The Interminable Debate: Free Trade versus Protection

John Fogarty

Despite the Hawke Government's recent announcement of a program of tariff cuts to be implemented throughout the 1990s, protectionist sentiment in Australia remains strong. ***John Fogarty****, a Melbourne-based economic historian, shows that protectionism has deep roots in Australian history and culture, and goes on to expose the central fallacies of the protectionist case.*

Probably the longest running argument about public policy has been that between free traders and protectionists. Adam Smith's attack on the 'mercantile' system was by no means the first exposition of the damaging consequences of protectionist policies and of the virtues of free trade, but it was, arguably, the most influential. Yet the power of Smith's argument and its eventual acceptance in Britain did not dampen the enthusiasm for infant industry protection of men like Alexander Hamilton and Friedrich List in young and developing countries like the United States and Germany.

When, towards the end of the 19th century, Britain began to feel the pressure of international competition, the orthodoxy of free trade came under challenge from the 'Little Englanders' under the banner of 'Fair Trade'. When the South American Republics gained their independence in the early 19th century, they were torn apart by the politics of commercial policy. The politics of protection loomed large in Australia's colonial parlia-ments in the 19th century, and a protectionist regime was one of the conditions for achieving federation in 1901. In spite of the strong support for free trade provided by economic theory, democratic societies have displayed a strong propensity to embrace protection.

Explaining Protection

Although economic analysis shows convincingly that tariff protection is an inefficient means of promoting development or effecting the redistribution of incomes and resources, it has had little to offer by way of explaining why democratic societies so persistently pursue protectionist policies. So economists have responded to the realisation that 'although free traders might win the arguments, protectionists win the votes' by widening the scope of the inquiry to encompass the political economy of protection.

Political economists like, for example, Olson (1965) and Krueger (1974) have sought to explain the process of public policy formulation by reference to small interest groups that lobby effectively to secure rents for themselves at the expense of the wider community. But a major problem with attributing protectionist policies to the lobbying power of concentrated interest groups is that in far too many instances there is a negative correlation between rates of tariff assistance and the degree of concentration (Quiggin & Stoekel, 1982:65). In addition, the very attempt to impose a machinery of economic analysis on what is essentially a problem of political decision-making inevitably means that seemingly irrational economic behaviours, which may in fact be quite intelligible from another viewpoint, tend to be dismissed as rationalisations (Anderson, 1980:136).

Although a protectionist regime provides plenty of opportunities for small but powerful interest groups to lobby, it is a mistake to assume that, in the Australian case, protection exists because of the activities of such groups. Protection became firmly rooted in Australia as a response to a perceived social need and has been institutionalised in Australia's social and political culture. Once the institutions of protection were in place, lobbying for preferential treatment became part of the system. It is only when we see protection as a pervasive civic ideology that we can begin to understand why Australians have clung so tenaciously to protection.

Essentially, the issue is one of distributional conflict. Economists have usually assumed that this conflict occurs between labour and capital as predicated in the Stolper-Samuelson model (1941). But this model fails to reflect the realities of many societies, especially resource-rich industrial economies such as Australia, where distributional coalitions between employers and employees in the manufacturing industries are often strong enough to exact rents from the mining and rural export industries. As Quiggin and Stoekel (1982:69) suggest, in such an economy it is the voting power of the majority, not the concentrated lobbying power of small groups, that provides the political dynamic for continuing policies of protection; the distributional conflict takes place between industries rather than between factors of production.

The New Protection

In the case of Australia this sectoral conflict is exemplified in the set of institutional arrangements known as

the 'New Protection'. The early Commonwealth parliaments consisted of three main parties: Protectionists, who soon assumed the title of the Liberal Party; the Free Trader Party; and the Labor Party. Following the bitter confrontations of the 1890s, there was a widespread desire in the community to find less damaging ways of resolving conflict. There was a widespread belief within the Liberal and Labor parties (who generally supported each other in government) that state intervention and regulation was the most appropriate means of ensuring more orderly and less destructive ways of resolving these conflicts. Labor was committed to protecting jobs and working conditions through its espousal of White Australia and arbitration; the Liberals supported protection for manufacturing industry, as a means both of achieving a more sophisticated level of economic development and of providing urban employment. These interventionist tendencies were married in Alfred Deakin's policy of New Protection.

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'The old protection had contented itself with making good wages possible. The New Protection sought to make them actual': so ran the slogan at the time. The New Protection sought to marry the twin objectives of economic and social justice by linking protection for manufacturing with the Arbitration Court, which was founded in 1904: tariff protection for manufacturers was made conditional on their paying fair and reasonable wages as determined by the Court. Although the linking of tariff protection with award wages was ruled unconstitutional in 1908, the objective was achieved through bounty legislation. By 1908, in spite of opposition from rural interests, the Commonwealth was committed to protection, the basic wage, and mediation in industrial disputes. A coalition between the state, industrialists and unions had been forged which has persisted to the present. If someone had thought of it, it might even have been called an 'accord'.

The Tariff Board and the 'Protection Issue'

The 1920s proved to be the crucial decade in which Australians decisively committed themselves to the protectionist path. World War I had spawned a number of industries under the protective umbrella of wartime conditions and fuelled a spirit of economic nationalism that favoured the retention and extension of manufacturing capacity. In this climate the tariff was extended considerably in 1921 and the Tariff Board set up to advise the government on the scope and level of protection to be afforded to industry. In its early reports the Board enthusiastically espoused the cause of protection, but by 1925 it was becoming increasingly aware of the burden of costs the tariff was imposing on the export industries. The combined effects of the Arbitration Court and the Tariff Board created an uncontainable cost spiral, and in its 1926 report the Board predicted industrial paralysis as the inevitable result of 'an ever-increasing wage rate and an ever-ascending tariff'.

As their costs rose, primary producers called for subsidies and home-price supports to compensate for the costs imposed by protection for manufacturing. The Patterson Scheme, which was introduced in 1926 to protect dairy farmers against market prices for butter by maintaining a high home price, became the model for other struggling export industries to emulate. Within a short time the Patterson Scheme formula was applied to a wide range of primary products such as dried fruits, tobacco and sugar. Leaders of farmers' organisations argued that, as opposition to tariff protection had proved futile, they had no alternative but to fight for compensatory assistance. By the end of the 1920s few primary industries were not enjoying some form of assistance through production bounties or subsidisation of such inputs as fuel and fertilisers. In addition, marketing schemes that gave monopoly power to producers' organisations proliferated. Within the primary-producing sector, the strong export performers like the pastoral industries were left to carry the burden of protection, while the less efficient producers climbed aboard the assistance bandwagon.

The Tariff Board's warnings grew more urgent as it became obvious that the merry-go-round could not be sustained indefinitely. In 1927 an expert committee under the chairmanship of Professor J. B. Brigden was set up to investigate and report on the costs of protection. This committee reported in 1929 that Australia's system of protection had gone too far, but that the economy had been well served by the tariff, which had enabled the country to support a far greater population than would otherwise have been possible, though at a lower standard of living than a smaller population would have enjoyed. The committee urged that the idea of tariff protection should not be questioned, only its level and incidence.

The 'Protection Issue' was vigorously debated amongst economists during the 1920s, the most persistent protagonists being Professors Brigden and

Frederick Benham. Benham argued that under free trade a considerable manufacturing sector would have developed and that it would have been more efficiently distributed between firms and products. He maintained, *pace* Brigden, that without protection Australia could have supported a similar number of people enjoying a **higher** standard of living.

Although these conflicting views of Australian political economy inspired vigorous discussion amongst economists, the wisdom of continuing protection was hardly challenged at all in the political arena. Australia entered the difficult Depression years firmly committed to the protection of manufacturing industry and a fair degree of compensatory assistance to the rural export sector. For one reason or another, all the political parties in the Commonwealth parliament — Labor, Nationalist and Country — endorsed tariff protection as the means by which national economic expansion would be secured.

The Protectionist Legacy

This historical sketch indicates how wrong is the notion, currently purveyed by some contemporary commentators, which designates the policy of 'protection all round' as the legacy of Sir John McEwen, as if it were an aberration. Far from being that, it is one of our most deeply-ingrained civic ideologies. Economists may be allowed to win the argument for a while, but when structural adjustment associated with opening up the economy begins to hurt and jobs are threatened, the electorate expects the government to 'do something'. That means protection, whether presented in the guise of 'strategic trade policy', export assistance, tariff protection for import replacement industries, or just plain subsidy.

If the political justification for protection has been the provision of employment and the maintenance of urban living standards, the intellectual justification has been based on the infant industry argument. In the 1940s and 1950s leading industrialists, while insisting that it was essential for manufacturing industry to be efficient, argued strongly that manufacturers needed the security of protection, particularly against exchange-rate fluctuation, in order to attract the necessary capital investment. After all, the prominent industrialist Sir Daniel McVey argued, tariffs were subject to review in the light of changing circumstances, and it was always open to the Board to decide that a particular tariff had outlived its usefulness. Yet the long history of protection in Australia suggests that it is very naive to expect that protection will be lifted when an industry reaches maturity. The legacy of the New Protection has a political dynamic of its own. The very fact of protection means that the industry is cut off from the stimulus and exposure to competition from the world's most efficient producers; awards governing the costs of labour are handed down without reference to international standards of productivity but are determined more by the bargaining strength of unions in an uncompetitive market; and governments are usually reluctant to bear the political odium of contributing to short-term unemployment by withdrawing protection. The longer a protected industry remains in existence and the larger it becomes, the more difficult it is politically to reduce its protection. One might even say that the more highly protected an inefficient and labour-intensive industry is, the more chance it has of maintaining its protection: this would explain why after more than 100 years we still have highly-protected clothing and footwear industries.

It may surprise some people to learn that the current fashion of exhorting all and sundry to increase productivity is not at all new. Those who were charged with building the Australian manufacturing industry after World War II period were extremely conscious of the need to lift productivity levels. A group of prominent businessmen founded the Institute of Industrial Management in 1941 with the objective of increasing the levels of productivity in Australian factories. In 1956 a report on productivity prepared by a Ministry of Labour Advisory Council warned that the connection between high productivity and higher living standards was not sufficiently understood by Australians, and that without increases in productivity Australian living standards would fall.

The job of economists, however, is to inform people of the costs of choosing amongst the options open to them. If people prefer nationalistic, beggar-thy-neighbour policies, they should at least be aware of how high the cost will be in terms of lower living standards.

But exhortations to lift performance, now as in the past, are unlikely to have much effect unless the parties concerned have incentives to change their ways. In a protected industry the incentives are perverse. Manufacturers have few incentives to seek markets overseas, and when the industry reaches an output beyond that which can be absorbed in the domestic market, its managerial attitudes, work practices and cost structures, as these have developed under protection, will

be incapable of meeting the challenge of exporting. Workers have little incentive to increase their productivity because they are bargaining within a closed system that imposes the same labour conditions on all participants in the industry. One of the baneful consequences of a long history of protection is an industrial relations ethos that offers no real rewards for increasing productivity and contributes to our comparative disadvantage as a manufacturing economy.

Consider the following statement:

> We must get cracking now, today, for rapid development of our export trade is not just necessary — it is absolutely vital. Tomorrow will not do. Every Australian must become export conscious because our economic life and standard of living could depend on our ability to get more of our goods on to foreign markets and get them there quickly.

Senator John Button must despair when he reads a statement like this one, which was made about three decades ago by the Chairman of the Commonwealth Banking Corporation, Warren McDonald.

Yet the message has been repeated many times. In the 1960s it came to be realised that the protectionist policies of the postwar period had been recipes for mediocrity and that although they had encouraged a widening of the technological base of manufacturing, the technology had remained derivative rather than dynamic and was generally incapable of producing anything other than what could be manufactured in more highly productive, lower cost economies. In 1965 the Vernon Committee judged that the future growth of the manufacturing sector required a shift from import replacement to increasing development of export markets for Australian manufactures. A decade later the Jackson Committee judged that the manufacturing sector had not risen to the challenge. It pointed out that manufacturing had for the previous ten years been trying to maintain its earnings by running down its capital stock. Industry was operating within an outmoded structure, ill-suited to encouraging the development of manufacturing exports and, in a slowly growing domestic market, real fixed capital investment in manufacturing had remained stagnant.

Yet to many Australians, the period when protectionist sentiment ran high constitutes the 'good old days'. True, economists kept extolling the virtues of freer trade and pointing out how a country like Australia, which relied so heavily on the export of commodities for its standard of living, could not go on for ever imposing costs on the export sector through protecting manufacturing. But the movement towards reducing levels of protection does not seem in many peoples' minds to have solved many problems. Current discussions over industry policy tend to move towards an ideological plane, evoking emotional reactions. The job of economists, however, is to inform people of the costs of choosing amongst the options open to them. If people prefer nationalistic, beggar-thy-neighbour policies, they should at least be aware of how high the cost will be in terms of lower living standards.

The Seen and the Not Seen: Frédéric Bastiat's Critique of Protection

Rodney Hide

The protectionists are down but not out in New Zealand. Protectionist stirrings are afoot even though freer trade is allowing consumers to enjoy a greater range of goods at lower prices than ever before.

The call for protection is persuasive. Protectionists are adept at rallying politicians and even consumers by playing up the commonplace that local businesses unable to compete with foreign suppliers go bust. The protectionists patriotically complain that the loss of jobs and industries is simply too high a price to pay for low-priced high-quality goods from foreign lands. They admit that free trade is theoretically ideal, but, they sigh, policy must be practical, and practical policy is protectionist policy.

Of course, the protectionists are talking nonsense, but combating their nonsense is difficult. One of the more successful and certainly the most entertaining attacks was that of the French pamphleteer Frédéric Bastiat. He waged war with his pen against the protectionists in the 1840s and no one since has come near his devastating wit in promoting the argument for free trade.

Consider his demolition of the argument that protection saves jobs in his pamphlet *What Is Seen and What Is Not Seen*. Bastiat argues that in making the play about jobs the protectionists are reasoning correctly but incompletely. In pleading for privilege, they are pointing out the effects that are seen, but leaving in the shadows those that are not seen.

It is easy, he says, to observe the survival of the protected business that would otherwise go bust, and the saving of the workers' jobs. Not so easy to see is the consequence of Joe Kiwi having to pay an extra $20 for a shirt. If he could have got his shirt $20 cheaper, Joe could have spent the saving on a pair of locally-made socks. The jobs in the sock industry destroyed by protection are left out of the protectionist's argument.

In addition, the $20 Joe would have paid for his foreign shirt would eventually come back to New

Protectionist Misconceptions

There has been an unfortunate tendency in recent public reactions against the liberalisation of the economy to portray the advocates of lower protection as heartless ideologues intent on promoting free trade regardless of the human or economic cost. This portrayal plays on a number of popular misconceptions.

'Protection creates jobs.' The jobs that protection provides are for low-productivity workers at higher wages than they would command in an open market. But it has to be realised that these jobs are 'created' at the expense of more productive employment in industries that are squeezed out by the high costs of protection. About 80 per cent of these costs is borne by the export sector (Clements & Sjaastad, 1985). Much of the rest is borne by manufacturing industries that could otherwise compete internationally.

In the absence of protection, the industrial structure would change; the least efficient industries would contract and the most efficient ones would expand. Contrary to the popular understanding, this restructuring would result in an overall increase in available employment because higher incomes in capital-intensive manufacturing would create a demand for more jobs in the labour-intensive service industries. And, of course, when the restructured manufacturing can compete in world markets, the scope for expansion, unconfined by the limits of the domestic market, would be enormous.

'Australia can never expect to be a significant exporter of manufactured products.' Protection makes this a self-fulfilling prophecy. The fact is that those countries that export the greatest volume of manufactures are also the greatest importers of manufactured products. Specialisation is the key to efficient manufacturing, but traditionally in Australia and in the industrialised countries of Latin America the object of protectionist policy has been to encourage manufacturing in a broad spectrum of import-substituting industries, with a resultant loss of the benefits of specialisation.

Even with protection, Australia does have manufacturing industries that can compete in world markets. Metals-refining is one area where we have a comparative advantage. Southern Aluminium with its motor vehicle wheels plant at Bell Bay provides a recent example of what efficient, outward-looking enterprises can achieve in export markets. We do have to bear in mind that protection has burdened us with a **comparative disadvantage** in manufacturing and it will require considerable restructuring and attitudinal change to rectify the damage. But it is important to appreciate that it can be done.

'Higher levels of protection are needed to encourage import-substituting manufacturing in order to correct the trade imbalance.' But import-substituting manufacturing may not be as import-saving as may appear at first sight. If new manufacturing industry is to be established, it will be necessary, of course, to import capital equipment to set it up. More important, how-

Zealand as demand for some product or another. Otherwise the foreigners selling us shirts would simply be piling up New Zealand dollars to no advantage. Once again, the business and jobs lost because foreigners do not have the wherewithal to buy New Zealand produce are difficult to see and protectionists simply ignore them.

Faced with the unseen consequences of protection, protectionists are likely to change tack and admit that free trade is theoretically sound, but that it is not the way of the world and that it is simply not practical. In his pamphlet *Theory and Practice*, Bastiat boils the debate down to two simple assertions. The free traders say that it is better to buy from another what it would be more costly to make oneself. The protectionists, however, say that it is better to make things oneself, even if it would be less expensive to buy them from another. Bastiat then asks us to look around and ask which of the two assertions enjoys the sanction of universal practice. What do the farmers, the manufacturers and the traders do? Does the farmer make his own clothes? Does the tailor grow his own wheat? Of course not.

It is clear, explains Bastiat, that the entire economy depends upon the division of labour and the exchange of goods and services between specialists. And exchange is nothing but the quite practical calculation that induces us to stop direct production whenever by buying we can save time and effort. No one makes for himself what he can more cheaply buy.

Thus, Bastiat declares, the protectionists are not practical people. How can they be? They can't point to a single person who acts according to their principle.

Bastiat recognises that the protectionists in their defence might well reply that their principle is not meant to be applied to individual people; rather, it is meant to apply to groups of people because groups do make for themselves even what they can more cheaply buy. But, Bastiat insists, this assertion too is erroneous. Groups like the family, the town, and the region without exception all reject the protectionist's principle in practice and have never even dreamed of acting on it. All procure for themselves by way of exchange whatever it would cost them more to produce directly. And nations too would do the same were they not prevented by force from doing so.

ever, is the impact that import prices have on the economy. Clements and Sjaastad (1985) have found that a 5 per cent rise in import prices causes wages to rise by more than 4 per cent. Taking this inflationary effect into account, the real value of protection of a 5 per cent rise in import prices is 0.6 per cent. Producers of import substitutes are fractionally better off than before, but exporters are 3.2 per cent worse off. Protection is no way to go about solving a balance of payments problem, as the Argentines have found to their great cost.

'If everyone else is raising trade barriers, Australia must retaliate to protect its interests.' This is the most seductive misconception of all. The sad fact of life is that although large economies can conceivably gain by imposing tariff barriers against small economies, small economies lose by raising tariff barriers against large economies. This is known as the 'terms of trade effect': when a small economy imposes a tariff on imports it is the consumer in the small country who pays, but when a large economy imposes a tariff its quasi-monopoly position in the market will enable it to 'force the foreigner to pay the duty', so that the small exporting country's producers bear at least some of the cost of the large country's tariff. The corollary of this is that small countries benefit proportionately more than large ones from a lowering of tariffs.

Small countries are not in a position to make the rules. Nor is it to their advantage to break them. Calls to increase protection for domestic industry either in retaliation against increases in protection in world trade or to achieve greater self-sufficiency are ill-founded. Australia's interests are best served by striving to obtain the freest possible world-trading system. The playing field may not be level, but protectionist policies will only tilt it further against us.

Conclusion

Given the prominent part that protection has played in Australia's political and economic history and its role in shaping some of our most important institutions, it is perhaps not surprising that many Australians find it difficult to accept that we would probably now be better off if we had been less protectionist in the past. At the same time the critics of protection have not always been sensitive to the concerns of ordinary people who have been expecting governments to intervene to protect their standard of living. Government intervention is often dismissed out of hand by the advocates of freer commercial policy who fail to distinguish between intervention that merely provides opportunities for rent seeking by firms and intervention that captures the benefits of externalities for the economy as a whole. This does nothing to help the ordinary citizen's appreciation of the argument.

Nevertheless, unless Australians can be convinced that, no matter what the pain of restructuring, a more open commercial policy is the path to creating a more dynamic economy for the future, that future does not look very promising.

The protectionists are not practical people, concludes Bastiat. The free traders are. The free traders base their argument on the practice and experience of every individual and every group of individuals whose acts are voluntary and can therefore be adduced as evidence. The protectionists, on the other hand, begin by coercing or impeding, and then seize upon forced or prohibited acts to support their case: 'See, practice proves us right!'

Moreover, Bastiat points out, in arguing against the theory of free trade, and even against theory in general, the protectionists are putting forward a theory of their own. But they are theorists of the worst kind because their theory that people should produce what they can buy more cheaply is not sanctioned by the practice of any person on earth.

We could well do with a Bastiat in our midst today. In the absence of such a wit exploding the contemporary protectionist fallacies we can do no better than return to his original salvoes. The protectionist arguments have not changed in a century-and-a-half and Bastiat refuted every one of them.

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