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CENTRE FOR
INTERNATIONAL
ECONOMICS

*Transparency,
Australian policy
processes and
international trade*

Prepared for

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Canberra & Sydney*

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Contents

Introduction	1
Free trade: why we don't see it?	2
Boxes, charts and tables	
1 Agricultural producer support total transfers to producers in high-income economies has barely changed. The decoupled proportion has increased marginally	3
2 Average level of producer support by country in the OECD	5
3 Average level of producer support by commodity in the United States	5
4 Composition of support	12

Introduction¹

As of July this year, the Doha Round of trade talks has been suspended. Unless they are restarted there will be no multilateral liberalisation of world agricultural trade or for manufacturers and services. This disappointing outcome is despite the well-known result from scores of studies that lower barriers to trade offers major economic gains to world economies.

The proposition advanced in this paper is that the primary cause of the lack of progress towards liberalisation, despite overwhelming evidence of the benefits, is a failed process. It is a failure on two counts – the process currently used to negotiate lower trade barriers is no longer working and actually makes the going harder, and second, a process that could work and has been demonstrated to do so, is not used.

The current process to try to lower trade barriers is a multilateral negotiation based on reciprocity. While this process may have worked in the past the underlying elements of previous successes have changed so it is not working now. On top of that, reciprocity is logically flawed as an economic concept. So, although reciprocity made political sense in the past, things have changed and the economic flaw is now making liberalisation harder.

The second process that could work, but is not widely used, except by countries such as Australia, is transparency of policy. This transparency of economic policy is more important since its application extends beyond just trade policy. It applies to other areas of economic policy as well and is therefore potentially more powerful as a process to generate welfare gains from policy reform.

Since Australia is one of the few countries over the last few decades to unilaterally reduce tariffs and other protection for industry, including agriculture, and since it is also one of the few countries to engage a formal process of transparency of policy, the experience is elaborated here. It is this favourable experience with transparency in Australia as well as sound

¹ This paper draws heavily on and builds on one element of an earlier report published by RIRDC: Stoeckel, A (2005), *Termites in the Basement: To free up trade fix the WTO's Foundations*, RIRDC, Canberra.

logic that has underpinned a recent public initiative by The Tasman Transparency Group to strengthen the WTO².

The structure of this paper is as follows. First, the well-known analysis of the gains from free trade in agriculture, as well as other goods and services is restated. Although the case for free trade is well described in plenty of studies, there are some conundrums that need to be addressed. For example, if countries are going to protect industry, why choose agriculture? And, if agriculture is to be protected, why do some countries protect their farmers more than others? Also, in those countries protecting their farmers, why do some agricultural industries receive vastly more support than others? Finally, and most worrying of all, is why governments choose market price support as the dominant form of support to farmers in preference to direct government payments through the budget? Answering these questions points to the main tenet of this paper: that the lack of adequate transparency of policy through 'due process' explains the persistence of protection for agriculture.

Next, the reciprocal multilateral bargaining process under the Doha round of trade talks is described and why it may have worked in the past, but is no longer working now. Indeed, it is argued that the current use of reciprocity is making a successful outcome harder to achieve.

The final step in the argument is to highlight the political obstacles to reform and how a systematic process of transparency can help overcome these obstacles. Australia's experience with transparency of policy is then highlighted and advanced as a model that could potentially be repeated elsewhere.

Free trade: why we don't see it?

One of the most enduring features of mankind as Adam Smith wrote over 200 years ago, is that people trade. As Adam Smith expressed it 'nobody ever saw a dog make a fair and deliberate exchange of one bone for another with another dog'.³ The point about trade and exchange is that it is everywhere and occurs in millions of small exchanges everyday, all around us.

² The Tasman Transparency Group, *An Initiative to Strengthen the WTO*, August 2006, www.nff.org.au.

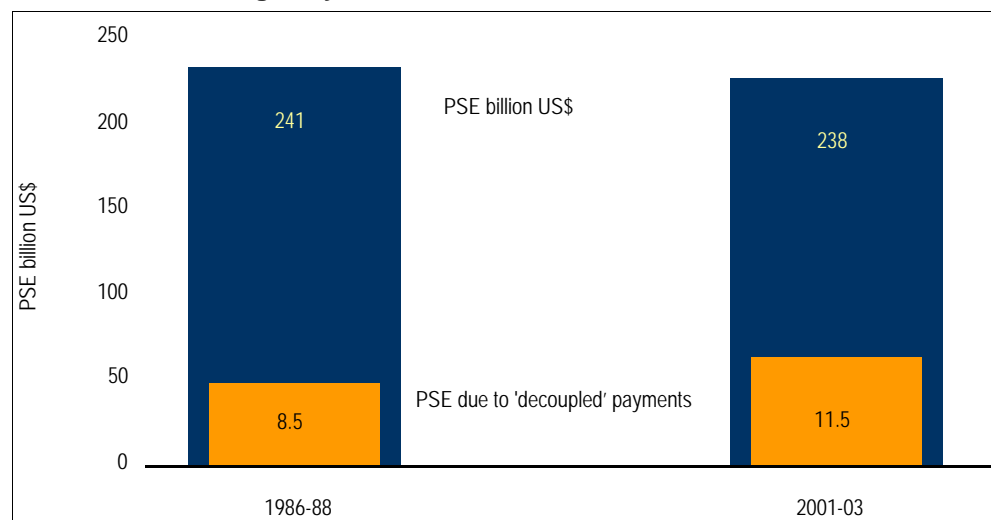
³ Adam Smith, 1776, *Wealth of Nations*.

The trade between two individuals is no different to the trade between Brisbane and Sydney and that is no different to the trade between Brisbane and Tokyo. But somehow international trade is treated differently. And somehow we treat one aspect of goods trade very differently from the rest, namely agriculture. The biggest barriers to international goods trade are found in agriculture. The best aggregate measure of the total transfers made to agriculture is what we call the Producer Support Estimate produced by the OECD. Chart 1 shows that there has been little change in this measure since 1986 when the Uruguay Round of trade talks first started. So-called 'decoupled' payments towards less-market distorting supports has risen, but the change over nearly 20 years is marginal. Agriculture has become the standout issue in trying to liberalise international trade. So why is it that international trade is treated differently from the trade between two individuals or two domestic cities? Why is it that within the class of international goods, agricultural trade is the most protected and why has there been the least amount of progress in removing those barriers?

Answering these questions is pivotal to securing more liberalised trade. It is no good proselytising on the necessity for countries to reduce their protection for agriculture. That message has been given many times before. Just saying that protectionist countries *should* do the right thing does not lead them to that action.

A more fruitful line of investigation is the *reasons* why such protectionist policies blatantly persist in the face of countless studies, including those by

1 Agricultural producer support total transfers to producers in high-income economies has barely changed. The decoupled proportion has increased marginally



Data source: World Bank 2006, *Agricultural Trade Reform and the Doha Development Agenda*.

respected institutions such as the OECD, IMF and World Bank that show enormous benefit from liberalised trade. Policy makers in the United States, Japan, the European Union and others are all aware of the research showing billions of dollars of gain to the world including developing countries if they liberalise their agricultural trade. They have all read the research or have been advised of the findings that millions will be lifted out of poverty if trade could be liberalised. In the United States the official advice to the President is that most farmers do not benefit from current commodity programs and that less market-distorting supports could be used.⁴ Yet the current betting is that the next US Farm Bill will be similar to the current one.

India's Prime Minister, Manmohan Singh, knows the value of free trade and undertook some desperately needed economic reforms in the early 1990s as the Finance Minister. He knows what India should do. Yet India remains one of the most highly protected economies. The United Kingdom's Prime Minister Tony Blair said that 'Europe's agricultural protection is a policy born of another age and it is time to end it.'⁵ Yet protection for Europe's agriculture remains.

Most leaders, policymakers and negotiators know what should be done. Yet protection remains. These leaders, negotiators and policymakers cannot do the right thing because the domestic political situation will not allow it.

The trade protection problem is a *political* problem. Solving this political problem, requires a political solution. The politics of protection has to change. Analysing just what are the politics behind protection and their roots provides the clues on how to change the politics.

What exactly is the political problem?

The political problem behind the difficulty in shifting protection has several dimensions, each contributing to the impasse over the need to lower trade barriers. Some common explanations for the political impasse when scrutinised have little basis. These are now discussed.

Farmers are 'special'

A common political excuse to persistent high protection is to argue farmers are special. But how do you explain why New Zealand and Australian

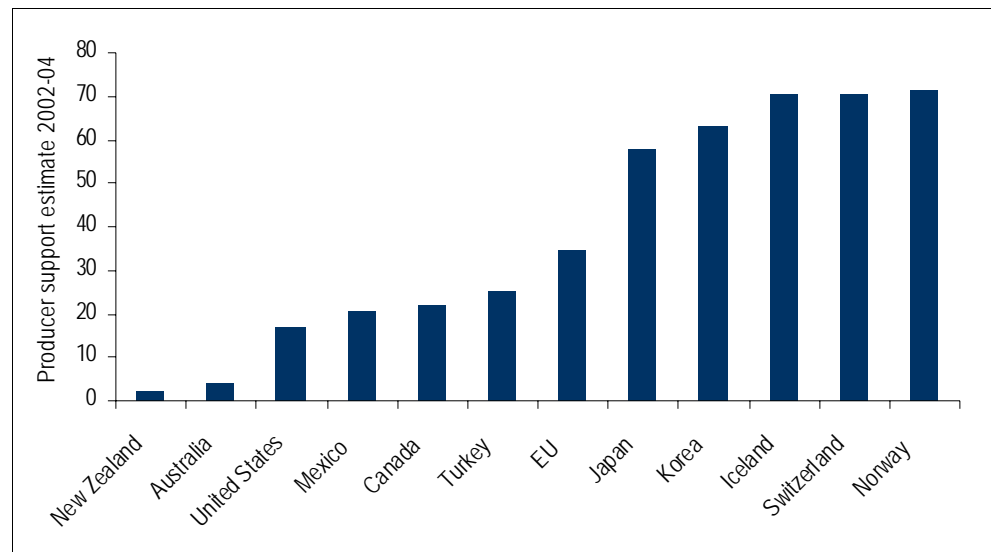
⁴ Council of Economic Advisors 2006, *Report to the President*, chapter 8, p. 173.

⁵ Prime Minister Tony Blair's address to Australian Federal Parliament, Monday, 27 March 2006.

farmers receive little or no protection (chart 2)? And how do you explain why in, say, the United States, some farmers like beef producers receive virtually no protection, but others in cropping or in sugar receive plenty (chart 3)?

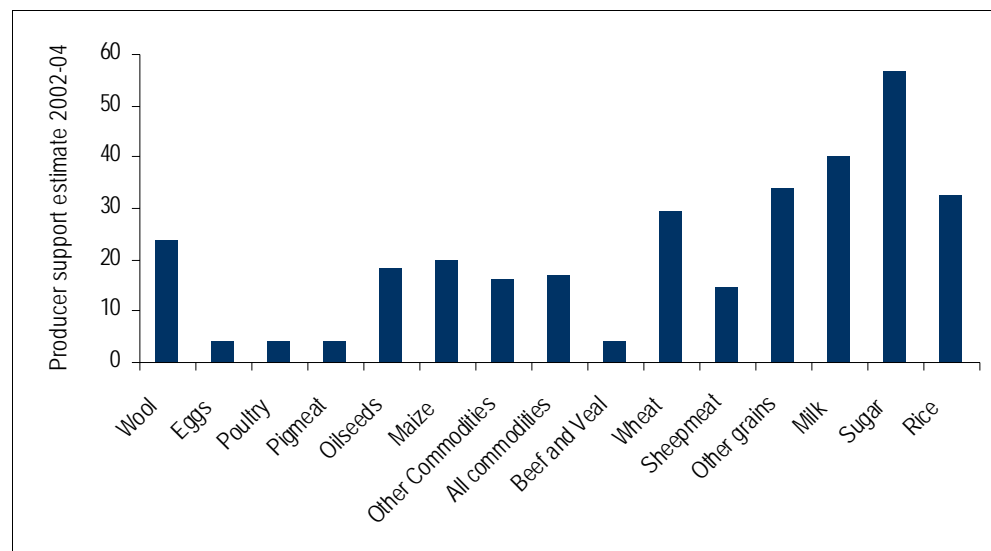
New Zealand and Australia reduced their support for their farmers for the same reason: that the country would be better off without giving the subsidies. But the political stimulus for reform in each was different. In New Zealand's case, a severe economic crisis at home simply meant the

2 Average level of producer support by country in the OECD



Data source: OECD.

3 Average level of producer support by commodity in the United States



Data source: OECD.

country could not afford the subsidies it was paying its farmers and other industry. Farm protection was removed virtually overnight⁶.

In Australia's case, there was no severe economic crisis but rather a long period of lack-lustre performance. A change of government ushered in a new set of institutional arrangements that led to a process of domestic transparency of policy.

The systematic and repeated assessment of all of Australia's protection arrangements across all industry saw protection removed, initially for agriculture and manufacturing but later service industries as well. Finally, all output and the factor markets of labour and capital were deregulated, a good synopsis of which is contained in Banks (2005). The transparency process, Australian-style, is developed and expanded later, but the point for now is that the review process introduced, whether by luck or good design, saw protection for Australian farmers substantially reduced. Farmers are not that 'special' so other political explanations for resistance to liberalisation need to be found.

Xenophobia and mercantilism

Xenophobia – the fear of foreign things – is another explanation for difficult politics behind protection. It is the only explanation for why international trade is treated differently than domestic trade. There is no difference between international and domestic trade it is just a labelling issue. People have a natural fear of foreign things. Politicians play on this fear and appeal to nationalist sentiment to win popularity. They directly or indirectly paint foreign products or services and foreigners themselves as the bogeymen and the reason for job losses or any other ills. But people are simply 'shooting themselves in the foot' by denying themselves access to the best value-for-money goods and services in the world. Keeping foreign goods out hurts the locals far more than it hurts the foreigner.

The major misunderstanding here has its roots in mercantilism – that the aim of trade is to accumulate treasure or in modern day terms that exports are good but imports are bad. Yet the purpose of all economic activity is to consume. Imports are the good things that enhance welfare. Exports are good too, but *only* because they are needed to earn the foreign exchange to pay for those valuable welfare-enhancing imports.

⁶ A good account of the experience is given by Federated Farmers of New Zealand: *Life without subsidies*.

We know there is a major misunderstanding in this ‘exports good, imports bad’ doctrine because in practically every department of trade in the world you will find export promotion authorities and incentive programs to exporters. Nowhere will you find import promotion authorities. Yet the most successful exporters in the world are also the most successful importers. The cruel irony is that those protectionist countries wanting to export more are actually penalising their own exports by stopping imports.

Mercantilism and reciprocity

Related to the issue of mercantilism is reciprocity, a basic principle of the WTO system. It is a mechanism used in multilateral trade negotiations to either liberalise markets or agree to new or changed rules.

Reciprocity is a bargaining tool. At its simplest level, it may involve a tariff reduction for a good like steel in exchange for another country’s offer to reduce tariffs on, say, textiles. But the bargain can be for anything of perceived value to a WTO member, including non-trade concerns, and need not be simultaneous in time.⁷

Reciprocity has three advantages. First, it changes the political dynamic, facilitating liberalisation. A second advantage is its basic appeal to ‘fairness’ – every member is seen to be contributing to liberalisation. The third advantage is that the reciprocity mechanism can overcome the ‘free-rider’ problem, which is inherent in any multilateral trade negotiation because of the unconditional MFN principle. Despite these advantages, reciprocity also has some drawbacks that are now holding the cause of trade liberalisation back.

The first advantage of reciprocity, that it changes the political dynamic of liberalisation, warrants expanding. Protection against imports persists because those who stand to gain from preventing imports into a country form effective lobby groups arguing for its retention. They point to the extra activity and jobs in their industry that protection creates. That is true for *their* industry. Unfortunately, all too often politicians and the public go along with this simple argument, believing ‘imports cost jobs’. This belief looks obvious, but turns out to be wrong.

Just why this belief is wrong is well known to economists. The mistake is that the argument ignores the second round effects on *other* industries

⁷ Bhagwati highlights several typologies that can be used to classify reciprocity – for example, whether it is ‘simultaneous’ or ‘sequential’, or ‘within trade’ or ‘outside trade’ in Bhagwati, J. 2002, *Going Alone: The Case for Relaxed Reciprocity in Freeing Trade*, MIT Press, London, p. 10.

where the burden of protection causes less activity and jobs to be lost. For now it is sufficient to note, whatever the reason, real or imaginary, that negotiators believe that, during multilateral trade negotiations, they are offering up a 'concession' in exchange for access (or something else of value) to another country's market. By tying the access to another country's markets (which, correctly, is of benefit) in exchange for removing a tariff on imports at home (the 'concession'), powerful political forces are brought into play. The interests of exporters who stand to gain from the negotiation are pitted against the interests of producers in import-protected industries who resist liberalisation. The 'jobs will be lost' argument made by locally protected producers is offset by the local exporters' argument that 'jobs will be created'.

Reciprocity therefore changes the political balance and makes liberalisation more politically possible. An added bonus is that if everyone liberalises across all industries together, the gains are greater and the adjustment costs smaller.

But, reciprocity is not working now as a major force for trade liberalisation, including for agriculture, for two reasons. One is that reciprocity is a dangerous political game because it sends out the wrong message about trade liberalisation. The other reason is that the political forces that could be brought into play to help secure liberalisation are now much weaker. No natural export constituency currently exists in the European Union or the United States to argue against the interests of the farmers who receive so much protection. Without these constituencies arguing for reform, politicians are not going to argue the case for reform.

That reciprocity makes good politics, but lousy economics, has been well known for some time. As put simply in the study by Viravan and others in the late eighties, 'the emphasis on reciprocity misinforms and mis-educates everyone (including trade officials) about the basic argument for liberal trade'.⁸ The problem is that reciprocity sets up a game scored by mercantilist rules: an increase in exports is a victory, but an increase in imports is a defeat.⁹ Reciprocity fuels the 'exports good, imports bad', message that is dead wrong. If the public wrongly believes imports are bad, politicians will find it that much harder to liberalise trade.

⁸ Viravan, A., 1987, *Trade Routes to Sustained Economic Growth: Report of a Study Group of the Trade Policy Research Group*, MacMillan Press for the United Nations, London, p. 136.

⁹ Krugman P. 1997, 'What Should Trade Negotiators Negotiate About?', *Journal of Economic Literature*, vol. XXXV, March, pp. 113-20.

Why is the ‘imports bad’ message wrong? Quite apart from the simple math that no one could export if there were no imports, the ‘imports bad’ message ignores basic economics and the basis for trade¹⁰.

Imports add to welfare because they allow a country to concentrate on what it does best. Exports are a good thing, but *only* because they allow a country to earn the foreign exchange with which to purchase imports. Indeed, should a country stop all imports, eventually all exports would stop too – so an import tax (barrier) simply ends up being a hidden export tax.

Playing clever politics around an economically flawed concept may have worked in the past, but it is now setting the cause of free trade backwards. That drawback is exacerbated by reciprocity’s second weakness – that it has outlived its usefulness. This was recognised as a potential problem before the Uruguay Round got under way, and it is even more apparent now.¹¹

However economically flawed the concept, if reciprocity is to work, it must pit some interest groups within the European Union, the United States or Japan against their farmers receiving protection. But there is little else left for others to liberalise from the European Union’s and the United State’s points of view – the simple average tariff on industrial products in the United States is 4.7 per cent. In the Europe Union it is 4.5 per cent. Although tariffs are higher in developing countries, these are not major markets for Europe or the United States.

Relying on reciprocity now to secure liberalisation of agriculture is not likely to work because it cannot bring strong enough political forces into play and the lousy economics it implies has mis-educated a wide public and is making the going harder.

Narrow vested interest groups

A common explanation for the lack of trade reform (or other costly policies for that matter) is that the beneficiaries of reform are widely dispersed and unorganised, but the gainers from protection are concentrated to a few and these people are highly organised and lobby hard for protection. The

¹⁰ The Tasman Transparency Group makes this point eloquently as well. Countries can only take **from** the negotiating table what they are prepared **to** take to the table. The so far failure of the Doha talks is that countries have not made good offers, and that is due to a lack of good domestic processes to ascertain what is in a county’s own interests.

¹¹ Viravan 1987, p. 137.

widely dispersed beneficiaries from liberalising trade are also not fully informed on the gains from change since it does not pay them to be so informed. The political bias is therefore for no change.

The argument looks appealing but it is wrong in fact. Look to the Australian case again. In Australia, the car and textile industries received high levels of protection from a high level of tariff support¹². The two industries lobbied hard and for a long time won the retention of their protection. The beneficiaries of reform were widely dispersed throughout the economy, the consumers and other industries using cars and textiles as inputs. It 'fits the bill' perfectly for an explanation of the lack of reform. So what happened to cause Australia to unilaterally reduce its support for its highly protected industries? It was the systematic and repeated economywide analysis of the policies of protection through an independent, open process of transparency. These two elements were sufficient to change the politics of protection in Australia to the great economic benefit of the nation. These two essential ingredients of policy reform are now explained.

One key: economywide analysis

The fundamental reason for wrong policy, which cannot be emphasised strongly enough, is that the secondary consequences of policy actions are overlooked. Mostly, only the first round immediate effects are considered – usually the costs impacting on the special interest group pleading for the policy. Hazlitt, in his book *Economics in One Lesson*, claims 'nine-tenths of the economic fallacies that are working such dreadful harm in the world today are the result of ignoring this lesson [of looking at secondary consequences]'.¹³ Protectionist trade policy falls into this category and Hazlitt devotes a chapter to that topic. Although that claim was made years ago, the same conclusion would stand today. Looking at 'secondary consequences' is just another way of saying 'economywide analysis' that looks at the benefits as well as the costs of policy. But the failure to measure the benefits as well as the costs is, in some cases, even worse than mere oversight – it is deliberate. In anti-dumping cases, for example, the law in practically every country in the world precludes the 'unseen' secondary effects (the benefits for consumers) from being measured.

Economywide analysis entails consideration of all linkages and secondary effects in a sector protected through a policy. It involves looking at both the

¹² See CIE *One shoe per Person* for a brief history of the policy and its cost.

¹³ Hazlitt, H. 1979, *Economics In One Lesson*, Three Rivers Press, New York.

benefits and costs of the policy. There are several ways this can be done. One early technique was to measure the *effective rate* of protection. In this method the penalties on an industry as a result of protection *elsewhere* in the economy are considered along with the benefits the protected industry receives. Today, with advances in computing techniques, economywide analysis using computable general equilibrium (CGE) models is routinely undertaken by researchers.

Another key: proper process

Economywide analysis on its own is not sufficient to educate the public and policymakers of the harm caused by restrictive trade policies and shift the politics. Proper *process* is also required. It is necessary to conduct economywide analysis openly by an independent agency so each stakeholder can see and comment on the other stakeholders' submissions. And this information must be formally injected into the government's decision making. So, for example, protected sugar farmers in the United States would be able to comment on the greens' input to any inquiry into sugar subsidies on their concerns for the damage the protection causes the Everglades in Florida¹⁴, to ensure that exaggerated claims are not made and vice-versa. A draft report by the independent agency should then be produced, and made available for written comment by all concerned.¹⁵ Through this *process*, those who benefit and those who bear the burden of the policy are identified. There will be a natural coalescing of those losing from the policy to lobby the government for change. That is, *an open, independent process of economywide analysis changes the politics of protection*¹⁶.

Protection is, after all, a political game. The suspended Doha negotiations are no exception. Economywide analysis makes economic sense *and*, when conducted through an open, transparent and independent process, makes political sense as well. When conducted in this manner, the politics for reform is also ultimately more powerful. With correct analysis, policymakers and the public will become better educated about the

¹⁴ Humphreys, J., van Bueren, M. and Stoeckel, A. 2003, *Greening Farm Subsidies: The Next Step in Removing Perverse Farm Subsidies*, RIRDC Publication No. 03/040, Canberra.

¹⁵ Specifically, the process of review has to involve a terms of reference issued to the independent reviewing agency, which then puts out an issues paper setting out the review framework and identifying key stakeholders. The agency calls for submissions and holds public hearings (anyone can see and comment on any other submission), and produces a draft report. Comments on the draft report, also in the public domain, are considered and incorporated as required, and a final report produced, which must be considered by government.

¹⁶ Stoeckel *Termites in the basement*

economics of trade protection. This changes the mindset of those reviewing claims for assistance and becomes built into government internal processes. The politics of protection changes with this education, making it harder for narrow vested interests to dominate the national interest.

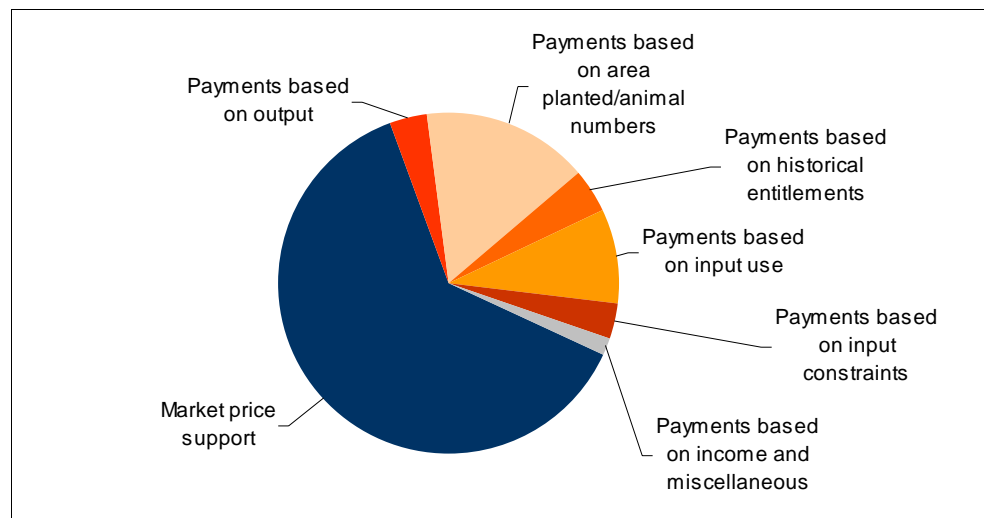
There must be something to informing the public about the costs of protection because there is one last uncomfortable fact: why do governments choose hidden mechanisms to give the bulk of support to farmers? Chart 4 shows that the bulk of assistance that's offered to farmers is mostly through market price support – it is mostly due to barriers at the border. Governments could give all the assistance via domestic support through the annual budget. Yet they choose not to and reducing market support for agriculture has been one of the main sticking points in the Doha negotiations.

The reason why direct payments are not used is that they would be up for annual scrutiny through the annual budget of the government. That implies two things: the policies owe their existence on deception, which is not much of a basis for policy, and the solution is clear, expose them.

Concluding comments

The reviews of Australia's import protection through the 1970's and beyond conducted through an independent, open and transparent process of economywide analysis highlights two things: it takes time and other competing lobby groups are brought into the political equation. Initially, the politics of protection proved hard to shift. The carmakers and textile manufacturers fought hard to retain their high levels of tariff protection.

4 Composition of support



With time, however, the politics changed. It became apparent that Australia's miners and farmers, the two main export groups, were bearing the burden of protection. They joined forces to form a coalition for reform that the government could not politically resist. Australia then embarked on a path of unilateral liberalisation to the benefit of the economy.¹⁷ Although pockets of low protection still remain, Australia is one of the relatively open economies of the world today.

The reduction in protection in Australia was the result of an open, independent process of systematic and repeated economywide analysis of protection. Critically, the mindset of enough people in Australia had changed and enough industry groups involved in the debate to swing the politics in favour of liberalisation. Narrow, selfish, vested interests still exist; they always will. But, with few notable exceptions, mostly the economic debate reported in Australia's responsible media highlights the secondary benefits of policy choices, portraying a balanced view of the costs and benefits of issues.

If systematically considering the secondary or economywide effects of trade policies through an open and independent review is this important, it is astounding that such analyses are rare. Yes, there are plenty of analyses, such as those by the World Bank¹⁸, of the economywide effects of trade policies, but studies conducted *in conjunction* with good governance processes are few and far between. Moreover, this transparency has to occur within domestic capitals, not an international organisation. Countries, such as Australia, choosing to routinely subject trade policy *at home* to this combination of analysis and due process have seen significant unilateral liberalisation of trade to the benefit of the country. That is why the Tasman Transparency Group has launched its initiative for formal transparency to occur in domestic capitals around the world through coordination in the WTO.

¹⁷ A good account of Australia's experience is by Banks, G. 2003, 'Gaining from trade liberalisation: some reflections on Australia's experience', Presentation to the IBBE&L/CEDA Conference, 'New Horizons in Trade: The WTO Round and Australia's Free Trade Negotiations', Adelaide Convention Centre, 5 June.

¹⁸ See for example, Anderson, K. and Martin (eds), W. 2006, *Agricultural Trade Reform & the Doha Round*, World Bank, Washington DC.



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Transparency, Australian policy processes and international trade

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Rural Industries Research Corporation for presentation to IAAE conference, Gold Coast — August 2006

Prepared by:

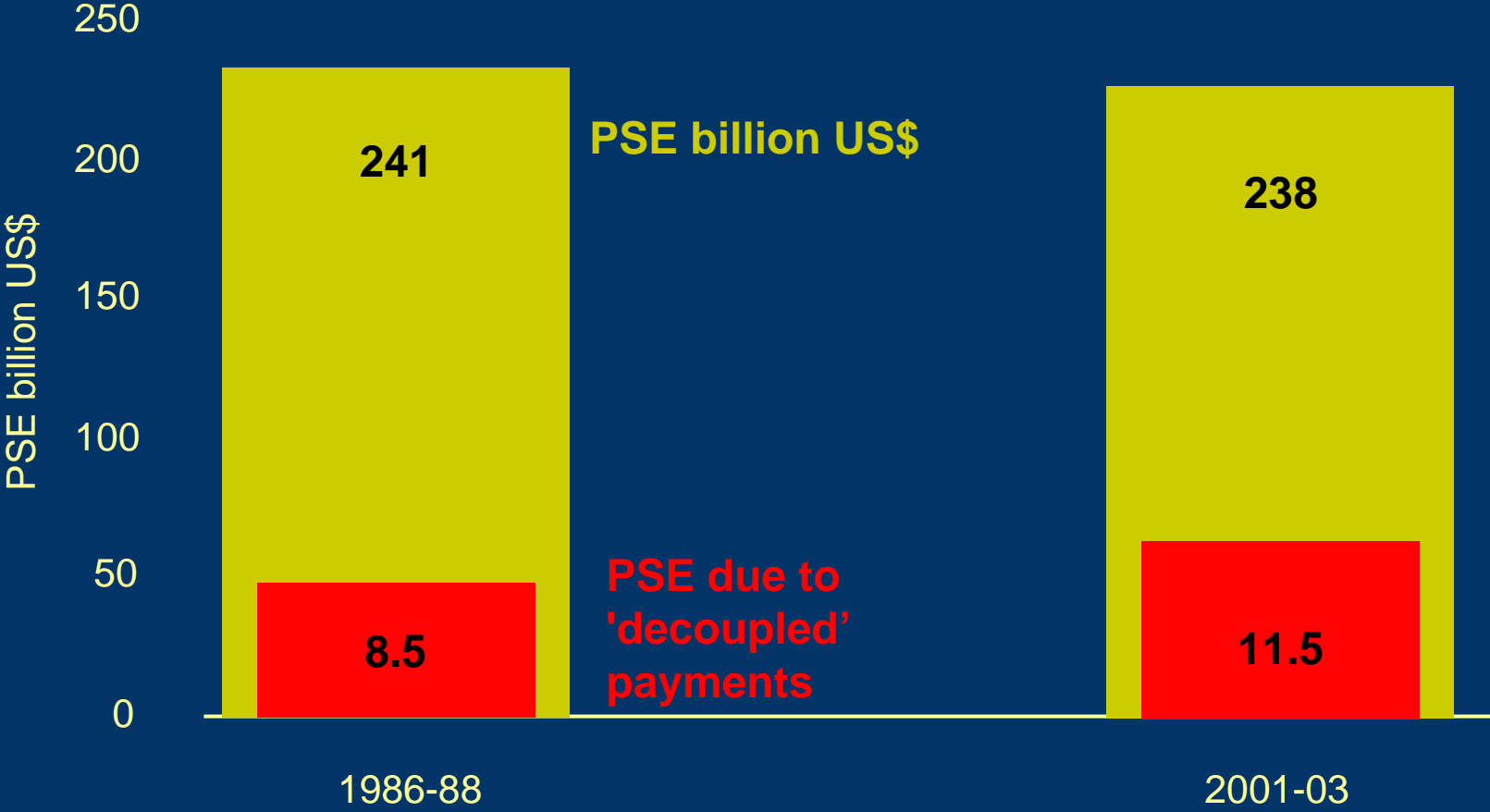
Dr Andrew Stoeckel

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Transparency Australian style: Lessons for Doha?

- Doha talks 'suspended'
- Primary cause is a failed process
 - Reciprocity no longer working
 - Transparency not used
- Few countries engage proper transparency processes
 - Has worked in Australia
 - Could it work elsewhere?

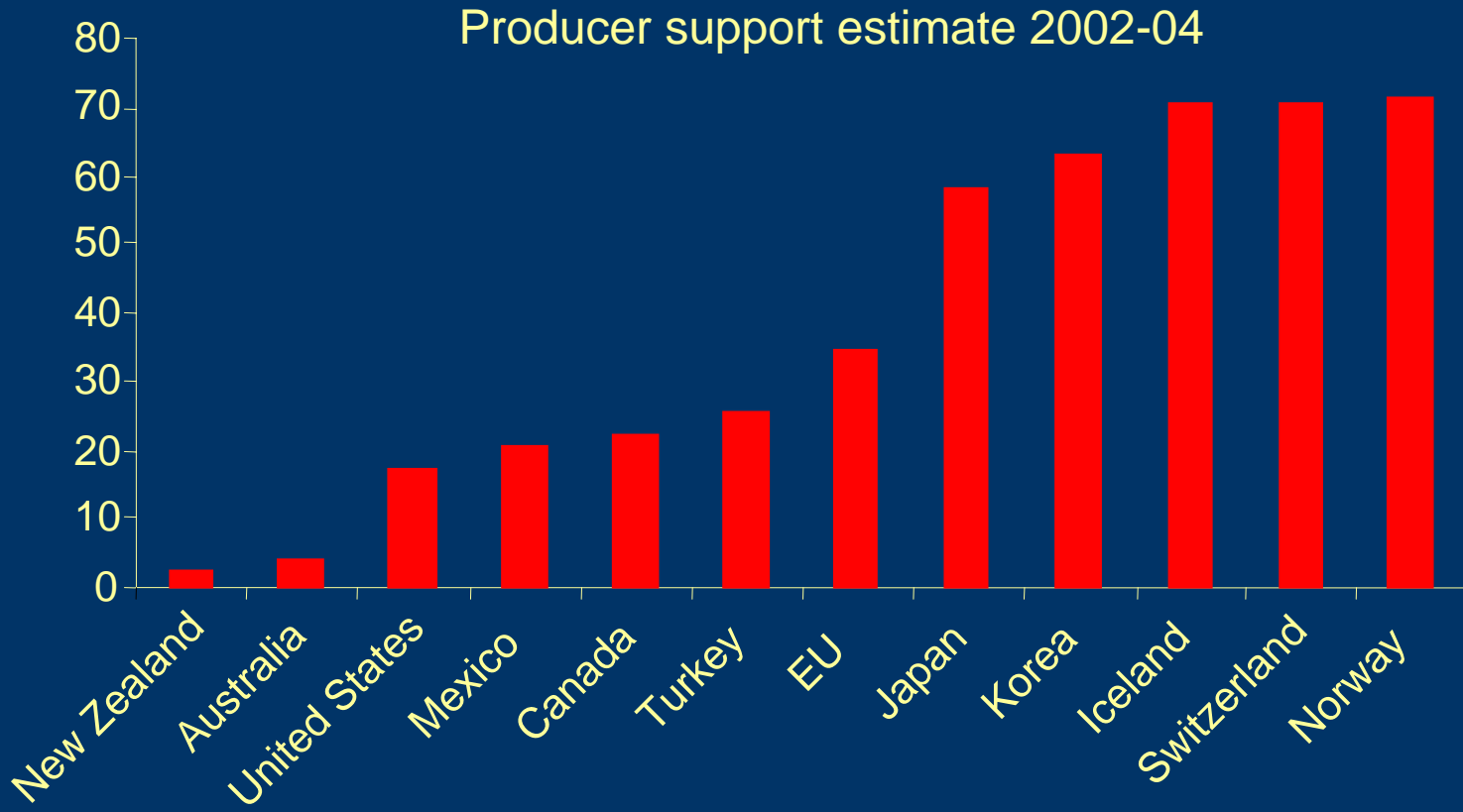
Agricultural producer support barely changed



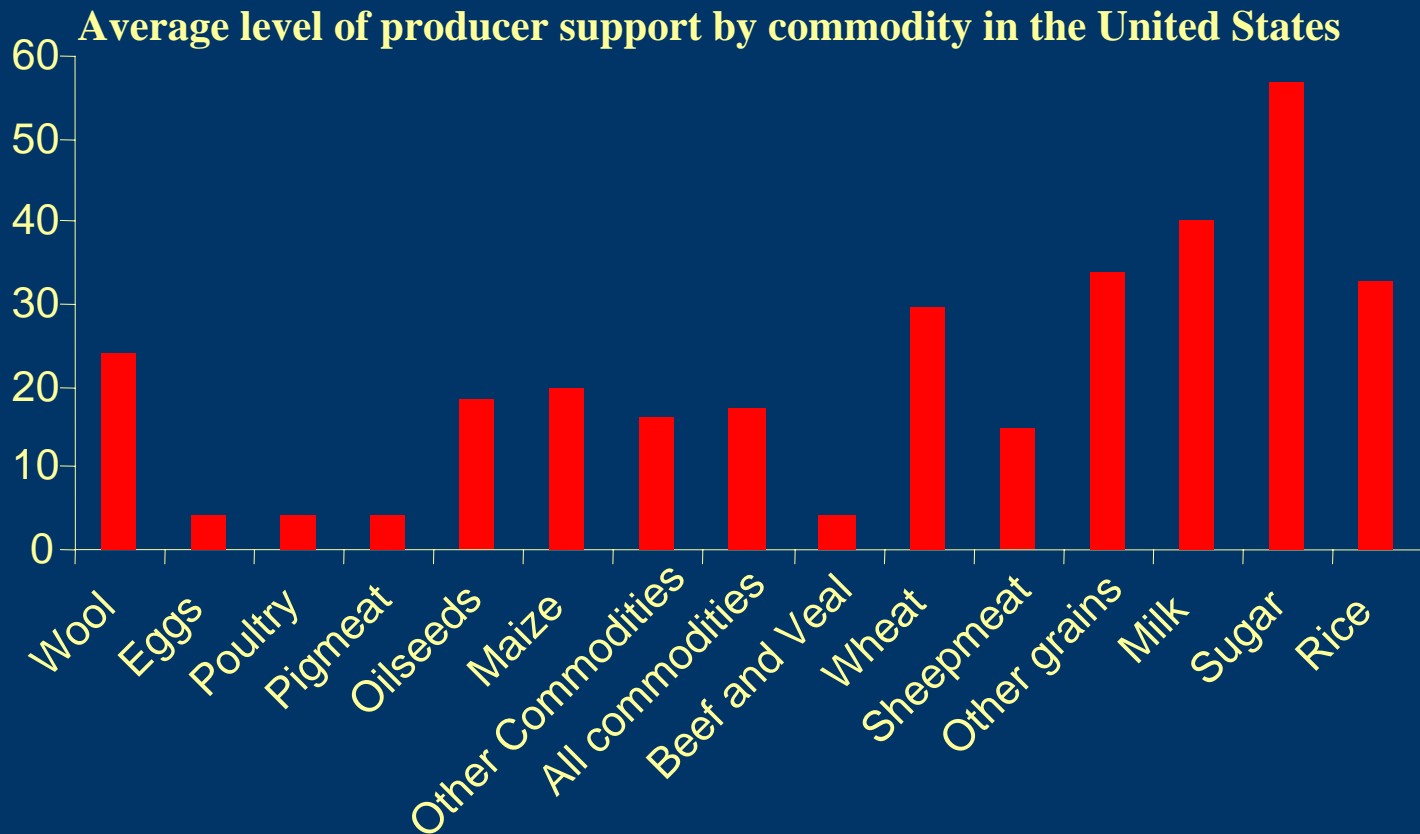
Why so little change?

- Know what to do
- Yet protection remains
- Political problem
 - Requires a political solution
- How do we shift the politics?

Are farmers 'special'



Are farmers special?



Xenophobia and mercantilism

- International trade treated differently from domestic trade
 - Many examples here
- Modern mercantilism
 - “Exports good, imports bad”

Mercantilism and reciprocity

- WTO negotiations based on reciprocity
- Reciprocity has three advantages
 - Changes domestic political dynamics
 - Appeals to ‘fairness’
 - Helps prevent free rider problem
- But concept flawed economically
 - ‘Concessions’ implies imports ‘bad’
- Reciprocity no longer working

Narrow vested interests

- Recipients concentrated (and organised) but beneficiaries widely dispersed (and unorganised)
- But then why did Australia unilaterally reduce car and textile tariffs?
- Systematic program of transparency the key
 - Economy-wide analysis one ingredient
 - ‘Due process’ the other

First key: economywide

- Secondary consequences of policy seldom measured
- Cannot appraise costs and benefits properly without economywide analysis

ECONOMICS

THE
SHORTEST
AND
SUREST
WAY TO
UNDERSTAND
BASIC
ECONOMICS

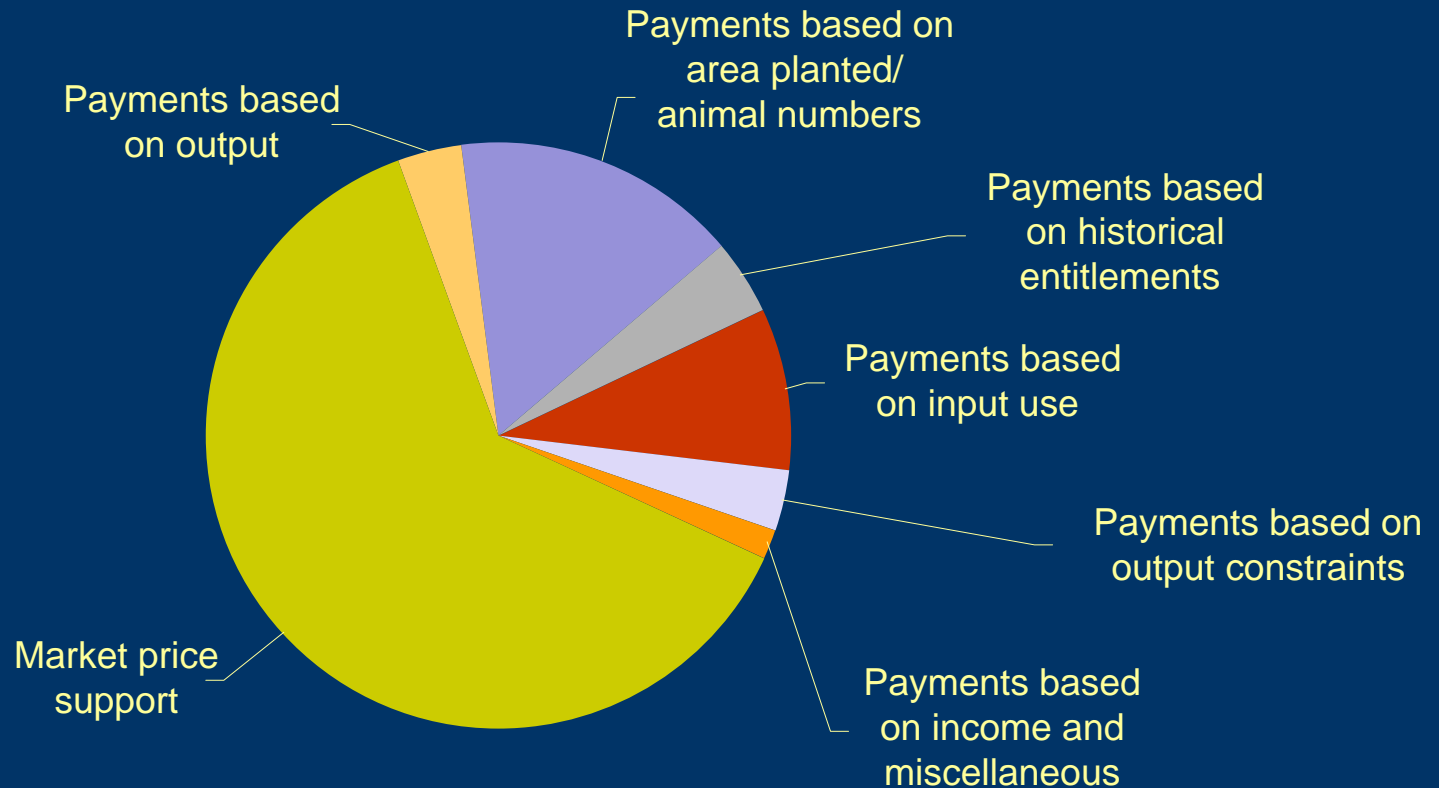
IN ONE LESSON

HENRY HAZLITT

Second key: 'due process'

- Independent agency to conduct review
- Interested parties to make submissions on public record
- Helps if initial discussion paper produced
- Helps if draft report for comment produced
- Recommendations injected formally into government decision making
- All to happen internally, not externally

Composition of support



Does 'best practice' transparency happen elsewhere?

- No
- Increasing use of first ingredient: economy-wide analysis
- But 'due process' is lacking
- Existing TPRM in WTO has neither of the two essential ingredients

Summary

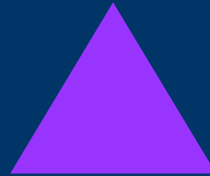
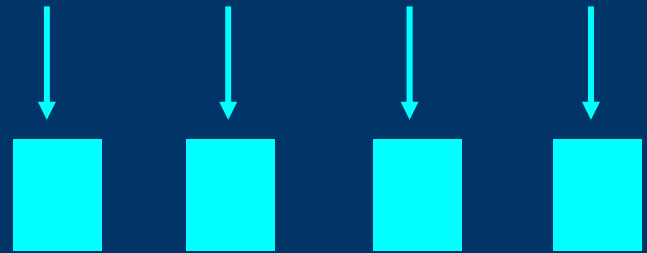
- Agricultural protection is a political problem
 - To solve it requires changing the politics
- Underlying processes behind Doha negotiations now inadequate to change the politics sufficiently
 - Reciprocity now no longer working
 - Fuels the wrong ‘exports good, imports bad’ message
- Transparency as a process shown to work in Australia’s case
 - Two ingredients: economy-wide and ‘due process’
- *Transparency changes the politics of protection*

Forces for and against reform

Forces against reform



Forces for reform



Price differentiation, domestic Wagyu beef production: Japan



Benefits of New Zealand reform

