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PROTECTION STRATEGIES FOR AUSTRALIA

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The Industries Assistance Commission and the Green Paper on Rural Policy support different protection strategies. Both strategies allow the achievement of a pattern of protection consistent with Pareto-efficiency. The Green Paper on Manufacturing proposed an approach to tariffs that would perpetuate inefficient resource allocation. The argument of the IAC and the Green Papers on protection policy is examined. A programme of across the board reductions in protection leading to free trade, modified for terms of trade effects, is suggested. It is also argued that initial increases in assistance for low cost industries are not inconsistent with such a programme.

Protection policies adopted by Australia in the future will have significant effects on the size and composition of the different economic sectors, including the rural sector, on the attainable level of average income and on the process of structural adjustment. Widespread discussion of different approaches to protection is therefore desirable. In this paper an attempt is made to state and evaluate three recently expressed views on desirable protection policies for Australia. In chronological order, the sources of these views are the Green Paper on *The Principles of Rural Policy in Australia* (RGP) published in May 1974; the Industries Assistance Commission (IAC) in its first *Annual Report* dated September 1974 and its elaborations on its views in subsequent annual reports and other publications; and the Green Paper on *Policies for Development of Manufacturing Industry* (MGP) published in October 1975.[1,2] The paper concentrates on examining the overall protection strategies and the means of changing protection advanced in these reports. The final section of the paper presents a summing up and suggests the adoption of a programme of annual across the board reductions in protection.

Overview

The reader may find it easier to follow the argument if he sees at the outset a picture of the protection strategies advocated by the IAC and in the two Green Papers. The table allows such a picture to be formed, albeit inevitably a simplified one. For comparative purposes

[1] The MGP and RGP are listed in the references under the names of the chairman (Jackson) and convenor (Harris) respectively of the groups which prepared the reports.

[2] The White Paper on Manufacturing Industry released in May 1977 devotes little attention to defining a longer term protection policy and only brief references are made to the White Paper in this article.

the table also shows the protection strategy of the Tariff Board, predecessor of the IAC.[3]

The final row of the table shows the *end situation* resulting from application of the various protection strategies. Before commenting on the entries in this row it is desirable to recall the conditions under which a country's protection policy will yield a configuration of relative prices consistent with Paretian efficiency in production, consumption and trade. The requirement for this is that tariffs on imports and subsidies on exports be uniform, except where departures are warranted on terms of trade grounds, and apply to *all* imports and exports of goods and services (e.g. Bhagwati and Ramaswami, 1963). The *rate* of protection does not matter. Uniform protection of zero per cent (free trade), 50 per cent or 1,000 per cent are equally good from the view of Paretian efficiency.[4] It is not the *existence* of tariffs or export subsidies, but unwarranted variations in protection between goods and activities, that causes domestic relative prices to differ from relative prices in world trade and reduces the gains from specialisation and exchange. A situation of uniform protection, modified for terms of trade effects, goes as far as is possible with the use of trade taxes and subsidies towards giving the price incentives for equating national or social rates of substitution in consumption (DRS) and national rates of transformation in domestic production (DRT) and through foreign trade (FRT). Together with the use of measures other than trade taxes/subsidies to remove economic inefficiency resulting from factors other than influence on world prices (for example, external economies and diseconomies), it gives the relative prices needed for equality of DRS, DRT and FRT for each pair of tradeable items. Moreover, there is nothing about this set of trade taxes/subsidies that prevents equality of social DRS and DRT between any item in the export or import competing sector and any non-traded good. This equality could be achieved, provided all other divergences were removed directly, by using exchange rate variations or identical proportionate changes in all trade taxes/subsidies to maintain external balance.

It can be argued that as it would be feasible to reach any of the end situations only over a long period, policies for changing protection in the medium term are more important than the ultimate position. Nevertheless it is of interest that modified free trade, the end situation under the *preferred* RGP strategy and seemingly of the IAC strategy, is con-

[3] In preparing the table it has been necessary to make judgements about those aspects of protection strategies which are not clear from a reading of the relevant reports. In these cases, which are fortunately few and not unduly difficult to make judgements on, the table gives my interpretation of the strategy. For example, I have judged it reasonable to write against export assistance in the Tariff Board column 'no strategy stated' because the Board was concerned predominantly with recommending tariff protection for import competing industries and did not publish guidelines for assistance to exports paralleling its points of reference for import competing activities. (This is not to deny that the Board's tariff recommendations often reflected a concern to restrict increases in the cost of inputs to export industries, especially those receiving little or no assistance.)

[4] This assumes that there are no administrative costs in collecting taxes on imports and distributing the revenue raised as subsidies on exports.

Protection strategy supported

Class of protection and end situation	Tariff Board	Rural Green Paper (RGP)		IAC	Manufacturing Green Paper (MGP)
		Preferred Strategy	'Second best' Strategy		
High protection for import competing industries	Decrease	Decrease	Decrease	Decrease	Decrease[b]
Low protection for import competing industries[a]	Increase	Decrease	Increase	No increase	Increases and decreases
High assistance for exports	NSS	Decrease	Decrease	Decrease	NSS
Low assistance for exports[a]	NSS	Decrease	Increase	No increase	NSS
End situation envisaged	Eventual uniform positive protection for import competing industries? NSS for export industries.	Free trade, modified for terms of trade effects.	Uniform positive protection for all imports and exports, modified for terms of trade effects.	Eventual modified free trade?	Protection at several different benchmark rates for manufactures sold domestically. NSS for non-manufacturing sector or for exports of manufactures.

NSS denotes no strategy stated.

[a] Extra assistance provided by the lowering of the exchange rate accompanying reductions in protection is disregarded.
[b] This is the overall strategy. However, some increases in high protection, initially at least, appear to be envisaged.

sistent with Pareto efficiency. The end result of the 'second best' strategy of the RGP is also consistent with Pareto efficiency if uniform protection applies to *all* exports and imports, including services. The end result of the Tariff Board strategy, uniform protection for import competing industries, would give efficiency only in a limited sense; it would not give the conditions for efficient allocation between import competing and export industries (or even between production for the local and overseas markets within a given manufacturing industry). With several different rates of protection for import competing manufacturing industry, the outcome envisaged in the MGP, the national marginal return would also differ *within* import competing manufacturing. The lower the level of uniform protection under the Tariff Board's strategy and the higher on average and the more dispersed the range of benchmarks under the MGP strategy, the more likely it would be that the end result of the Board's strategy would be higher welfare than with the MGP's strategy.

The Industries Assistance Commission

The annual report of the IAC for 1974 outlined a protection strategy that differed in important respects from the course supported by the Tariff Board. The IAC argued that

> 'if the community's resources are to be used more efficiently, in the interests of promoting economic growth and thereby improving the wellbeing of the people of Australia, resources must be encouraged to move into activities which require low levels of assistance, or none at all' (1974, par. 121).

This involved no departure from the Tariff Board's position. But whereas the Tariff Board enunciated a general strategy of increasing low rates of protection for import competing industries as well as reducing high rates, the IAC said that low cost activities[5] should be encouraged

> 'by decreasing high levels of assistance, rather than by increasing low levels of assistance or providing assistance to industries which at present have none' (App. 5.5, par. 1).

This general strategy was reiterated in the 1975 *Report,* though exceptions allowed for there appear to permit significant departures from the strategy.[6]

Under its charter the IAC advises the Government on assistance to industries throughout the tradeable goods sector.[7] The IAC's emphasis on encouraging the movement of resources into low cost activities in *all* import competing and export areas, rural and mining

[5] The IAC defines low cost industries as those 'which require relatively low levels of assistance or none at all' (1974, par. 123).

[6] A rather unclear paragraph in the 1975 *Report* said, in part; 'In rejecting a general strategy of raising assistance to low cost industries, the Commission has not, of course, precluded the possibility—for example, on resource allocation grounds—that it may recommend the provision of additional assistance to a low cost industry or the provision of assistance to an industry which has previously received no assistance (par. 3.21).

[7] Industries producing non-traded goods also come within the IAC's area of inquiry. The IAC has not presented guidelines for improving resource allocation in this sector.

as well as manufacturing, is therefore to be expected. However, the IAC has played down the importance of reducing high protection. Thus it offers the understatement that:

> 'In addition to the approach the Commission has proposed for the development of low cost industries, the objective of improving the efficiency with which the community's resources are used will also require a gradual reduction in the levels of assistance which are high' (1974, par. 137).

Perhaps this merely reflects the realities concerning possibilities for reducing protection in a period of high unemployment. Evidence that the IAC is keen to facilitate reductions in high assistance is easily found. Its concern that the 'widely spread and much less visible' benefits of protection reductions be given proper weight in relation to the 'very concentrated and highly visible' adjustment costs is important in this respect (1975, par. 3.29). So is its emphasis on improving structural adjustment assistance (see especially IAC 1975, 1976 and 1977a, b, and c) and its countering of the widespread over-emphasising of tariff reductions *vis a vis* exchange rate changes and wage increases in the recent problems of Australian industry. However the IAC considers that feasible reductions in high protection following the industry by industry approach will leave a distinctly uneven pattern of protection for a very long time (1974, par. 144 and App. 5.5, par. 4).

Although the IAC has said that its general approach is to reduce high rates of protection rather than increase low rates, it has not indicated whether the *points of reference* introduced by the Tariff Board in 1968 are currently adequate as a practical guide to what constitutes high cost and low cost production. It appears that the Tariff Board set its points of reference at 25 per cent effective protection and 50 per cent effective protection on the basis of protection received or needed by *import competing* industries (Tariff Board 1967, par. 61; 1969, par. 30). This was understandable, though not economically justified, in view of the scope of the Tariff Board's task.[8] Given that the IAC Act requires the Commission to take a broader view of efficiency than did the Tariff Board the terms high and low cost must now be defined in relation to rates of assistance received by all import competing and exportable production. Because rates of assistance for rural and mining industries, and for manufacturing for export, are in general lower than protection for import competing (mainly manufacturing) production sold domestically, (e.g. IAC, 1974, pp. 15-16, p. 18; IAC, 1976a, p. 72) benchmarks determined on this broader basis would be lower than those based on protection for import competing activities only. In addition, rates of protection for the import competing parts of manufacturing have fallen since 1968 due to tariff decisions for individual industries and the 25 per cent across the board tariff

[8] As long as there is some substitution in production or consumption between manufactures on the one hand and tradeable rural, mining or tertiary items on the other hand, assistance that is regarded as 'low' or 'high' in import competing manufacturing industries should (if overall efficiency of resource use counts for anything) be defined with reference to characteristics of other parts of the import competing and export sectors. Characteristics that are important include rates of assistance, size and substitution possibilities with the importables sector.

of July 1973. Average effective protection in manufacturing has been estimated at 28 per cent in 1974-75 compared with 36 per cent in 1968-69 (IAC, 1976, p. 114. It seems most inappropriate, therefore, for notions concerning rates of protection which delineate economically efficient or inefficient production to be determined by the points of reference that were used by the Tariff Board.[9]

The IAC has placed emphasis on encouraging movement of resources, especially new resources, into low cost industries without assisting them through tariffs or assistance to export industries. Its reasons for this are mentioned later in discussing the policy of tariff compensation supported in the RGP. Several ways of encouraging resource movement have been mentioned, including: reducing the prices or increasing the mobility of inputs important in low cost industries; providing assistance for innovation and research; improving access to overseas markets through linking industry trade and development policies; and improving income stabilization arrangements for rural industries (1974, paras. 126-36). In the 1975 *Report* the term 'general measures to improve the mobility, quality and productivity of resources' is used to describe measures other than assistance provided for individual industries (par. 3.6). Regarding these general measures as a substitute for assistance to low cost industries is erroneous. It would be just as important to examine their merits if the IAC were following a strategy of increasing protection to low cost industries.[10] Moreover, even if the removal of various externalities and other divergences between private and social valuations caused a net movement of resources into low cost tradeable activities (not an obvious result) the misallocation due to uneven protection would remain. This misallocation cannot be reduced by removing *other* sources of inefficiency.[11] It can only be reduced by achieving something approaching uniform protection, positive or zero, throughout the tradeables sector.

The IAC has also emphasised the role of exchange rate adjustment associated with tariff reductions in stimulating low cost areas of the economy. Its argument is not above criticism. Tariff reductions affecting a large part of the import competing sector are said to

> 'lead to (or allow the maintenance of) a lower exchange rate than would otherwise be the case. This will enable low cost

[9] Snape (1972) argued that the points of reference should be reduced to about 15 and 30 per cent. The tariff reductions that have occurred since 1972 suggest that the economically appropriate protection benchmarks would now be lower than in 1972.

[10] The question whether the measures are what is needed to efficiently remove divergences between private and social costs or benefits is pertinent in both cases.

[11] The IAC's approach in supporting general measures to increase mobility, quality and productivity to attract resources into low cost industries contrasts with its emphasis on choosing the best instrument for the job in other contexts. Thus fiscal, monetary and exchange rate policies are seen as more efficient than industry protection policy for dealing with unemployment and balance of payments deficits (1974, par. 52, and p. 17, f.n.4) and location specific bounties are seen as superior to general industry assistance measures for achieving decentralisation of industry (1974, App. 5.4).

> industries to compete more successfully in the domestic and overseas markets for their products' (1975, par. 3.24).

The reduction of high tariffs, considered on its own, will tend to increase the use of resources in export activities, low protection import competing industries and the non traded goods sector. However the effect of exchange rate changes associated with the tariff reductions is on allocation between the non-traded goods sector and *all* parts of the tradeable goods sector, including those that still receive high rates of protection. The lower exchange rate compared with the no tariff reductions situation will stimulate production in all components of the tradeable goods sector. But the improvement in resource allocation *within* that sector is attributable to the reduction of high tariffs, not the lower exchange rate.

The Green Paper on Rural Policy

The RGP is of interest in discussing protection strategy because of its argument for 'tariff compensation' assistance for rural export industries and because of the end result of uniform positive protection underlying much of the argument.

Although it is preceded by a confused and confusing discussion of the effects of tariffs on farmers' costs,[12] the argument for assistance to rural exports is advanced on resource allocation, rather than equity, grounds. It is presented as a 'second best' argument, on the grounds that only slow progress can be expected following the 'preferred course' of gradually removing tariffs and adjusting the exchange rate.

> 'If the objective were simply to raise living standards all round, the preferred course of action would be to gradually lower both tariffs and the exchange rate so as to maintain full employment. This would mean that industries with a low or medium level of tariff protection would get the same or more protection from a devaluation. The disadvantaged would be the highly protected industries which would have to undertake the necessary structural changes as resources were released for other, less highly protected, industries. The preferred course, replacing the tariff with an exchange rate devaluation and leaving the tariff to be used for special situations, such as infant industries, would therefore provide difficulties for these industries. Given the practical difficulties, such a course is likely to be followed, at best, only slowly.
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> There is then a case on economic grounds, a second best course of action, for providing some compensating protection, i.e. assistance, to the export sector. Some industries in the sector already have levels of assistance which probably exceed an economic level of compensatory protection. Others have less' (paras. 3.63-4).

Although the RGP's argument for assistance to rural export industries is presented in the name of second best, the course that appears to be supported in the RGP does not correspond to what economists generally mean by second best. Questions which would

[12] For comments on the RGP's discussion see Edwards (1975, pp. 15-16) and P. Lloyd (1975, p. 148).

be of interest in a second best approach would be of the following type: what method and rate of assistance is economically justified for the beef or wheat industry if current assistance for other rural industries, manufacturing, minerals and tradeable services is retained? How would these rates change if all tariffs were reduced or increased by 10 per cent? The general tenor of the RGP suggests that questions of this type were not the main concern of its writers. There is a quick progression from the notion of second best in the section quoted above to a situation that corresponds closely to first best or Pareto optimality. It is said that:

> 'Subject to one general qualification,[13] the most efficient allocation of resources would, in principle, be obtained if the general level of protection or assistance to the export industries were broadly equivalent to that given to import competing industries' (para. 3.71).

The idea of *uniform protection* now becomes central to the argument in the RGP.

It was noted earlier that uniform protection applying to all items (tariff on all imports and subsidy on all exports) would be as good from the view of Pareto efficiency as free trade.[14] A *second best* approach, however, would not involve subsidising all exports (rural, mining, manufactures and services) at a uniform rate if the range of tariffs continues to be wide. The second best solution would require that the rate of producer subsidy for an exportable item depend on substitution relationships in production as well as rates of protection in other activities. Consumer prices of exportables, if they were not among the unalterables, would also need changing though not in general by the same proportion as producer prices (P. Lloyd, 1975, p. 150).[15] The RGP's statement (para. 3.110) that differences in foreign elasticities of demand is the one factor justifying departures from uniform assistance for rural export industries does not hold in a genuine second best situation.

The uniform protection framework in which the RGP's discussion of second best was conducted has, understandably, led to different interpretations of its policy recommendations.[16] Harris (1975, p. 140)

[13] This is the terms of trade effect. The RGP suggested that the only rural industry where this would be significant was wool. The magnitude of the difference in the rate of export subsidy that would be appropriate for wool and for other rural export industries was not considered. Nor was it said that, in the event that the 'preferred course' were followed (tariffs removed and the exchange rate lowered) a tax would be needed on wool exports to achieve efficient resource use.

[14] Harris (1975, p. 123) accepted the formal correctness of this point but argued that, in view of the difficulties in reaching uniform positive protection, this could be viewed as a 'second best' strategy and free trade could be regarded as 'first best'.

[15] Determination of best feasible subsidies/taxes for producers and consumers of a product can be regarded as a less restrictive constrained maximisation problem than determination of the second best policy towards producers when the constraints include a particular consumer price for the product.

[16] In commenting on the tariff compensation argument of the RGP, the IAC accepted that 'full compensation' or uniform protection would be 'equivalent, in terms of resource allocation, to no assistance' (1974, App. 5.2, par. 15; 1975, par. 3.17), but rejected uniform protection because of practical problems in

has stated that the approach intended in the RGP was that 'the process of providing any warranted tariff compensation would be a gradual one, with the question being looked at as cases came before the IAC'. In assessing the case for adopting such a piecemeal strategy of assisting low cost rural export industries (or other low cost export and import competing industries) one's judgement about how long substantial tariff (and other) protection will be retained is important. The IAC appears to agree with the RGP view that substantial protection for import competing (and some export?) industries will continue for a long time. If one accepts this assessment, it is hard to dismiss Harris' argument that:

> 'if an export industry competes for land, labour and capital with highly protected import competing or export industries and would generally be able to compete effectively with relatively low levels of assistance, it is difficult to see how it could be validly argued that it would not be worthwhile in economic terms to provide "some" assistance' (Harris, 1975, p. 141).[17]

This is so in spite of the point made by P. Lloyd (1975) and others, that the task of determining warranted rates of assistance for individual industries is complicated by the formidable problems of piecemeal policymaking.[18,19]

The RGP can be criticised for not pointing out the *generality* of its argument for tariff compensation—though generality could be inferred from the uniform protection concept underlying much of the argument. As Harris (1975, p. 140) has recognised, the argument for assistance on second best grounds is as applicable to low protection import competing industries and to exports of manufactures receiving low assistance as to rural export industries. In principle the second best argument suggests assistance for mining exports also. Harris suggests other reasons 'such as the uncompetitive nature of the industry, and differences in time horizons' why mining exports need

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reaching it over a long period (1974, App. 5.5). The IAC also rejected an alternative interpretation of the RGP's argument. It said that a policy of *selective* tariff compensation for the industries 'most seriously disadvantaged by the tariff . . . would be difficult to apply in practice, and is unlikely to be successful' (1974, App. 5.5, par. 6). Harris has countered the IAC's arguments. As noted earlier, the IAC appeared to backtrack in its 1975 *Report* (par. 3.21).

17 As Harris indicates, this argument in the Australian context owes much to Gruen. See Gruen (1968, 1971).

18 A. Lloyd (1977) has argued that the points advanced against a piecemeal strategy of increasing assistance to lightly protected industries apply also to the present system of piecemeal reductions in high rates of protection. In spite of this, Lloyd considers that proponents and opponents of tariff compensation would regard the present system of tariff reform as better than no reform.

19 The writers of the RGP may have expected the IAC (whose first *Annual Report* appeared four months after publication of the RGP) to adopt a broader version of the Tariff Board strategy and be willing to extend extra assistance to low cost import competing and export industries. With such a strategy there would be stronger grounds than at present for expecting the piecemeal process to lead eventually to something approaching uniform protection throughout the export and import competing sectors. In those circumstances it would seem harder to question 'tariff compensation' for agriculture on efficiency grounds.

not be suboptimal in the absence of assistance (p. 139).[20] While the RGP took tariffs in manufacturing as the immovable (or only slowly removable) constraint justifying assistance for rural export industries, longstanding assistance to the *rural sector* can be cited to support protection for manufacturing and mining on second best grounds.

Another, related, point is significant. The RGP points out that resource misallocation has been caused by the provision of widely divergent rates of assistance for rural industries which compete closely for resources (e.g. wheat and coarse grains, beef and dairying, (para. 6.92)). But the existence of high and longstanding assistance for dairying, for example, is not used as an argument for compensating protection for *other* rural industries. If, however, rural industries compete more closely with each other than with non rural industries for resources, as is likely in the short run at least, the second best rate of assistance for a relatively unprotected industry such as beef would probably depend more on protection for other rural industries than on tariffs in manufacturing. Consequently, reductions in high rates of assistance in farming are, to a degree, a substitute for increases in assistance to those rural industries receiving little or none.[21]

The form of assistance

The RGP considered two means of providing assistance to the rural export industries. The first was subsidies. Subsidies paid on *exports* are the counterpart on the exports side to tariffs, and raise domestic producer and consumer prices of exportable items. A subsidy on all exports at the same rate as a tariff on all imports would be necessary to achieve the first best Pareto efficient uniform protection situation of the RGP. But, as noted earlier, a second best solution for an exportable item in general requires one rate of tax/subsidy on production and another on consumption. Hence a second best situation generally cannot be achieved by means of export subsidies alone. An export subsidy can raise producer *or* consumer price to the second best level if a rise is required, but would need to be accompanied by a tax or subsidy to change the other price as appropriate.

The reservations of the RGP writers about subsidies are, however, on *other* grounds. Perhaps this is because of their uniform protection framework in which export subsidies give a *first best* outcome.

> 'In practice, increases in protection using direct budgetary expenditures would have to compete with conflicting expenditure needs. Society may well decide to give preference to those needs having high social or community priority such as those dealing with poverty and defence, and accept the loss of economic efficiency that this might entail' (par. 3.75).

This is a realistic assessment. However, if tariffs cannot be reduced, subsidies do not compete so clearly with provision of other goods (e.g. defence) if one takes a general equilibrium view over time. By paying

[20] Conventional theory suggests, however, that the uncompetitive nature of the mining industry would be an extra reason for thinking output and exports would be *suboptimal*.

[21] Admittedly, as observers of the dairy, egg or dried vine fruit industries know, it is not only in manufacturing that reductions in assistance involve 'practical difficulties'.

the subsidies justified on economic grounds resources would ultimately be competed away from the import competing sector: external balance must be maintained. The national cake would be enlarged, making more resources available for any purpose.[22]

Assistance can be given to rural export industries without calls on public revenue through home consumption price schemes operated with equalisation of returns from local and export sales. Schemes of this type have long existed for a number of rural industries including wheat, butter, cheese, dried vine fruits and sugar. The writers see problems with home price schemes, including the possibility that domestic prices could be undermined by interstate trade, and difficulties in price setting due to the absence of suitable grading systems for some products (par. 6.104). Another fundamental point needs to be recognised. Home price schemes cannot give the price conditions for either a first best or a second best allocation of resources. Because the rate of producer subsidy that can be financed from any given 'tax' on domestic sales varies inversely with the proportion of production exported, home price schemes in conjunction with a uniform tariff cannot give uniform nominal and effective protection throughout the tradeable goods sector as is required for a first best situation. Nor can they in general change both producer and consumer prices in the way needed for a second best solution.[23]

Despite the general impossibility of obaining second best resource allocation with the use of export subsidies alone or home consumption prices with equalisation, it is likely to be possible to *improve* resource allocation in some cases by the use of one of these measures. If the combination of measures that give a second best solution is ruled out, it may be preferable to use a less than second best export subsidy, home price scheme or other measure rather than to do nothing.

The Green Paper on Manufacturing

This report supports lower tariffs and reduced reliance on tariffs as an instrument of industry policy. Most economists would see this as economically sensible. However the description of tariff reductions as an 'essentially negative process' (p. 162) suggests a narrower perspective than that adopted by the IAC or in the RGP.[24] Even from the

[22] If the social return from extra public spending, on defence for example, exceeds the return from extra resources in lightly protected export industries, it will generally exceed by a *larger* margin the social return from marginal resources in highly protected import competing industries. In these circumstances the sacrifice incurred through high protection in import competing industries is likely to be particularly high, and the case for tariff reductions particularly strong.

[23] The use of *input subsidies* for the export sector to reduce the welfare loss caused by the tariff has been analysed using simple models by Warr (1977). The general import of his analysis is that subsidies on non-traded inputs (such as labour), or on non-traded *and* traded inputs, are superior to a subsidy on a traded input (such as fertiliser) only. Warr (1977 and forthcoming) shows that when there is an economic case for subsidising the use of traded inputs in agriculture the informational requirement for determining the optimal rate of subsidy is onerous.

[24] The then chairman of the IAC, a member of the committee which prepared the MGP, did not sign it. Rattigan (1975) indicated that a major reason for not signing the report was that it did not adopt an economy-wide approach to the determination of policy for manufacturing.

view of the manufacturing sector, tariff reductions confer gains as well as costs (lower input prices and, as recognised elsewhere in the MGP (p. 179), the directly related fall in the exchange rate). Reductions in high rates of protection would generally be expected to increase profitability in areas of manufacturing receiving little protection, including much manufacturing for export. From a broader community perspective, surely tariff reductions which result in higher real incomes are not a negative thing even if the reductions need to be accompanied by 'positive measures' such as adjustment assistance and lowering of the exchange rate?

It is recognised in the MGP that the current industrial structure does not represent the best use of Australia's resources (p. 161). Reduction of tariffs is seen as a necessary though not a sufficient condition for improving the contribution of manufacturing to the economy (p. 166). The key features of the MGP approach to tariff reduction are, firstly, delineation of multiple tariff benchmarks and, secondly, gradualism.

In relation to benchmarks the MGP says:

> 'We believe suitable and appropriate long term benchmark tariffs for the products of various types of industrial activities should be set following inquiry by the IAC' (p. 176).

In what appears to be prejudging the outcome of an inquiry into the appropriate level of benchmarks the MGP says:

> 'In respect of some industries, recent tariff decisions will have already reduced tariffs to the appropriate benchmark level . . . In some other cases, the pace of change has proved to be too rapid for the industry's capacity to adjust and tariffs will need to be reviewed to determine whether they need to be raised for a period and whether a more appropriate timetable for reduction is necessary and desirable' (p. 176).

The question of prejudging aside, the argument concerning benchmarks is open to two important objections on theoretical grounds.

The first objection is to the idea that the situation to be attained over an extended period should be one of multiple tariff benchmarks (p. 9 and p. 176). Ultimately all industries are in competition with each other for resources. In general an imbalance in resource use which reduces average real income can be expected to result from maintaining several levels of protection within the part of manufacturing for local consumption. As Corden (1967) has said,

> 'it (the industry rates approach) is clearly inadequate as a guiding principle for tariff-making. It does not deal at all with the problem of resource allocation as between industries' (p. 149).

Nor, one could add, does it deal with the effect of differences in nominal protection on consumption. This is not to deny that, until modified uniform protection is reached throughout the tradeable goods sector, higher rates of protection can be economically justified for some industries than for others. But the benchmarks, and rates of protection during the movement to them, envisaged in the MGP seem to be determined by 'need' rather than by second best considerations.

The second problem with the MGP's concept of benchmarks is that there is no provision for changing their levels with economic developments outside manufacturing. It is evident from the earlier discussion of limitations of the Tariff Board's points of reference for a broad interpretation of economic efficiency that the protection economically justified in one part of the tradeable goods sector depends on developments elsewhere in the sector. The factor that seems most likely to produce a need for change in any benchmark established for manufacturing is growth in the relative size of the low protection mineral export sector. This would reduce the rate of economically justified protection for manufacturing. While inflexible benchmarks would have the advantage claimed in the MGP of reducing tariff uncertainty for manufacturers, they involve the risk of an open ended national cost from increasingly unrealistic benchmarks.[25] Commitment to a particular tariff benchmark would mean foregoing opportunities for ensuring that, within the context of a relatively declining manufacturing sector, the low cost part of the sector was encouraged relatively to the highly protected areas. The likely alternatives to reductions in tariffs (and non tariff assistance) if the growth of mineral exports causes a strong balance of payments would be a higher external value of the Australian dollar and/or greater domestic inflation than would occur with tariff cuts.[26] Unlike reductions in tariffs and other industry assistance, a higher exchange rate or higher inflation would adversely affect *all* parts of the import competing and export sectors, regardless of their international competitiveness. One implication of this is that failure to reduce tariff benchmarks as the mineral export sector expanded would restrict the scope for profitable development of low cost mineral activities.

With the setting of benchmarks,

> 'the general principle should be that tariffs will be reduced to the benchmark levels by small, gradual and predetermined instalments over five to fifteen years. The reduction instalments would be inexorable, except for suspension during any period of significant unemployment' (p. 9).

There is much to be said for reducing tariffs according to a known programme. Uncertainty would be reduced. However, there is a reason for retaining more flexibility than is envisaged in the MGP. Just as in times of unemployment there is a case for postponing scheduled tariff reductions, there are times when the economy may be best served by tariff cuts *in excess* of the predetermined amounts. With near full employment and an external surplus this is likely to be superior on resource allocation grounds to revaluation or higher inflation which, in drawing resources out of export and import competing industries, do not discriminate between those which are highly protected and those

[25] The MGP does not recognise that growth in the relative share of the minerals sector in the economy implies a fall in the relative share of manufacturing.

[26] The MGP argues that future balance of payments surpluses should be handled by restricting capital inflow, 'buying back the factory' and encouraging Australian investment overseas rather than by revaluing the dollar (p. 181 and pp. 10-11). The disadvantage of this to consumers and the effect on available savings are noted as 'other aspects to be considered' (p. 181). They are not, however, considered in the MGP.

which are internationally competitive. It would appear undesirable to make a commitment that was asymetric with regard to provisos for departing from the scheduled programme of reductions.

Reference must be made to the Green Paper's failure to deal satisfactorily with the relationship between protection of manufacturing for the local market and for export. Considerable emphasis is placed on the role of Australia's tariffs in discouraging manufacturing for export. The tariff reductions supported by the MGP would reduce this bias against exports. However, the MGP does not recognise that the end situation of several levels of tariffs is inconsistent with an efficient allocation of resources between manufacturing production for the local market and for export. It would also be inconsistent, as the MGP implies but does not say (p. 159), with efficient allocation of resources between production of manufactures for the local market and rural and mining production for export. Use of *export subsidies* to prevent underallocation of resources to manufacturing (or other) production for export is not considered. Payment of bounties on *production* of export goods is not favoured because of the revenue requirements and possible protests from trading partners (p. 174). There is a call to encourage

> 'new investment that will be efficient, internationally competitive and export-oriented, particularly where it is based on Australian talents, skills or resources, and where the degree of processing or transformation is the maximum consistent with international competitiveness' (p. 188 and p. 8).

This objective was endorsed in the White Paper on Manufacturing Industry (p. 17). Both papers gave little guidance on how to achieve it. However tariff reductions, favoured in the long run in both papers, would help greatly.

Finally, a comment on non tariff means of assisting manufacturing industry is appropriate. A suggestion which has much to commend it is that greater use be made of *bounties* to achieve desired attributes such as decentralised production or modern technologies (p. 177). Bounties would generally be in addition to a benchmark tariff. Selective investment allowances which 'stimulate nationally desirable investment rather than investment *per se*' are favoured (p. 189). Little guidance is offered on *how* to select such investments though one can appreciate that 'the undeveloped nature of many aspects of Australia's social and regional policies' creates problems in this respect (p. 176). Of much less economic merit is the suggestion that assistance provided to industries in *other countries is* generally relevant in determining assistance for Australian industries (p. 186). This idea is economic nonsense, as is the one specific application of it—that annual depreciation allowances for tax purposes 'should be generally comparable with those in the developed countries with whom Australian manufacturers are expected to compete' (p. 188).[27] Lastly, like the IAC, the MGP emphasises the need for improved adjustment assistance to facilitate efficiency-increasing changes in resource use.

[27] Unfortunately, the question whether Australian tariffs, or total protection, should be comparable with tariffs or overall protection in competitor countries is not discussed.

A Summing Up

The Green Paper on Rural Policy and the IAC, both of which place the objective of efficient resource allocation to the forefront, have advanced opposite views on protecting low cost industries. One can empathise both with the IAC commissioners and the writers of the RGP. The former, only too aware of the difficulties in reducing protection, and of the way in which protection for one industry affects the relative protection of others, are reluctant to suggest that protection be made easier to get. The authors of the RGP, on the other hand, argue that if widespread and substantial protection is to continue to be a fact of life in manufacturing, some assistance can be justified on second best grounds for rural export industries. Other low cost industries throughout the tradeable goods sector—in mining and in low cost areas of manufacturing producing for export or the local market—can also point to second best considerations to support claims for assistance. One can see their point of view. And one can also appreciate the commissioners' dismay at the prospect of a deluge of applications for protection each predicated on the argument that assistance for the industry concerned would on balance draw resources to it from areas receiving higher protection.

The difficulties in following a piecemeal, second best approach to protection policy suggest that the across the board approach to protection policy should be considered seriously. We have in the 25 per cent tariff cuts of July 1973 an example of this approach. That action has been widely criticised. However, the evidence indicates that the contribution of the tariff cut to recent and current unemployment is small in relation to total unemployment and to unemployment resulting from revaluations of the dollar and from wage increases (e.g. Klijn (1974); IAC (1974); IAC (1975); Gruen (1975); Gregory and Martin (1976)). There is even evidence that a general tariff change causes a change in the *same* direction in unemployment in the relatively short run (Dixon *et al.*, 1977). There is irony in the fact that currency changes, which do little to improve resource allocation between manufacturing, farming and mining (or within any of these sectors) should apparently have been a much more important factor than the allocation-improving tariff cuts in causing unemployment. Gregory and Martin (1976) estimate that for the period from the second to the fourth quarter of 1974 exchange rate changes were four times as important as the 25 per cent tariff reductions in their effect on imports. If the adverse short run effects of the across the board tariff change are seen in proper perspective it would seem essential to regard that step as an option for use again in the future. It may be possible however to gear the economy better to protection reductions, thereby reducing adjustment problems. It would appear to be easier for the economy to adapt to a programme of regular, moderate, across the board reductions in protection, announced well in advance, than to occasional large and unprogrammed reductions. There would probably need to be an element of flexibility in the timing of the reductions. The programme of gradual pre-announced tariff reductions recommended in the MGP is consistent with this approach. But if the end result was different rates of protection in different areas of manufacturing (as envisaged in the MGP) the national marginal return from resources would remain higher in some industries than in others on a long term basis.

If across the board reductions in protection are considered to be options for the future, the rates of assistance which can be justified on second best grounds for low cost industries are reduced. This does not mean that such assistance ceases to have a role. In fact, if the prospect of continuing protection is accepted, second best issues are relevant in achieving the efficiency objectives set down in the IAC Act. These issues suggest that a small *across the board increase in low rates of protection* (e.g. raising nominal protection on all exportable and importable outputs and inputs to 10 per cent where protection is less than this) would improve resource allocation.[28] The fact that these would need to be reversed later to achieve free trade is not an economic argument against their use. It needs to be stressed however that (except where terms of trade considerations indicate otherwise) any across the board assistance should, on efficiency grounds, apply to exports of manufactures, rural and mining commodities, and services as well as to all import competing production. The economic case for a strategy of increasing low rates of assistance becomes weaker if the increase applies to just part of the tradeables sector—e.g. only to import competing manufacturing.[29]

Increases in low rates of assistance are not inconsistent with the objective of ultimately eliminating protection. I share P. Lloyd's (1975, pp. 151-2) view on the desirability of implementing a rational long term programme for removing tariffs and assistance to export industries. In view of political and other problems in subsidising many low cost exports and protecting industries that 'don't need' a tariff (including tradeable services such as tourism), an end situation akin to free trade is the only way that relative prices for all tradeable goods and services are likely to be made consistent with Pareto efficiency. The LNCP Government is committed to achieving 'a less complicated tariff structure based on gradual progress towards lower and more stable tariff levels than in the past' (White Paper, p. 36). Perhaps the IAC in spelling out its strategy beyond the period of its systematic industry by industry review of protection (scheduled for completion in 1978 but likely to be delayed by the Government's decision in August 1977 to withhold the final references to the IAC) will see virtue in a programme of staged reductions in assistance for import competing and export industries, leading gradually and predictably to free trade modified for terms of trade effects. (Measures other than trade taxes/subsidies

[28] The existence of a generally close relationship between rates of nominal and effective protection for manufacturing activities (IAC, 1974, p. 56) supports the view that the simple across the board approach suggested would increase real national income.

[29] There is an issue other than second best relevant to the political economy of assistance to low cost industries. It may be politically possible to reduce high protection more quickly if at the same time new production and employment is being stimulated directly in low cost parts of the economy. This raises the seemingly paradoxical prospect that the provision of assistance to low cost industries will not only reduce indirectly the ability of high cost industries to compete for resources but may also allow *larger direct reductions* in protection for the high cost industries.

would continue to be justified to encourage particular forms of production, consumption or resource use—where there were external economies, for example). Determination of the 'best' timetable for phasing out protection is a complicated matter. In principle, the smaller adjustment costs resulting from a more gradual approach need to be balanced against the smaller discounted conventional net benefits (Corden 1974, p. 373). While making no claims about its optimality, I suggest that bearing in mind the evidence on the relative unimportance of tariff reductions as a cause of recent unemployment, the increase in the relative profitability of low cost import competing and export industries due to general reductions in protection, and the exchange rate consequences of lower protection, a schedule for removing protection in annual instalments over 20 years (with provision for waiving reductions when unemployment is high and for larger reductions when the labour market is tight) would provide a climate of protection certainty in which a comfortable adjustment to an internationally competitive economy should ensue.

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