Agenda, Volume 4, Number 2, 1997, pages 135-142

Reciprocity and Protectionism in Australia's Trade Policy

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AFTER almost a decade of steady progress with unilateral liberalisation of trade barriers, uncertainty has reappeared during the past twelve months or so about the future of Australia's trade policy.

Some decisions by the Liberal-National Coalition government elected in March 1996 have contributed to this uncertainty, which the opposition Labor Party has used as an opportunity for demanding continued protection for some Australian jobs, notwithstanding its own previous commitment to trade liberalisation and microeconomic reform. The conclusion in July 1996 of the general tariff reduction program begun in March 1991 has been followed by reviews of protection for passenger motor vehicles and components (PMV) and textiles, clothing and footwear (TCF); these are required to establish further liberalisation beyond 2000, when PMV tariffs are scheduled to fall to 15 per cent and TCF tariffs to 15–25 per cent. The reopening of the protection debate, along with vacillating comments by some ministers, has encouraged some industrialists to expect a sympathetic reception for proposals for industry support schemes.

The optimism that followed the successful conclusion of the Uruguay Round of the GATT and the establishment of the World Trade Organisation (WTO) has also receded following the WTO Ministerial Meeting in Singapore in December 1996. The information technology agreement, followed shortly afterwards by an agreement on telecommunications under the General Agreement on Trade in Services (GATS), represent significant progress outside the normal negotiating round. The Singapore meeting gave some support for a new round of trade negotiations to begin in 2000, but gave time for reflection before real preparations begin. The APEC Summit in November 1996 reiterated the Bogor Declaration of 1994 and approved individual action programs, but it did not take any new initiatives.

Given that the arguments for continuing trade liberalisation remain valid, why has the political mood changed so suddenly? Can policy stability be restored?

The Economics and Politics of Trade Policy

The history of trade policy in Australia is one of contradictions and swings in policy. Occasional periods of enlightenment are followed by conservatism and back-sliding.

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The removal of general import quotas in 1960 was followed by rising tariffs and selective quotas under trade minister Jack McEwen. The 25 per cent tariff cut in 1973 was followed by the introduction of import quotas and increased access to antidumping duties in 1974-83. Now the unilateral liberalisation originally embraced by the Hawke Labor Government in 1988 is being reconsidered.

More than two centuries after it was elaborated by David Hume and Adam Smith, the case for free trade remains a mystery to most politicians and commentators. Yet the economics of free trade is simple, 'logically true and non-trivial' (Samuelson, 1969). The benefit from trade is that it enables a country to obtain imports at a lower price (in terms of real resources) than they can be supplied domestically. The real-resource cost of exports exchanged for the imports is lower than the equivalent domestically produced substitutes. The saving of resources represents the gain from trade, since those resources are available for additional production. Restricting the free movement of international commerce reduces the gains from trade.

The economics of trade policy has become more sophisticated in the past 30 years. New concepts, such as effective rates of protection, the theory of second best and general-equilibrium analysis, have been introduced. Many of these new approaches were devised and tested by prominent Australian economists, and have become embodied in the analysis of Australian trade policy in recent years (Corden, 1971, 1997; McDougall & Snape, 1969). Recognition that the effects of a tariff (or other trade instrument) spread throughout the economy established the link between import prices and export volumes, as traded and non-traded production compete for the same stock of domestic resources. In short, import tariffs are a tax on exports (Clements & Sjaastad, 1984). Reducing import protection has the effect of increasing exports.

But although the economic case for free trade is straightforward, in that economic welfare increases in aggregate with trade liberalisation, in practice any change in trade policy will benefit some interests and harm others. Other things being equal, a tariff reduction decreases producers' incomes in import-competing industries, while raising real incomes of consumers (through lower prices) and exporters, as increased imports release resources from the contracting import-competing industries. It is therefore rational for import-competing industries to pursue higher prices and profits by persuading governments to raise tariffs or apply other trade-restricting measures.

Why do governments submit to these pressures? The problem is that the political system reacts to the 'identity bias' arising from changes in protection. Businesses and workers in a protected industry are identifiable 'losers' from trade liberalisation. Consumers and exporters, on the other hand, are dispersed, and their gains are difficult to identify. Politicians and governments react more to obvious effects than to invisible ones. Localised hardship in a community has more political impact than general, dispersed welfare gains, even though the economic value of the latter may be much larger.

The political economy of trade policy has been formalised by Baldwin (1989). Some industries apply real resources to influence trade policy decisions to earn economic rents from quasi-monopoly status. These resources are applied to the political process up to the point where marginal returns equate with marginal outlays in terms of political/economic goals, being spent on research, legal briefs, party contributions, and so forth. Bhagwati (1988) has called this 'directly unproductive profit-seeking'. These activities reduce rather than contribute to the gross national product. They offer potential returns only for the lobbyist, but represent waste in national economic terms.

One recent innovation in trade theory has caused new confusions among policy-makers. In conditions of imperfect competition in an industry, subsidies or tariff protection could improve its international competitiveness. This 'strategic' protection argument revived protectionist demands from many quarters, even though the conditions under which this sophisticated adaptation of infant-industry protection and terms-of-trade arguments for tariffs would be beneficial were strictly limited (Krugman, 1987). Such increases in protection are contrary to the rules of GATT/WTO. In general, the conditions for strategic protection apply only where economies of scale and R&D expenditure require large markets. But these seldom need to be larger than the internal markets of the United States or the European Union, and even there foreign competition tends to improve efficiency.

Unfortunately, the theory of 'strategic' protection generated arguments for 'picking winners' and 'strategic marketing' that suited political interests favouring government intervention in Australia as elsewhere. This contributed to the continuing protection of PMV in Australia and the view that a substantial domestic market is essential for exporting (supported by subsidies in the form of export facilitation schemes). It is also evident in recent calls for industry policies by the Chief Executive Officers of some Australian corporations (*The Australian*, 3 March 1997). The adoption of strategic protection by the US authorities to promote high-tech industries encouraged its use by smaller countries (Tyson, 1992).

Rising Uncertainty

The average tariff on Australia's manufactured goods is now close to that of the OECD. Even in PMV and TCF, Australian protection is probably no higher than in most OECD countries, which in these sectors commonly employ import quotas and/or voluntary export restraints. Yet Australia's effective rates of protection in these sectors are higher relative to the average manufacturing effective rate of protection than they were before 1991 (Pearce & Stoeckel, 1996). This distortion of resource allocation is holding back Australia's economic growth, both directly by discouraging new activities and indirectly by encouraging an ethos of government intervention to support industry.

The politically sensitive issue of protection was forced upon the new Coalition government partly by the need to refer PMV and TCF to the Industry Commission after the program of general tariff reductions was completed in July 1996, but also by external pressures. The Uruguay Round Agreement on Subsidies made export

facilitation measures unacceptable, and liable to attack under the WTO's dispute settlement procedures. At the same time, the Uruguay Round agreement on textiles and clothing requires import-quota arrangements to be phased out progressively by 2005. Neighbouring countries have been exerting pressure on the Australian government over its rules of origin and market access for TCF. The WTO and other international bodies such as APEC require changes to trade policies affecting TCF industries.

Yet the Coalition government has also stimulated the protectionist debate with initiatives of its own. In July 1996 it reintroduced a 3 per cent revenue tax on imports of capital goods and inputs by revoking the tariff concession scheme, which exempted from duties imports for which no domestic substitute existed. The effect of this is to raise the cost of equipment and intermediate imports to domestic producers and exporters. In February 1997, ICI ceased production of plasticisers in Australia because the combination of the 3 per cent import tax on inputs and reductions in tariffs on outputs made the process unprofitable.[1]

A further source of uncertainty has been the growing involvement in trade policy by government bodies other than the Industry Commission. In recent years the Department of Foreign Affairs and Trade (DFAT) has produced several reports on trade, of which the most recent are *Winning Markets* (1995) and *Trade Outcomes and Objectives Statement* (1997). These reports reflect the old mercantilist doctrine that holds that national economic welfare is promoted when exports are maximised and imports minimised. They focus on Australia's export performance and propose strategies for opening overseas markets to Australian exporters, but largely ignore the effects of Australia's trade policy on the domestic economy. Reciprocity in trade negotiations is granted priority over domestic reasons for industry assistance. In addition, domestic departments such as Industry, Science and Technology (DIST), Communications and the Arts, and Primary Industry and Energy usually act for their client industries and support industrial development schemes of various kinds, even though the Uruguay Round agreements contain many provisions that circumscribe national governments' freedom to support industries and make member governments subject to correction through the WTO's dispute settlement mechanism.[2]

To differentiate its trade strategy from its predecessor, the Coalition government has endorsed bilateral negotiations and reciprocity, and has made some

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[1] A zero tariff on final output combined with a 3 per cent tariff on imported inputs results in a negative effective rate of protection on the processing, which encourages imports of the final product. See *The Australian*, 28 February 1997.

[2] With so many organisations involved, contradictory proposals are often presented to Cabinet. In the recent Howe Leather case, the US authorities threatened to take Australia to the WTO Dispute Settlement Body because export facilitation payments contravened the Uruguay Round Agreement on Subsidies. When Cabinet considered this problem, conflicting recommendations were presented by DIST and DFAT. Ultimately the government decision to discontinue export facilitation acknowledged the commitments made in the Uruguay Round.

claims of success in the 1997 DFAT report *Trade Outcomes and Objectives Statement*. Yet Australia's scope for exerting bilateral leverage is limited by its size (it accounts for only around 1 per cent of world exports). The strategy will encourage Australian firms to seek government assistance. Emphasis on reciprocity in international negotiations, shoring up as it does the notion that protection from foreign competitors provides a lever for opening other countries' markets, devalues the argument for liberal trade, as well as upsetting trading partners accused of 'free riding' for offering small tariff reductions in negotiations. It brings into question the seriousness of Australia's commitment to the APEC goal of free trade and investment flows for developed-country members by 2010.

Another serious effect of the government's stance on industry protection has been to encourage the opposition Labor Party to follow suit. The recent statement on PMV tariffs by the Labor leader, Kim Beazley, represents a complete reversal of his party's position in government, when it promoted trade liberalisation (with support from the Coalition parties): ' ... we say to the rest of the world that we will look for downward movement in their protection levels before we move further' (*The Australian*, 11 March 1997). Other front-bench Opposition spokespersons have followed this lead, even though it has been rejected by former Labor leader Gough Whitlam, who as Prime Minister implemented the 25 per cent tariff cut in 1973. According to Mr Whitlam, 'There is nothing in the traditions of the modern Labor Party which endorses industry protection ... Protection has always protected profits, not jobs' (*The Australian*, 14 March 1997).

Reciprocity

The principle of 'reciprocity' that lies at the heart of Australia's present trade policy regime is a mercantilist notion with a long history in international trade relations. Reciprocity requires that one country's tariff liberalisation should be balanced by equivalent reductions by another country to give 'balanced' bilateral trade. In reality, a multilateral trading system, offering overall balanced trade, is much more efficient. Hence the goal of multilateral trade and payments for the post-World War II Bretton Woods system. Unfortunately, reciprocity survived in the GATT because each liberalising step required broad reciprocity. In times of fixed exchange rates and limited currency reserves, shifts in trade balances were a major concern. In practice, negotiators sought to balance concessions made, not to achieve full equality of market access.

The survival of reciprocity in the GATT processes has encouraged the US to advocate a new form of reciprocal trade balancing. This requires equal market shares in broad industry categories, as well as overall balance in bilateral trade (which is usually defined as merchandise trade without any reference to trade in services or investment flows and income). This so-called 'full' reciprocity is the foundation for the 'managed trade' doctrine.

Reciprocity has now been accepted by Australian politicians, without question and with little understanding. No attention is given to trade statistics or tariff effects. It is buttressed by the argument that trade liberalisation in the past decade has

caused rising unemployment. But how would it be applied when Australia has a large trade deficit with the United States but substantial trade surpluses with Japan and Korea? This trade pattern reflects broad measures of comparative advantage. Australia's resource-based exports go to Japan and Korea, while they and the US all supply manufactured goods to Australia. (As it happens, Australia's large trade deficit with the US is almost balanced by its trade surpluses with Japan and Korea. If trade in services is included, the gap disappears.)

Mercantilism is evident in the tendency to identify export performance in specific markets as an indicator of diplomatic effort. DFAT's 1997 *Trade Outcomes and Objectives Statement* (like the earlier *Winning Markets*) emphasises access to overseas markets as a target for foreign economic policy. But this focuses on only a fraction of the trade policy program, and ignores the benefits to exports that arise from domestic trade liberalisation. As well, the benefits from increased exports depend on domestic resource allocation. And the use of exports as an indicator of performance in foreign economic policy provokes domestic producers to seek government assistance to raise profits and income. But all such assistance is costly, whether it takes the form of export promotion or import protection.

Multilateral liberalisation enables Australia to exert its influence through associations, such as the Cairns Group. Moreover, multilateral agreements, like the WTO, underpin trade liberalisation and minimise back-sliding, which bilateral approaches can seldom prevent. Promoting reciprocity offers little reward for a medium-size mixed economy. Only large economies like the US stand to gain from bilateral trade threats.

Trade and Domestic Policies

New WTO disciplines add another dimension for trade policy. The scope of trade policy was expanded by the Uruguay Round agreements, and further disciplines are evident in the new WTO agenda that came out of the December 1996 meeting in Singapore. These new rules (some of which are still embodied only in framework agreements) affect investment, industrial subsidies and standards, trade in services, quarantine standards, intellectual property, and so forth, and restrict governments' freedom to assist their national industries. This imposes a limit on interventionist policies that goes far beyond traditional trade policy measures. With the backing of the WTO dispute-settlement procedures, the freedom of governments in domestic policies is being constrained in ways that are only now becoming apparent. These new constraints are recognised in DFAT's 1997 *Trade Outcomes and Objectives Statement*.

The Australian Antidumping Authority is under review. One of the failures of the Uruguay Round was the lack of real amendments made to the GATT antidumping provisions. 'Unfair trade' provisions in the GATT remain an open invitation to use new duties against competitive imports which can be 'made to measure' to block foreign competition. The principal traditional users of antidumping measures were the US, Canada, the EU and Australia. Now antidumping legislation is being employed in many middle-income countries too. Because the GATT rules

are unclear, antidumping is effectively an invitation to protect. With Australia adopting low tariffs (with a few exceptions), the antidumping rules should be tightened to take account of consumer interests and user-industry concerns. At present, only producers' interests are assessed in antidumping cases, in Australia as elsewhere.[3] In economic terms, 'dumping' is a dubious concept. To allow easy access to this anti-competitive measure in the reformulation of the Antidumping Authority would send another protectionist message to the Australian community.

Concluding Comments

Australia and New Zealand are not the only high-tariff countries that adopted unilateral trade liberalisation in conjunction with domestic economic reforms in the 1980s. The revival of market economics in the US and Britain at the turn of the 1980s influenced the economic reform programs adopted by highly indebted middle-income countries in Latin America. Following the East Asian model of export-led development, these countries chose economic reform and trade liberalisation as the way to correct domestic imbalances (guided by the IMF and Western banks). Deregulation became the accepted economic model.

In Australia, deregulation of the financial sector at the end of 1983 broke the stranglehold of regulation and opened other economic sectors to liberalisation, including trade policy. The Hawke Government accepted the idea that unilateral liberalisation brought major benefits to an economy, whereas reciprocity was a slow process bringing uncertain returns. It was presented strongly to the Australian public as the only way to prevent the country becoming a 'banana republic'.

Against this trend, the Coalition government has been sending mixed messages to Australian industry and foreign suppliers about its trade policy intentions. The uncertainty has weakened the community's will to accept economic reform — ironically, at a time when the international economic system has advanced in openness and disciplines.

Industry leaders have revived calls for a comprehensive and cohesive industry policy, and the Labor Party has followed their lead. They argue from casual observation that Asian economies like Malaysia and Taiwan use industrial strategies, ostensibly to good effect. But, however industrial policy is packaged, it represents a transfer of income from consumers and taxpayers to the favoured industries. Once begun, the capacity of the government to refuse similar requests from other industries becomes difficult, causing the expense of industrial supports to increase and their effectiveness to decline.

The economic theory of trade establishes that trade liberalisation raises national output and welfare. True, the gains for the liberalising country will be greater if other countries liberalise at the same time; but there are gains regardless of whether other countries reciprocate. The difficult question that receives little attention in the present debate is how the domestic losers (such as PMV production workers) should be compensated by the gainers (PMV purchasers) as tariffs are dismantled.

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[3] This is also true of quarantine: see the Nairn Report (1996).

Labour markets do not clear efficiently in all regions of Australia; labour market failure deserves more attention in the trade debate.

The attitude adopted towards the inquiries into PMV and TCF will set the tone on trade and industry policies beyond 2000. After a decade of trade liberalisation and economic reform that has helped to reshape the Australian economy, the stance adopted towards trade policy during the next decade will be crucial to cementing that progress. Participation in another WTO round of negotiations and in APEC liberalisation depends on reform and adjustment in the domestic economy, including adjustment to continuing trade liberalisation.

The forthcoming White Paper on Foreign and Trade Policy provides the Commonwealth government with an opportunity to remove much of the recently created uncertainty. The seeds of doubt sown in the community by vacillating and avoiding a clear commitment to continuing liberalisation must be removed. The necessary political commitment to market forces is evident in current macro- and microeconomic policies. What is now needed for continuing microeconomic reform is the reassurance that demands for any continuation of protectionist policies will not be heeded.

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