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REHEARING THE CASE AGAINST TARIFF COMPENSATION: REPLY

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Professor Harris has played a prominent role in arguing the case for tariff compensation and I welcome his response to my paper. Many substantive arguments were presented in my paper with which reasonable people could take issue, but if my arguments are valid they must surely constitute an overwhelming case against tariff compensation. Some of these arguments are discussed in Harris's comments but although his tone suggests discomfort with the implications of my arguments, his comments deal primarily with the imperfect language in which they were expressed, rather than their intellectual substance. A concerted attack on the analytical basis of my conclusions is almost entirely absent. Where substantive issues are discussed, however, Harris has not represented my arguments accurately. Much of his commentary is devoted to attacking extreme and relatively foolish views peripheral to the main issues, but in any case not held by me and certainly not advanced in my paper. Some reply is necessary but, even if Harris's points against my paper were granted in full, the case for tariff compensation would not have been rehabilitated from its present dismembered state in any essential way. I will discuss first the 'devaluation equivalent of the tariff' argument, then the role of political judgments in economic analysis, and finally the informational requirements of tariff compensation.

The 'Devaluation Equivalent of the Tariff'

Harris attempts to rescue his earlier 'devaluation equivalent of the tariff' notion as a principle for guiding tariff compensation by redefining it. I take it that the earlier notion (spelled out on page 132 of his 1975 paper) has now been abandoned, at least by him. Harris redefines the term 'exchange rate' to mean the ratio of (an index of) traded goods prices to non-traded goods prices. This is a very different concept from *the* exchange rate, the rate at which two currencies, say the U.S. dollar and the Australian dollar, exchange for one another. The latter is what the term 'exchange rate' means in the vocabulary of every economist and international traveller I know and is what Harris was clearly talking about in his earlier paper. The traded/non-traded goods price ratio (it is sometimes called the 'real' exchange rate and, though I think it is misleading, I will adopt the term here) is well defined even in barter trade models containing both traded and non-traded goods but in which money is not present and hence exchange rates have no meaning. Similarly, exchange rates are well defined in monetised economies in which there are no non-traded goods and hence Harris's 'real' exchange rate is undefined.[1]

Harris goes on to deny that 'the exchange rate is an essentially monetary phenomenon'. If by 'the exchange rate' he means the traded/non-traded goods price ratio as defined by him earlier, he is obviously right, but this is not what I was talking about. That the rate at which two moneys exchange for one another is 'essentially monetary' is true by definition, but this statement does not mean that real variables like tariffs do not affect it. This point is made quite explicitly and discussed at length on page 95 of my paper. But all this is of only peripheral relevance to tariff compensation.

More importantly, the issues involved in tariff compensation are well defined in models which contain neither money nor non-traded goods, and hence neither the exchange rate nor Harris's 'real' exchange rate is defined. The ubiquitous 2×2 trade theory model is an example and the model analysed in Warr (1977) and 1979) is another. So what does Harris's 'real' exchange rate have to do with tariff compensation? He literally does not say.[2] To show that this notion is a useful one for discussions of tariff compensation, all Harris needs to do is to explain: (a) what the effect of abolishing tariffs would be on his 'real' exchange rate; (b) whether this is a short-run or long-run effect; and (c) what the direction and magnitude of any such effect implies about the appropriate levels of tariff compensation. When these questions are answered within the context of a well-defined economic model, I will gladly agree that, within the context of that model, the 'real' exchange rate equivalent of the tariff is a useful concept. As it stands, though, its introduction merely adds to the earlier confusion.

The Role of Political Judgments

The role of political judgments in economic analyses is an issue on which there is plenty of room for honest disagreement. The argument presented in my paper is that the same scientific standards should be applied here as elsewhere in economics. The clumsy and *ad hoc* qualities so often to be found in economists' assumptions about matters of political feasibility, when they are stated explicitly at all, are in my view not characteristic of good social science.[3] This would not matter so much if economists' policy recommendations were not so heavily dependent on them. This case is argued in my paper by, among other things, considering alternative models of the political process which imply that tariff levels may themselves be responsive to the adoption of tariff compensation. I do not assert that this *would* happen. That would be in-

[1] There is a special case in which the exchange rate and Harris's 'real' exchange rate move together. This would occur if the prices of non-traded goods were fixed in nominal (money) terms, while those of traded goods were flexible. This is a rather extreme case but for very short-run analyses it may be of some interest if the prices of non-traded goods adjust more slowly to external shocks like exchange rate changes than the prices of traded goods.

[2] Harris states only that the concept is advanced 'partly for analytical convenience'; but since no analysis is presented by him it is unclear what this means.

[3] My earlier paper contained a short list of examples of economic studies which, in general terms, reflect the approach I am advocating. I am pleased to have the opportunity now to add Sieper's brilliant conference paper (Sieper 1979).

consistent with the entire thrust of my argument. Instead, the fact that it could happen, under seemingly reasonable assumptions and that, if it did, the case for tariff compensation would be severely undermined, shows that the standard tariff compensation argument makes strong, questionable and unstated political assumptions.[4]

Harris's counter-attack takes the form of portraying my argument in a distorted and extreme form. Except in his final paragraph, Harris represents me as having deprecated *all* use of political judgments by economists as constituting 'political guesswork', a taunt repeated many times in his short comment. This absurd position is one that I do not hold and which my paper explicitly disavows (page 87). The argument is not about *whether* economists should make judgments about matters of political feasibility, but about the quality of evidence on which they are founded. As a bare beginning, it seems to me, honesty requires us to concede that we are uncertain as to what is politically feasible and what is not. My papers on tariff compensation show that this alone has important implications for economists' recommendations on policy issues like tariff compensation.

Naturally, it is not my view, and my paper does not suggest, that arguments 'in principle' for tariff compensation should be suppressed because of the 'rent seeking' effects their public discussion could generate. To a large extent, these resource costs are part of the price we pay for political freedom. Nevertheless, extending the list of policy instruments has a clear social cost, namely the resources expended in lobbying over the *levels* of those instruments. I do not wish to be dogmatic about this, but it seems obvious that, if these resource costs are large, they must be considered in an economic analysis which purports to shed light on the question of whether the list of policy instruments should or should not be extended to include things like tariff compensation. This has nothing to do with the freedom of the community to make what Harris regards as mistakes, a freedom I would not wish to deny anyone. It is simply a question of whether the arguments 'in principle' Harris refers to are good economics or not. It seems clear that arguments for tariff compensation which focus on resource allocational issues, while ignoring the resource costs that the introduction of these policy instruments imply, miss an important part, perhaps the dominant part, of the resource allocational story. As a society, we may well decide to live with these costs, but surely we want to know how large they are. If the economists do not tell us, who will?

It may well be the case that the anecdotal examples I cited to illustrate the poor record of even the best economists in predicting matters of political feasibility prove only that they are fallible. But Harris seems actually to be claiming that economists' judgments on these matters, on which they receive no professional training, are *no more* fallible and no less reliable than their judgments on matters of economic analysis, on which they receive extensive formal training. I cannot believe it, but if this devastating characterisation of the competence of our profession were accurate, economics would indeed be 'the reigning sophistry of our age', as charged by Henderson (1978) in her recent book.

[4] Harris's summary of this argument reads: 'Basically, Warr denies the plausibility of the proposition that the general level of tariffs is "given" (for some relevant period). This is of course a political judgment.'

Informational Requirements and Costs of Errors

I have written three papers on tariff compensation. The other two, more analytical papers, Warr (1977 and 1979), are cited extensively in my *Journal* paper, which simply summarises their results. These papers present evidence in support of the propositions that, even when tariff levels really are fixed: (a) the potential welfare gains from tariff compensation, optimally applied, are likely to be small relative to the gains from tariff reductions (themselves not overwhelming); (b) the informational problems presented by tariff compensation are severe and errors will inevitably be made, a problem which does not arise with across-the-board tariff reductions; and (c) quite small errors, resulting in levels of tariff compensation above their optimal levels, can have a welfare cost which dwarfs the gains potentially available from getting them right.

These arguments could certainly be disputed. The relevance of the analytical model on which they are based, the appropriateness of the assumptions underlying the numerical examples I presented, and the correctness of my logic are all potential avenues of debate; but Harris pursues none of these. According to him, my conclusion that economists should concentrate on recommending across-the-board tariff reductions rather than tariff compensation is based on nothing more than 'political guesswork'. Harris's Comment largely ignores my other two papers on tariff and this suggests that he may not have properly considered the arguments they contain in support of my conclusion.[5]

Elsewhere in his Comment Harris graciously acknowledges that the informational requirements and costs of error discussed in my paper are a serious problem for tariff compensation. He then adds: 'In general, however, the same information needs and similar possibilities of error would seem to apply to any microeconomic policy measure.' Would Harris seriously apply this remark to policy issues like interest rate controls, housing rental controls, minimum wage laws, across-the-board tariff reductions, import quotas, price and wage controls as a way of controlling inflation etc? Gross generalisations like this cannot be substantiated. While there are exceptions, the point is that informational problems tend to be particularly severe in the case of piecemeal interventions justified on 'second-best' grounds. Tariff compensation is a good example. As for the costs of error, my analysis suggests they are particularly severe when they lead to excessive levels of tariff compensation in the form of input subsidies, but I know of no research which would enable one to generalise this result even to similar kinds of second-best interventions. The necessary research has yet to be done.

At the end of my *Journal* article I conjectured that the debate over tariff compensation could divert attention from the central issues of

[5] The only mention Harris makes of either of these papers is an ambiguous reference at the end of his footnote 9. 'See Warr (1979)' to find what? And what 'empirical judgments' is Harris referring to? Neither Harris's earlier paper nor his Comment makes it clear what empirical judgments Harris thinks levels of tariff compensation *ought* to be based on. Furthermore, I do not know anyone, myself included, who does not accept 'the "in principle" validity of the tariff compensation argument', as far as it goes. Indeed, in my own work on the subject, I have tried to make this argument clear and rigorous. The problem, as I have tried to show, is that the argument does not go far enough.

commercial policy. The exchange between Harris and myself is in danger of confirming this speculation, and that would be a pity. Professor Harris and I seem to disagree on several issues relating to tariff compensation but, as I understand it, we are in essentially complete agreement as to the desirability of gradual across-the-board reductions in levels of protection. Considered next to this much more important issue, our honest disagreements take on a more realistic and less divisive perspective than they otherwise might.

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