Industry Commission Inquiry into Textile, Clothing and Footwear, *Transcript* 19 February, 1997.

I think Bert Kelly would have enjoyed that — paying tariffs by accident. In fact there is a range of by-laws still in existence, often appearing to give almost firm-specific assistance. One is the shirting example referred to in the quotation, with duty free imports being allowed if the material weighs less than 125 grams per square metre; another allows imports of man-made-fibre coat linings on the basis of buy one metre in Australia and import four meters of imports duty free. And there are many others similar by-laws in TCF and PMV. So the old wrinkles which attracted the attention of Bert Kelly's neighbour, farmer Fred, and Eccles, Bert's economist, have not all disappeared and still provide highly specific and often sizeable assistance.

5. SOME COMMON VIEWS

In a very thoughtful talk at the commemorative evening arranged by the Centre for Independent Studies, Paul Kelly (no relation) spoke of the clarity, courage and responsibility of Bert Kelly. In the context of current debate on PMV he argued that it was necessary to address, in an intellectual debate, five issues. These he drew from the minority (draft) Industry Commission report on PMV. While not addressing that industry specifically, I wish to comment on the issues raised by Paul Kelly.

For convenience I express the five points in terms of propositions, even though Paul Kelly was not advocating the views. They are:

(a) Further tariff reductions should be conditional on microeconomic reform.

(b) Further tariff reductions should only be undertaken on a reciprocal basis; that is, only if our trading partners also reduce their barriers.

(c) Other APEC countries will exclude PMV from their APEC commitments. Why shouldn't we do so also?

(d) Small tariffs have small costs.

(e) Regional pain outweighs national gain.

(a) Conditionality

When tariff reductions were announced by the Labor Governments, other more general microeconomic reforms were also promised. It is argued in some quarters that these reforms have not been delivered and that further trade reform should be conditional on significant microeconomic reform.

One can feel sympathy for those who are experiencing the squeeze of competitive pressures and who view others as being privileged and cosseted. In the TCF hearings, we have been asking for examples of regulations or other matters which are providing significant barriers to efficiency and which could be reformed. Apart from taxation and labour, there has been a shortage of detail.

Be that as it may, I make three points on conditionality.

(i) While there are many areas ripe for microeconomic reform and these are detailed in the *Stocktake*, many reforms have occurred over the last decade or so. These include reforms relating to:

Competition policy, including competitive neutrality and other aspects of the COAG agreements
Contracting of Federal, State and Local Government services
Electricity supply
Air transport
Telecommunications
Banking and Finance
Labour regulation
and, for better or worse,
Universities

Many of these reforms have reduced costs facing most, if not all, industries, and further efficiency gains are in prospect.

(ii)What is the particular relevance of microeconomic reform for highly protected industries? First we should note that where many reforms are taken together, those who lose from some reforms may gain from others: this was addressed in last year's IC *Annual Report*. But while microeconomic reform can be expected to raise productivity in general, there is no reason to think that highly protected industries will benefit more than others. Indeed there are some microeconomic reforms which may be expected to make life harder for highly protected industries. For example, lower international transport costs or improved customs procedures will make imports cheaper. In general it is not clear that microeconomic reform will make life easier rather than harder for industries with high protection, but that is not to say that specific reforms may not help these industries and/or assist in the adjustment process. But to make further tariff reductions conditional on microeconomic reform may be to give up a bird in hand for two in the bush.

(iii)Should tariff reform be conditional on specific microeconomic reforms? Much prospective microeconomic reform is at the State level. Would this mean that if, for example, South Australia does not proceed with electricity reform, further tariff reform should not be undertaken? If this were to be the case, some States could have an effective veto on tariff reform.

(b) Reciprocity

The argument here is that further tariff reductions should not be granted until other countries reduce their barriers. This view has been advanced in a large number of submissions to the TCF Inquiry and many participants (and others) have suggested that Australia is "ahead of the pack" in trade barrier reduction. The Australian Chamber of Manufactures' submission to the TCF inquiry includes the following:

> ACM recommends the Federal Government undertake bilateral negotiations with countries importing [that is, exporting] textiles, clothing and footwear into Australia to ensure equal access for Australian manufacturers to their home markets...
>
> ACM recommends that where agreements cannot be reached for fair and equal access by the year 2000, the same import tariffs applying in the importing [that is, exporting] countries be adopted for textiles, clothing and footwear entering Australia...
>
> While ACM recognises the second recommendation could attract retaliatory responses, it believes Australia needs to signal clearly to other countries that free trade can only achieved if all countries contribute equally to the task.
>
> Australian Chamber of Manufactures, *Submission to Industry Commission Inquiry into Textiles, Clothing and Footwear*, February, 1997.

First, perhaps we should ask whether Australia is in fact now a relatively open market. Until the last decade Australia, along with New Zealand, had the highest barriers to imports of industrial products and by far the lowest binding of tariffs (under the GATT) of the countries of the OECD.

Australia is now catching up, though after the Uruguay Round tariff reductions are fully implemented for industrial products, we shall still have an average tariff higher than most other OECD countries. Australia's trade weighted *bound* tariff for industrial products after the Uruguay Round reductions are fully implemented has been estimated to be 12.2%, the highest for any developed country other than South Africa and more than three times the developed country average, (Hoda, 1994, pp.47 and 55.) This figure may be a little misleading for there are problems with the averaging of tariffs and many of Australia's tariffs are bound under the GATT at significantly higher rates than

those which are actually applied.[2] Nevertheless Australia's general tariff rate of 5% remains higher than the general tariff level of most other developed countries and Australia's bound rates are significantly higher than the bound rates of those countries.

On PMV the Australian tariff of 22.5% (and 15% in 2000) is significantly higher than the EU's 10%, the United States' 2.5%, Canada's 8% and Japan's 0%. (Industry Commission, 1996b, Table 7.2) For TCF, comparisons are more difficult because of the plethora of different tariff rates, but in 1996 there was no TCF tariff greater than 15% in the EU, 34% in the US, 29% in Canada and 20% in Japan (other than leather). (DFAT communication). For Australia the 1996 tariff on clothing was 37%; it is scheduled to be 25% in 2000.

On the other hand, unlike most other developed countries Australia now does not have quantitative barriers to protect TCF industries against exports from developing countries. In this regard Australia is relatively open compared to many other OECD countries for TCF imports from developing countries. There is a heavy responsibility on the members of the WTO to ensure that the EU and US do in fact remove these quantitative barriers by 2005 in the manner agreed in the Uruguay Round negotiations.

The focus in many quarters these days has shifted towards Asia in talking about market opening. It is not always clear why this shift has occurred, though Bert Kelly (or Eccles or Fred) could have suspected that it is because the markets for *Australian* manufactures — including PMV and TCF — *are* in fact relatively open in Europe and North America, and Japan. Indeed Australia essentially receives preferential access to North America and Europe for TCF products because of the quantitative restrictions imposed by countries of these regions on imports from developing countries.

Many Asian markets, though not Hong Kong or Singapore (which together comprise more than half Australia's economic size, or three New Zealands), do have significant trade barriers and in many cases these barriers are much higher than those in Australia. In most of these cases the barriers have been falling and in terms of the degree of market opening — which has been the traditional form of reciprocal bargaining under GATT, in contrast to market open-ness — most of the relevant countries are not too far behind Australia if they are behind at all. The point remains, however, that some markets in Asia are less open than those in Australia — Australia is neither the most nor the least open market in the world.

[2] Australia's average tariff on manufactured goods, when the average is weighted by production rather than trade, is estimated to be 4% in 1996–97, falling to 3% in 2000. (Industry Commission, 1996a, p.149.)

But what of agriculture? Here Australia has long and justifiably complained about other countries' barriers. The reluctance to reduce these barriers was the centrepiece of Australia's stated reluctance to reduce its own trade barriers in the Kennedy and Tokyo Rounds of multilateral trade negotiations. More was achieved in the Uruguay Round, but we await significant implementation. Here again perhaps we should see if there is a mote or something larger in our own eye. Sugar and tobacco import barriers are now largely gone but it is still impossible — not just difficult — for a great many primary products to be exported to Australia.

Australia has unique flora and fauna and does not have many of the plant and animal diseases which exist in other parts of the world. We do well to guard our shores with quarantine barriers which are stricter than those of most other countries. But are all the barriers justified? And is the process of investigating risk too cumbersome? It takes a year or two for other countries to receive an answer to a challenge, and to a large extent these challenges have to be country by country and product by product. The recent challenge to Australia's quarantine restrictions on salmon related only to wild caught (not farmed) Pacific (not Atlantic) salmon from Canada and USA. It took two years or more for an answer. I am not for a moment suggesting that the final decision was not correct, but simply pointing out that the restrictions are very tight, and that the procedures for challenging them very costly in time and effort.

One other barrier to trade with Australia which springs to mind is anti-dumping action. In June 1995 Australia had 86 anti-dumping measures in force compared with the 305 for the US, 178 for the EU, and 91 for Canada. (WTO, 1995, p.10) The next highest user of anti-dumping measures was far behind.

Thus Australia is not quite the open economy that some proponents of reciprocity suggest. I now move from the facts to the relevance of other countries' barriers.

Trade barriers are in many ways like rocks in a harbour — they discourage imports *and* exports. We have rocks in our harbour, they have rocks in theirs, and both discourage trade. Generally it can be argued — and theoretical and empirical analysis supports this — that the rocks in our harbour, a country's own trade barriers, do more harm to us than do the rocks in their harbours — that is, other countries' trade barriers. We can think of a hierarchy:

1. It is best for us if both we and they reduce barriers.
2. It is good for us if we reduce our barriers even if they do not.
3. If no-one does anything, no-one gains.

Of course politically it is easier if other countries reduce their trade barriers when we reduce ours, not just because of the additional gain, but because the exporters who will gain from the reduction of other countries' barriers provide an easily identified group of beneficiaries and a countervailing political force against the import-competing industries that oppose liberalisation. But the point remains that we will gain — and get the greatest part of the potential gain — if we do it alone rather than reciprocally.

But now consider what we mean by reciprocity. The Australian Chamber of Manufactures in the recommendation I quoted above appears to suggest that reciprocity be country and product specific. Country specific action would be in direct contravention of GATT's first article which specifies unconditional most favoured nation (MFN) treatment. It could mean we had a different tariff for every country, and for every product, determined by each country's barriers against Australia. Conditional MFN, for this is what it is, was attempted by the US in the nineteenth century. It led Jacob Viner to comment:

> The most-favored-nation clause in American commercial treaties, as conditionally interpreted and applied by the United States, has probably been the cause in the last century of more diplomatic controversy, more variations in construction, more international ill-feeling, more conflict between international obligations and municipal law and between judicial interpretation and executive practice, more confusion and uncertainty of operation, than have developed under all the unconditional most-favored-nation pledges of all other countries combined.
>
> Jacob Viner, "The Most-Favored Nation Clause in American Commercial Treaties", *Journal of Political Economy* XXXII (February 1924)

The US abandoned conditional MFN in 1922; since then all tariff reductions by the US, apart from preferences for developing countries, and the free trade agreements involving Israel, Canada and Mexico, have been on an unconditional MFN basis — albeit with very careful specification of products in many cases.

Some advocates of reciprocity have argued that the problem is not so much Australia's access to overseas markets as such, but the distortions to the world market caused by other countries' barriers. For example, it is argued that because Australia does not have quantitative barriers to TCF imports while most other developed countries do have such barriers, exports from developing countries (particularly China) which otherwise would go to North America or Europe are being directed to Australia instead. (TFIA, 1997 and Pacific Brands, 1997) It is proposed that Australia should not reduce its tariffs on TCF beyond the levels scheduled for 2000 unless the EU and the US do in fact remove their quantitative barriers by 2005 in accord with their Uruguay Round commitments.

Alternatively it is suggested that for TCF Australia should tie its post-2000 liberalisation to that of APEC economies or to the US (Pacific Brands, 1997). Again this would have some implementation problems, including those referred to above. Further if the focus is just on the US (or any other single country) should we make the link product-by product, or should the link be to an index of US tariffs and/or non-tariff barriers? (Most US tariffs, including TCF, are lower than those in Australia.) Should we include all products, only TCF, or textiles, clothing, and footwear separately? Should we include only products of export or import-competing relevance to Australia? And so on.

Australia is a very small part of the world's TCF industry; evidence has not established that the barriers of North America and Europe in fact have affected the supply of TCF imports to Australia, or the ability of Australia's TCF industries to compete abroad.

Overall there are difficulties of facts, conceptualisation, and implementation which have not been addressed adequately by the proponents of reciprocity. And it might be recalled that in determining community wide benefits and costs, the interests of consumers and other users of products need to be taken into account, along with those of producers

(c) APEC – Will cars be excluded?

Paul Kelly's next point was the concern that in the APEC negotiations and individual action plans, cars will be excluded by some Asian economies and that therefore Australia should not feel bound by the commitment to free trade in PMV by 2010. We might note that developing APEC economies are not committed to free trade until 2020, so it will be hard to determine by 2010 whether or not cars, or any other products, are being excluded by the developing economies of APEC.

Leaving that aside, the points made above regarding reciprocity are relevant. But there is a further point.

Between the Bogor (1994) and Osaka (1995) meetings of APEC, Australia invested considerable effort in ensuring that no products would be excluded from the APEC commitments. The result in the Osaka communication is presented under the heading of Comprehensiveness: "The APEC liberalisation and facilitation process will be comprehensive, addressing all impediments to achieving the long-term goal of free and open trade and investment."

Australia's main objective was to ensure inclusion of agriculture. It would not be a good signal for Australia to exclude products on the assumption that others will do so; it would encourage others to depart from the comprehensiveness

which the Australian negotiators took so much trouble to achieve, for the benefit of Australian exporters and Australians as a whole.

(d) Small tariffs have small costs

Theory

In addressing this question I use a diagram similar to one which was presented in Attachment A of the Minority Report in the Draft report on PMV (Industry Commission, 1996b, p.250.) This is Figure 2, a standard textbook presentation of the costs of protection for an industry where many producers produce a fairly undifferentiated product and in which economies of scale are not significant. Pm is the free trade price of imports; added to this are two alternative levels of tariffs, 5% and 10%. D and S are domestic demand and supply curves, respectively. The tariffs tax consumers, yield revenue to the government, and assist domestic producers.

Starting with the tariff of 10%, the reduction of consumers' surplus caused by the tariff is shown by the sum of all the shaded and dotted areas. The gain of producer surplus (a transfer from consumers to producers) is shown by the dotted area. The tariff revenue, shown by the diagonal shading, is a transfer from consumers of the product to taxpayers as a whole — other taxes can be reduced for an equivalent budget position.[3] (Alternatively, government expenditure can be increased.) We are left with two "cost of protection" or "Harberger" triangles, the areas with horizontal and vertical shading.

Now reduce the tariff from 10% to 5%. The cost of protection is now only the horizontally shaded triangles: there has been a gain of the two vertically shaded areas. So if we now remove the remaining 5% tariff the additional gain is relatively small: the horizontally shaded areas. Obviously if we had started with a 60% tariff and removed 5 percentage points of it, the gain would have been very great. It is quite true in this analysis that there in a relatively small gain from reducing a small tariff.

But what if there had been other taxes besides tariffs? In Figure 3 we assume there is a 5% tax on consumption as well as a 5% tariff. The tax on consumption raises the price to consumers but not the price received by producers. The tariff raises the price for both. For simplicity I assume both the 5% tariff and the 5% consumption tax are struck on the free trade import price.

[3] The assumption here is that tariff revenue can be replaced by other sources of government revenue without economic cost. To the extent that there are economic costs arising from raising the replacement revenue, these costs need to be taken into account.

Now the gain from removing the tariff (while the consumption tax is left in place) will be the horizontally shaded "production" triangle as before, plus the larger vertically shaded "consumption" area. The cost of the 5% tariff is now significantly larger than when there was no consumption tax. (This point has been made by Robert Albon and by the Western Australian Chamber of Commerce and Industry in Submissions to the PMV Inquiry.)

Now consider the effect of economies of scale. This is addressed in Figure 4. Here we assume the product could be produced domestically or imported. It can be imported at a given price of Pm. The domestic firm has economies of scale, but average costs (AC) do not fall below import prices: assistance is required for the firm to exist. In free trade domestic demand is supplied by imports. Now assume a tariff is placed on imports at a level just sufficient for the domestic firm to exist and that this tariff is 5%: this is shown in Figure 4. (Any lower tariff would give a triangular consumption cost, but have no production effect.) The cost of protection of the tariff of 5% will be the whole horizontally shaded area shown in Figure 4; this is the whole loss of consumers' surplus, for there would be no producer surplus (normal profits only are being made) and no tariff revenue, for domestic production will have replaced imports completely. Now add another 5% to the tariff. The cost of the additional tariff is shown by the vertically shaded area, and is much smaller than the cost of the first 5 percentage points.[4]

What this simple analysis brings out is how important it is to use a model which is appropriate to the industry. We find that in some cases a small tariff has a small cost; in others it has a large cost. In some cases the reduction of a large tariff brings a much greater gain than an equal reduction of a small tariff; in other cases the reverse applies. There is no fully general rule.

In Practice

In considering whether in practice the effects of small tariffs are a matter of concern for industries, we might recall that early in 1996 the Labor Government and then the Coalition Government, proposed the discontinuation of the Tariff Concession Scheme. Essentially what was under consideration was exemption from the general 5% tariff when there is no domestic producer competing with imports. (The Tariff Concession Scheme is not generally applicable to the industries with tariffs higher than 5%, TCF and PMV.) The new government settled on 3% instead of zero as the new tariff concession level. A couple of press reports indicate the degree of concern.

[4] If we allow for product variety as well as economies of scale, the analysis is more complicated — one can no longer aggregate into one commodity but must take account of demand for variety. For a method to proceed in this see Snape (1977).

> In Email's appliances businesses, the abolition will cost $4.5 million a year on components and raw materials not made in Australia and presently imported duty-free...
>
> BHP has reportedly threatened to close its stainless steel business at Port Kembla if concessions are abolished...
>
> Chris Jones, managing director of electrical component manufacturer Zenner Electric estimates his company's costs will rise 3 per cent, cutting growth from 15 to 20 per cent a year to less than 5 per cent.
>
> Peter Roberts, "End to Tariff Concession Alarms Business Leaders", *Australian Financial Review*, 22 April 1996, p. 29.
>
> The proposal to scrap the Tariff Concession System was vigorously opposed by more than 30 peak industry bodies which saw such a move undermining delicately balanced industries...
>
> "The disaster which industry was facing some weeks ago has now been avoided", Mr Goldner [of Deloitte Touche Tohmatsu] said.
>
> Mark Abernathy, "Good News and Bad News in New Tariff Concessions", *Australian Financial Review*, 21 May 1996, p. 34.

Some of the opposition to the removal of the concession may have been related to income redistribution and rent seeking rather than efficiency costs as such. But even if this were so, considerable productive resources were devoted to the battle, including the time of politicians, which could have been spent on other matters.

Thus we had a very clear demonstration in this circumstance that 5% did matter.

(e) Regional Pain versus National Gain

The tension between gainers and losers from almost any government action, any technical change, and any trade liberalisation is always difficult to handle for policy makers. Last year's *Annual Report* of the Industry Commission tried to address some of the questions in the context of microeconomic reforms. The lessons are that the full distributional effects of any particular reform are not always the same as first-round effects, and that packages of reforms are likely to have offsetting effects. Other changes are occurring all the time also, all of which have distributional consequences.

General safety nets can provide a cushion in most cases, and the IC position, with which I concur, is that generally this is the best approach. But for some changes there will be particularly severe effects on regions or groups of people. I shall not address possible specifics here, but restate general principles, some of

which are set out in the IC's submission to the Committee reviewing business programs (Industry Commission, 1997).

(i) In general it is inefficient to assist people by assisting the industries in which they are currently employed, and particularly inefficient if it is the need of the least efficient part of an industry that determines the level of assistance.

(ii) Difficulties for regions and individuals will be eased by the removal of obstacles to mobility.

(ii) Labour market flexibility aids adaptation.

(iv) There are mechanisms through the Grants Commission for inter-state transfers.

(v) It is unwise to have policies which will encourage people and resources to enter industries, or sections of industries, which are likely to decline in the future,

(vi) Specific assistance programs should:

- be well targeted
- be transparent
- maintain market incentives
- avoid unnecessary compliance costs
- have effective monitoring and reporting
- have competitive provision where services are provided.

6. IN CONCLUSION

While much has changed since Mr. Valiant for Truth started his journey, much has remained the same. The tariff debate right now is being conducted with a vigour we have not seen for many years. Many of the players have changed as have some of the arguments. Some of the arguments however, would have been all too familiar to the Bert of old — we can note the modern ring to some of the "we would have no manufacturing left" comments in the statement by Mr McEwen quoted earlier. We might also note a modern, South Australian and Victorian perhaps, ring to what Mr McEwen thought of the calibre of the Tariff Board — now the Industry Commission.

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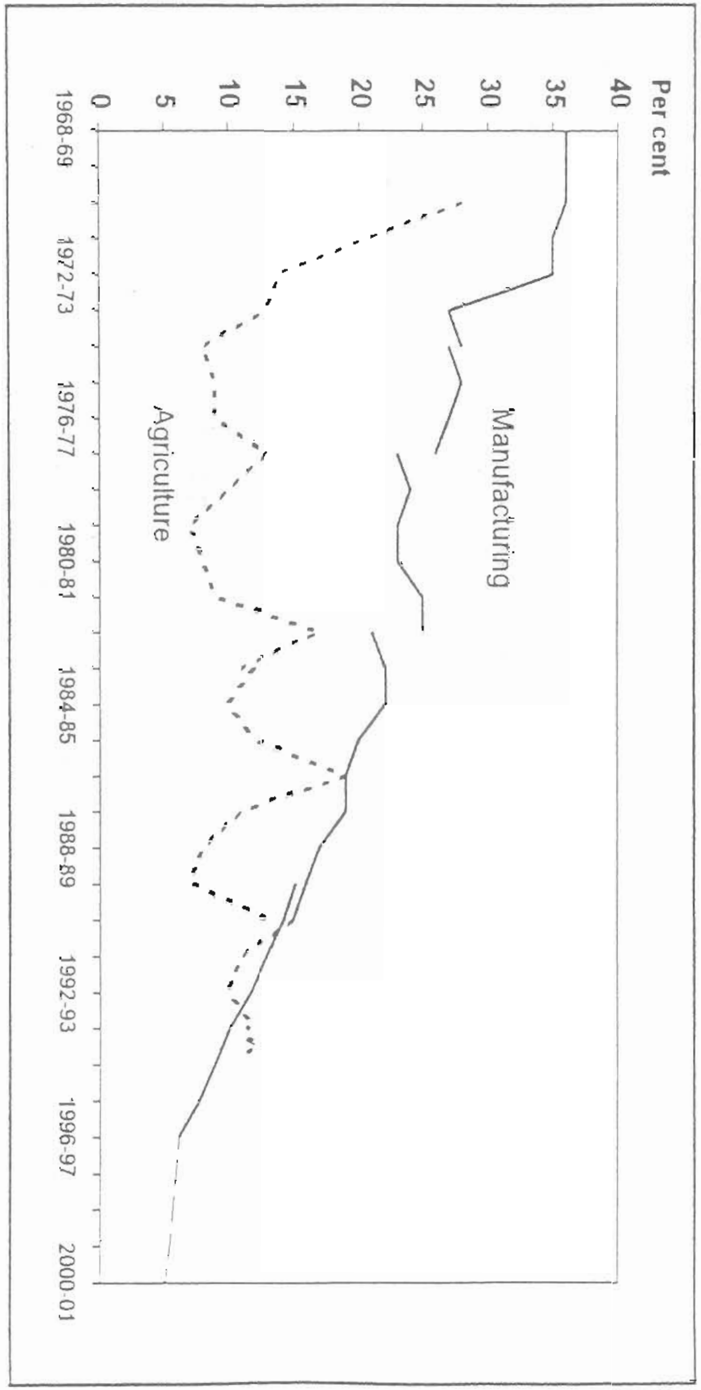
5 May, 1997

Effective rates of assistance for agriculture and manufacturing: 1968–69 to 2000–01



Source: IC estimates.

FIGURE 1

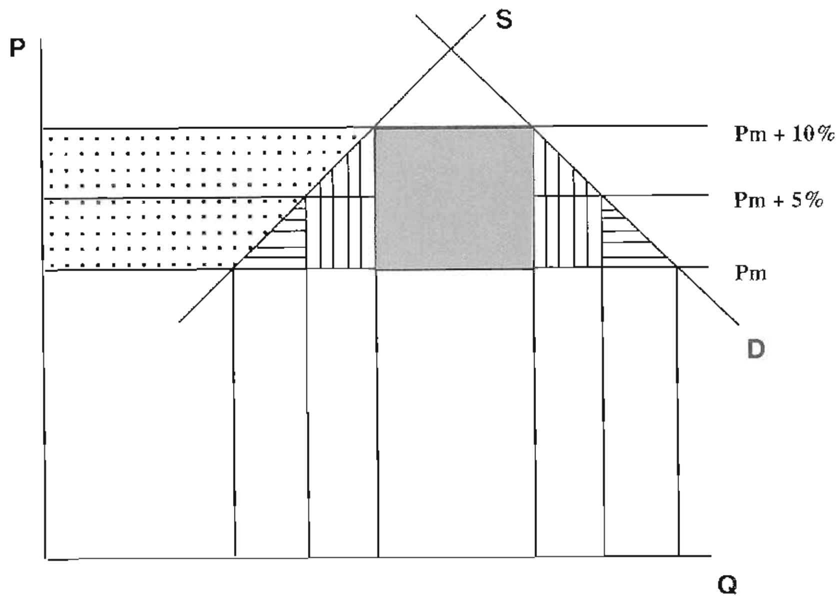


FIGURE 2

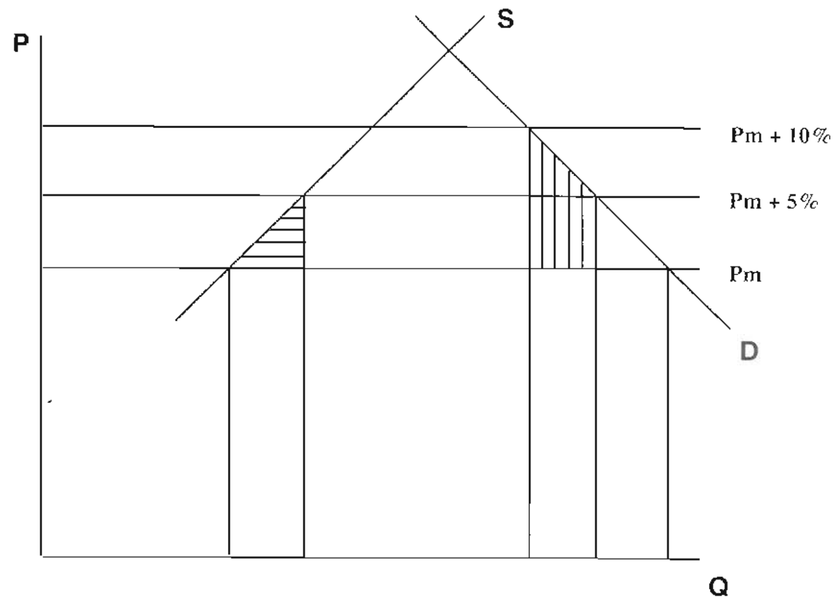


FIGURE 3

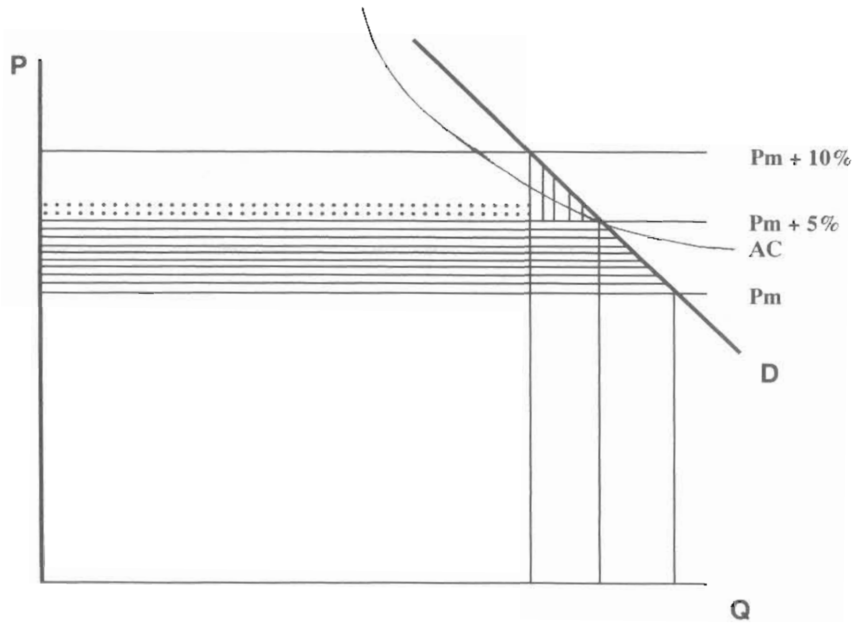


FIGURE 4