Rear Vision on Trade Policy
Wrong Way, Go Forward

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THE CENTRE FOR INDEPENDENT STUDIES

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Executive Summary

Pig farmers seeking to stop imports of pork into Australia are standing candidates in 15 Coalition-held seats. Their objective is to reverse Australia's World Trade Organisation (WTO) commitments. If the pig farmers succeed, primary producers in other countries will retaliate.

The global trading system is under constant threat from the failure of domestic adjustment to WTO agreements. Motor vehicle and textile, footwear and clothing industries in Australia have succeeded in stalling domestic tariff reforms. The pressures to backslide on trade agreements is also considerable in other WTO member countries. If backsliding becomes more prevalent, the benefits delivered by the WTO system will decline.

Australia has gained most from international agreements when the political process has persuaded the electorate, and those in the industries concerned, of the gains to be won from domestic adjustment. More than 80 per cent of our estimated gains from the Uruguay Round result directly from our own removal of trade barriers. The gains will be even greater if APEC countries meet their Bogor commitments for the reduction of protection.

Policies affecting trade flows do not begin or end in the international arena. Decisions about reducing protection must be implemented at home. Without increasing our competitiveness through improved technology, higher productivity and better marketing at home and abroad, in other words, through greatly improved management, we cannot benefit from the agreements that we have taken part in negotiating.

A new round of WTO, or any other multilateral or bilateral negotiations, will not mean much unless the need for greater competitiveness is faced squarely at home. It should also receive high priority in WTO trade surveillance and discussions leading up to the next Round if we want to see further reductions of international trade barriers.

Present WTO rules do not deal effectively with backsliding. Extending or tightening the rules will not succeed if the need for domestic adjustment by the industries affected is not taken seriously. n

Why are we backsliding on our WTO commitments?

Recent Australian governments have placed a very high priority on promoting a competitive Australian economy. This approach involves reducing the influences on domestic production that hold back the performance of Australian industries. To this end a program of microeconomic reform was begun several decades ago. That program is ongoing, with emphasis on taxation and labour market reform.

In addition, the government has been exploring the scope for policies aimed specifically at encouraging competitiveness for Australian industries supplying domestic markets that may also become exporters. The search has to date produced two quite different, and potentially conflicting, approaches. One, ‘industry policy,’ involves providing special assistance in the hope that this will help industries to become world-competitive. The other involves reducing impediments (in the domestic and world trading environments) to growth in those industries that are already, or could become, world-competitive, so that they may generate employment and profits by accessing wider, international markets. By realising their potential, they would contribute to Australian economic growth. Reducing protection (barriers to entry to national markets) worldwide is an essential component of this policy.

While neither approach has yet been fully developed, recent government decisions provide important insights about the likely contribution each can make to promoting a competitive Australian economy. The package introduced for the textiles, clothing and footwear (TCF) sector, for instance, conveys much about the ‘industry policy’ approach (Howard and Moore 1997). It involves a tariff reduction pause and special assistance to promote ‘the development of an internationally competitive TCF sector in the lead-up to the free trade environment beyond 2010.’

But these industries are in decline in industrial economies worldwide, notably in countries in which they enjoy high levels of protection. Though some specialised lines of production will survive in Australia for the domestic market and for export, overall decline is inevitable. The bulk of the TCF sector involves low-wage, labour-intensive production which is unsuitable for a high wage country such as Australia. Australian producers have been moving off-shore during the last several decades and will no doubt continue to do so if they wish to remain in production in these industries. Attempts to retain these industries will be at the cost of moving Australian workers to high wage employment. On the basis of the model provided by the TCF sector, the ‘industry policy’ approach to promoting a competitive economy is not promising.

The second approach to competitiveness is much more positive. It involves no special government assistance and no risk of ‘picking losers.’ It helps promote competitive production by improving the market opportunities available to our (established and emerging) world-competitive industries. What scope is there to improve our present approach to opening world markets for these industries?

We rely on reciprocity through international negotiations and agreements to reduce protection, and on international rules to enforce compliance with the agreements negotiated. This process, however, does not address the problem of establishing a commitment, within Australia, to accept the domestic adjustment involved in liberalisation. This is the single most important issue now determining progress in opening world markets through the WTO.

The National Farmers’ Federation knows that progress in opening agricultural markets through the WTO depends on building commitments, within participating countries, to accept that uncompetitive domestic producers must adjust. The Federation notes that ‘to keep trade reform on track there is a huge job to build a domestic consensus in all WTO countries’ (National Farmers’ Federation 1998:12). The same message was conveyed in the recent White Paper on Foreign Affairs and Trade:

> The benefits ... need to be explained and communicated effectively ... Although there is abundant evidence that trade liberalisation ... contribute[s] significantly to economic growth and job creation, often the public perception is the reverse: that reductions in tariffs ... lead to job losses. This is because the benefits ... are often less immediately apparent than the costs ... for particular firms or industries (DFAT 1997a:21).

The problem of market access for our world-competitive industries, and for those that could become internationally competitive, arises from the fact that there are two separate, and potentially conflicting, processes at work in liberalising world markets through the WTO. One takes place in the international arena, involves trade negotiations and culminates in international agreements to reduce protection. The other takes place within each country participating in the international process. It involves decisions about the domestic adjustments required to comply with international agreements. The latter is a domestic process, beyond the reach of international agreements and rules.

The commitment to liberalise is generated externally by international agreements negotiated every ten years or so in Geneva. There is nothing in WTO agreements or rules that requires or helps participating countries to address the domestic adjustment involved in liberalisation. Decisions about domestic adjustment involved in complying with the agreements are made in continuous domestic policy making at home by WTO members, not in Geneva. When governments fail to honour the agreements to reduce trade barriers, it is because they have not been able to persuade domestic producers to accept the necessary adjustments.

Governments are finding ways of avoiding their external responsibilities in order to meet domestic pressures. They have reduced the traditional forms of protection (mainly tariffs) covered by the international agreements, but now rely on less visible barriers to avoid the adjustments those agreements would necessitate for their protected domestic industries. Some have had non-tariff barriers in place for a long time. Others have introduced new non-tariff barriers to replace tariffs as the latter were negotiated away. In both cases domestic adjustment is averted.

A significant gap arises between the (potential) market gains from multilateral agreements and the actual (realised) market outcomes. Average tariffs in OECD countries have been reduced from 40 per cent to 4 per cent since the 1950s. (DFAT 1997b:x). At the same time, non-tariff barriers have grown to the point where they affect one half of world trade (Rattigan and Carmichael 1996:97). There has been a significant increase in the use of such devices, and in the number of countries using them, since the early seventies.

The increase has been greatest in major industrial countries, notably the United States, followed by Germany, France and Britain. Japan has the highest proportion of trade subject to such devices (Laird and Yeats 1990). The principal barriers are in agricultural trade and these are the countries principally responsible for corrupting world agricultural markets. Because they have relied heavily on international bargaining through the GATT and WTO, their interest in the domestic effects of liberalisation has been intermittent – revived every ten years or so as each Round of multilateral negotiations becomes due. There has been no ongoing domestic commitment to accept the adjustment involved, and no real incentive to build such a commitment.

The least competitive industries requiring the highest levels of protection have the strongest incentive to seek exemption from liberalisation. When they succeed (as have textiles and clothing in the United States; agriculture in the European Union and Japan; and textiles, clothing and footwear and motor vehicles in Australia) the gains for all countries from liberalising through the WTO, are eroded.

In the past it has been argued that if the WTO rules do not deal adequately with backsliding, then the solution is to extend or tighten the rules. The approach to backsliding developed in the Uruguay Round involves bringing all existing barriers into future multilateral negotiations, strengthening the international rules governing non-tariff barriers, international surveillance to enforce compliance with agreements and improved dispute settlement procedures. Australia has endorsed this approach. (Fischer 1997).

Hogging the Market

In June this year, Australian pig farmers called for increased tariffs on pork imports from Canada. Farmers blamed increased imports for the 30% fall in pig saleyard prices that had occurred in the first half of the year.

However, while imports rose sharply in 1996-97, they were flat in 1997-98. The Australian Bureau of Agricultural and Resource Economics (ABARE) suggests that the Australian pig farmers themselves were to blame for the downturn in prices. With rising pig prices and farming profitability, and with increased export opportunities, farmers rapidly expanded production in 1997. This resulted in an over-supply of pig meat which, combined with the fall in beef prices, led to the decline in saleyard prices for pigs.

This episode illustrates several points. Fluctuations are a normal part of economic activity. One of the best known phenomena in agricultural production is what is called in the US economics literature the ‘hog cycle.’ A rise in the price of pigmeat leads to an increase in supply and a consequent decline in price, followed by a decline in pig numbers and supply of pigmeat. This is followed by a price rise, increased numbers of pigs, and so on. Pig farmers should be well aware of this phenomenon and therefore take it into account as a part of their business risk management.

However, as in other areas of economic activity, if the political situation is amenable, there is always the temptation to ask the government (meaning the rest of society) to bear the risk instead of the pig farmers. These requests usually take the form of requests for protection against competition from producers in other countries. To ask for subsidies instead of increased tariffs or quantitative import restrictions would expose the high transfers that taxpayers are being asked to contribute to the whingeing industry. But why should consumers cover pig farmers’ risks? Why not grape growers’ risks? Or those of tomato growers? Or those of citrus producers, who are also seeking protection?

The cost of protection for specific industries is not the only issue. Australian exports depend heavily on agricultural products. Our overseas markets are being substantially expanded by the liberalisation of agricultural trade under the auspices of the WTO. The process is slow because Australian pigs do not turn out to be the only backsliding breed. If we give Australian pig producers protection, all other countries will retaliate. The WTO system will unravel precisely in that area where it is of great importance to us.

Not all pig producers have become unprofitable as a result of the recent 'hog cycle.' Well-managed production units that take advantage of Australia's excellent location for pig farming for overseas as well as for domestic markets can have every expectation of maintaining their position in the domestic market and accessing export markets. Australia has ample land, world priced feed inputs and the technological expertise to produce first class pork products.

The issue facing producers is domestic and international competitiveness. To be as profitable on average as its outstanding producers are already, the industry has to take a much broader view of efficiency. The quality of products, streamlined production and a search for new markets are essential. A long term investment perspective has to take the existence of 'hog cycles' for granted, as farmers do elsewhere.

Price, interest rate and exchange rate fluctuations have to be taken into account. This means a much higher level of understanding of financial issues and futures markets than is common. The current low value of the Australian dollar is particularly favourable to exports. Producers could currently lock in grain supplies at low prices for several years. The changing environment of the industry means that economies of scale are likely to be desirable either through larger producing units or by producers working together,

Pig producers should examine the experience of the wool industry before they opt for government intervention. Wool growers are still paying for their attempt to cartelise the industry through a 'floor price' which inevitably became unrealistic. Disposing of the low quality wool stocks accumulated is a major problem. So are flocks of low wool quality sheep for which there is no market.

Pig producers need to be educated about the implications of competitiveness in pig farming. So do the Australian public and politicians who have to be able to withstand protectionist assaults from the industry on the public purse. Australia has excellent institutions for this job. ABARE and State Departments of Agriculture have been created and are maintained for this purpose. The Productivity Commission is looking into the industry's problems. Seeking protection for the pig industry through the electoral process is an attack on the taxpayers' purses and Australia's standing in the international trading community.

But this approach cannot overcome backsliding for three reasons. First, it operates only after the event. It catches up with today's non-tariff barriers only in tomorrow's multilateral negotiations. Second, the scope for replacing the non-tariff barriers now in use with others, just as effective, is endless. Many of the new barriers are seen by governments introducing them as belonging to domestic policy – beyond the reach of international agreements. Third, the approach does not address the underlying problem, that is, the pressure at home to avoid the domestic adjustments involved in honouring the WTO agreements.

Towards a solution

While the Uruguay Round was in progress an approach was proposed, in the Leutwiler (1985) and Long (1987) reports and later, by developing countries at UNCTAD VII and by the IMF, which addressed the causes of backsliding. It involved a domestic review system, operated within WTO by individual member countries to ensure compliance with WTO agreements.
Such a review system would enable governments to make the domestic trade-offs clear when domestic producers seek tariff maintenance and less obvious forms of protection. It would operate at home, in the domestic policy environment of WTO member countries, where decisions about adjustment are made.

This proposal addresses the underlying problem at source. It makes its impact on decisions about domestic adjustment as they are being made, not after the event. Because it would focus on the larger domestic rewards from honouring agreements, governments would be armed against the adjustment-averting demands of uncompetitive domestic producers. Such an approach recognises that governments will continue to be under pressure to avoid the domestic adjustment resulting from international agreements until their constituents at home are persuaded that the gains in national wealth that multilateral liberalisation makes possible depend on honouring the agreements.

Attention to domestic adjustment is at present missing from international liberalisation efforts. The absence of domestic adjustment programs has made backsliding inevitable. Domestic opposition to liberalisation kept agriculture off the negotiating table for thirty-odd years prior to the Uruguay Round, and the task of securing significant progress in opening agricultural markets still lies ahead. Until a way is found to deal with the underlying problem, access to world markets for our most competitive industries will be influenced less and less by the agreements reached in Geneva, and more and more by the domestic pressures on other governments (Hathaway and Ingco 1995; Gallagher 1997; National Farmers' Federation 1998).

Industry organisations have expressed similar concerns:

> Australia is in danger of locking itself into yesterday's approach to trade reform. There is no doubt that agricultural protectionist interests in countries such as South Korea and Japan will continue to pressure their governments to backslide on their trade reform commitments.
> Governments can get up to all kinds of games in cheating on rules to protect domestic political interests. ... Australia provides a classic example of how domestic transparency can change the debate on industry protection. ... *A*

> *public informed of the costs and benefits of trade intervention by government will create the countervailing domestic political pressures to prevent backsliding* (NSW Farmers' Association 1995; emphasis added).

The importance of trade issues for Australia has been heightened by the urgent need for export growth. The ratio of exports to GDP rose from 15 per cent in the 1970s to more than 20 per cent in the 1980s, but has become stalled so that external debt continues to accumulate. We canot rely on WTO agreements to deliver increased export opportunities for our industries if our governments do not initiate the adjustments necessary to wean our own uncompetitive industries from tariffs and non-tariff barriers. We cannot expect other countries not to backslide if we are doing so ourselves. We lose the power of moral and practical persuasion in the international arena. The failure to become internationally competitive, for example in motor vehicle production, is constraining export growth in our highly competitive farm sector.

The message conveyed by Prime Minister Howard, by former Prime Minister Hawke and in the recent White Paper (Department of Foreign Affairs 1997a) is straightforward.

- The role of international negotiations is to secure a collective commitment from governments to reduce their trade barriers. That is an important step, but it only gets half the job done.
- The other half is faced by governments individually in their domestic environment and involves persuading their constituents that the adjustment involved for protected domestic producers in honouring those international commitments is worthwhile. It is the positive or negative perceptions held at home about the domestic consequences of liberalisation that ultimately determine how much takes place.

Australia's experience in the Tokyo and Uruguay Rounds demonstrates why progress in opening world markets depends on building a commitment at home. In the Tokyo Round, when international commitments were perceived to be driving our approach, our least competitive industries were quarantined from the negotiated reductions. Later their protection was reduced unilaterally, in a domestic policy context, to secure the domestic gains involved. Our negotiating position in the Uruguay Round, by contrast, was built on domestic achievements: we sought and obtained credit for the 1988 and 1991 tariff reduction programs.

In other words, we were able to address the domestic implications of adjustment when the domestic costs of maintaining uncompetitive industries were the issue, but not when the context was trade bargaining. This suggests that WTO processes should begin with domestic decisions that resolve the domestic trade-offs (between the national gains at issue in liberalisation and the adjustment costs involved for protected domestic producers), and culminate in international negotiations and agreements to reduce protection – not the other way around.

The domestic commitment to accept the adjustment involved in liberalising would then result from conscious domestic choices and policies. Reductions in protection would be evidently nationally rewarding, rather than emerging as the outcome of a balancing act in the international arena between the requests of foreigners and the demands of domestic pressure groups.

To prevent backsliding, the functioning of the WTO system must be closely linked to the domestic choices faced by participating countries. An understanding of the domestic consequences of those choices can then be incorporated into the conduct of trade policy at home. So long as the issue is seen as involving no more than tightening existing WTO compliance rules, the problem will remain. External processes do nothing to correct the negative perception, fostered by those facing adjustment, that liberalisation simply hurts domestic producers for the benefit of foreigners.

We have gained most from participating in international trade negotiations when the trade-off between the costs of adjustment for protected industries and gains in national wealth was resolved at home through domestic processes. More than 80 per cent of our estimated gains from the Uruguay Round result directly from our own unilateral reductions of protection, as would some 90 per cent of our estimated gains from APEC countries meeting their Bogor commitments (McKibbin 1997; Industry Commission 1997:19).

Trade policy – that is, measures affecting trade flows – does not begin nor end in the international arena. It is the international dimension of national policies adopted for domestic reasons. While international cooperation is very important, decisions about domestic adjustment have to be made before reducing protection will become effective.

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