AUSTRALIAN INDUSTRY
GROUP

# Review of Australia's General Tariff Arrangements

## Supplementary Submission

June 2000

## CONTENTS



APPENDICES

# OVERVIEW

This submission responds to a number of issues arising out of the Commission's draft report and supplements some of the points raised in our original submission provided to the Commission in January.

In short, the Australian Industry Group opposes the Commission's draft recommendation in relation to the reduction of 5 per cent tariffs and believes that it should be rejected by the Government.

The Australian Industry Group stands by the recommendations made in its original submission.

We urge the Commission to reconsider its draft recommendations along the following lines:

- there are no pressing grounds for a unilateral reduction in general tariffs from 5 per cent to 'Free';
- as an immediate priority, the Government should reduce the rate of tariff on business inputs imported under the Tariff Concession to 'Free'; and that
- future tariff reductions be considered in the context of trade negotiations which deliver reciprocal and proportionate reductions in trade barriers currently imposed by Australia's trading partners.

A copy of the Australian Industry Group's media release, issued in response to the public release of the Commission's draft report is provided in Appendix A.

The Australian Industry Group believes the outcomes of the review have to focus on two key objectives:

- providing a domestic environment which facilitates the development of a competitive, dynamic and globally engaged manufacturing sector; and
- ensuring that Australia has maximum leverage to continue to push for improved access to international markets.

We submit that the Commission's draft findings effectively support neither of these objectives.

In particular, we remain unconvinced of the Commission's findings on the impact of the reduction in Australia's last remaining 5 per cent tariffs. It is apparent that the Commission's modelling assumptions and interpretation of model results displays an in-built bias against import-competing manufacturing. In particular, we question the Commission's assumption about the induced impact on productivity in affected industries – which accounts for no less than 75 per cent of the total projected increase in GDP. Indeed, if taken to its logical conclusion, the Commission's modelling approach could imply that the best policy is not merely to eliminate tariffs but to subsidise imports substantially - a farcical result.

In our view it seems clear that on any conservative analysis the supposed gains, which are hardly substantial, would be clearly outweighed by the associated costs of adjustment.

In addition, we maintain our view that the 5 per cent general tariff is a valuable, albeit small buffer for Australian industry, against exchange rate volatility and uncertainty, in an environment where existing capital markets do not adequately cater to the needs of all sectors of industry.

In relation to the second objective, the Australian Industry Group contends that Australia should not concede remaining tariffs without securing in return reciprocal and proportionate access to the markets of our trading partners.

The Australian Industry Group put forward evidence detailing Australia's current barrier protection vis a vis the rest of the world and specifically in relation to APEC economies. It is arguable that Australia has already more than met its commitments in relation to the APEC goal of free and open trade by the year 2010. Indeed, on any measure, Australia is now one of the most open economies, if not the most open economy in the world.

In finalising its report the Commission should have due regard to Australia's current and future trade policy interests. Australian industry is becoming increasingly concerned with the fact that Australia seems to be making all the moves on free trade. Despite the sentiments expressed at the recent meeting of APEC Trade Ministers in Darwin, there is a discernible lack of international support for a new WTO round and there are growing questions about the effectiveness of APEC. In this environment, we believe there are justifiable concerns that Australia should not undermine its ability to secure practical advantage in future trade negotiations.

The value of such a strategy is amply demonstrated by the recent settlement of the trade dispute with the United States involving Australian automotive leather manufacturer Howe and Company Pty Ltd. A key part of the settlement with the United States is an agreement to remove tariffs on a range of products. Had the Commission's draft recommendation already been accepted we would have been left with a weakened bargaining position, to the potential detriment of Australian industry.

The following sections address our specific concerns with the Commission's draft recommendations, identify the issues of concern that we have with the Commission's analysis and highlight some key issues of relevance to Australia's standing in the broader international trade policy context.

## THE COMMISSION'S DRAFT RECOMMENDATIONS

The Commission has made two draft recommendations, vis:

- General tariff rates on goods under reference be reduced to 'Free' sooner rather than later preferably on 1 July 2001; and
- Consistent with draft recommendation 1, concessional arrangements related to the goods under reference be abolished on 1 July 2001.

In arriving at these recommendations the Commission formulated four basic options for reductions in tariffs over the period to 2005. In essence these options are as follows:

- to be set at 'Free' from 1 July 2001 to obtain the gains as soon as possible
- to be set a 'Free' from 1 January 2003, providing a longer period of forewarning for affected industries;
- to be phased down with a reduction to 2.5 per cent on 1 July 2001 and set at 'Free' on 1 January 2005.
- to be set at 'Free' on 1 January 2005 to coincide with the scheduled reduction in PMV and TCF tariffs.

It is stated that the Commission has considered the case for making no unilateral tariff changes in the decade to 2010, however, it has apparently chosen to exclude this option on the grounds that it believes it would unduly delay the supposed overall community benefits, small though they may be.

The Australian Industry Group is dissatisfied with the Commission's narrow definition of the options identified above. The options presented certainly do not fully take account of the views, evidence and submissions received by the Commission. In effect these options amount to an attempt to redefine and limit the decision-space within which it believes the Government should be focussing its attention.

We argue that the Commission should simply and impartially identify the full extent of the decision-space available to the Government.

In practical terms, the Government faces a far more complex range of options than the Commission has chosen to identify.

At the very least, the option of retaining the general tariff at a rate of 5 per cent until the APEC 2010 deadline, combined with removal of the 3 per cent tariff on business inputs under the Tariff Concession System should be identified and considered.

## THE COMMISSION'S ANALYSIS

The Commission's draft recommendations appear to rest heavily on the results of analysis conducted using the MONASH model.

The Australian Industry Group has sought feedback on the Commission's modelling from Professor John Quiggin. His comments are provided in Appendix B. In summary, however, some of the key issues identified by Professor Quiggin's are as follows:

- the Commission's modelling assumptions and interpretation of model results display an in-built bias against import competing manufacturing;
- the Commission's results rely on hypothetical and unproven claims that the removal of remaining tariffs will generate a significant rise in manufacturing productivity;
- the Commission disregards terms of trade effects even though its own modelling shows them to be significant; and
- the Commission fails to adequately address its terms of reference in relation to the impact of the floating exchange rate on the competitiveness of Australian industry.

Building on the critique provided by Professor Quiggin, the Australian Industry Group wishes to highlight the following areas of concern arising from the Commission's analysis.

### Analysis of Welfare Effects

There is considerable doubt about the direction and magnitude of the supposed welfare effects arising from the Commission's analysis.

By the Commission's own assessment, even on the basis of the most optimistic assumptions the projected magnitude of any benefits arising from a reduction in general tariffs are "small relative to those estimated … to result from the assistance reductions introduced in the May 1988 Economic Statement" (Draft Report p.35).

Indeed, the Commission's modelling appears to confirm one of the central points made in the Australian Industry Group's original submission, namely that the overall allocative efficiency benefits stemming from an elimination of the general tariff are small and are likely to be outweighed by the associated adjustment costs.

Even if one only controls for the impact of the Commission's assumption about the extent of any induced increase in productivity (the so-called 'cold shower' effect), the estimated gain in GDP is reduced to just 0.02 per cent of GDP by the year 2010. Accordingly, this one assumption acts to magnify the projected benefits of the Commission's preferred recommendation by 400 per cent.

In the absence of this assumption the Commission's modelling would show that the removal of tariffs could have a negative impact on GDP in the short-term.

On the same basis, the Commission's analysis also suggests that even over the longer-term households would be clearly worse off. Excluding the impact of the Commission' s assumptions about induced productivity growth real household consumption is projected to fall by 0.06 per cent, or $210 million, a year by 2010. In the short term, this reduction would be considerably larger.

The Australian Industry Group is concerned that the Commission's analysis of the welfare effects of its preferred option, seem to rest so heavily on a single untested and unproven assumption.

We submit that the Commission should not rely on the modelling results incorporating an assumption about induced productivity effects of the removal of remaining general tariffs.

At the very least, the Commission should present, in its final report, a range estimates of the impact of removal of tariffs on key economic variables, reflecting the level of uncertainty about the true extent of the assumptions used.

**Adjustment Costs**

Moreover, we are concerned that the Commission has also chosen to overlook, ignore or down play much of the evidence presented to it in relation to the potential adjustment costs associated with a unilateral reduction in 5 per cent tariffs.

In particular, the Australian Industry Group presented evidence from responses received in a survey of 550 member companies operating in 11 manufacturing sectors. The results of the survey showed that a clear majority of member companies were opposed to a further unilateral reduction of general tariffs. The vast majority of respondents (81 per cent) indicated that they thought any future lowering of Australian tariffs should be conditional on reciprocal action by our trading partners.

The survey also showed that a majority of companies thought that a unilateral reduction in tariffs would adversely impact upon production, sales and employment.

The Commission has sought to cast doubt on the results of the Australian Industry Group's survey results indicating that "the methodology of, and response rate to, the survey are such that little quantitative significance should be placed on the results" (Draft Report, p. 33).

However, it is apparent that the Commission, for its part, has made no effort to independently verify or make any assessment of the likely adjustment costs associated with its preferred option at the individual firm level. The Commission seems to have completely disregarded the evidence tendered in submissions by a number of individual companies testifying to the potential impact of adjustment costs. To our knowledge the Commission has not approached one member company to discuss, on a confidential basis, current commercial arrangements and the potential impact of tariff removal on production, investment and employment decisions.

The Australian Industry Group regards the Commission's approach to the calculation of adjustment costs, derived using the labour input loss index (LILI) methodology, as completely academic and arbitrary.

The Commission has estimated that labour adjustment costs associated with removal of tariffs under reference would be a net $91 million (based on 1998-99 prices) in the first full year, declining to around $70 million after nine years.

We believe the Commission needs to acknowledge that the use of this methodology will only provide a partial and incomplete estimate of the total adjustment costs arising from removal of tariffs. It does not, for example, take account of the additional costs that will arise from resultant closure/bankruptcy of some businesses.

We also take issue with some of the assumptions underpinning the calculations of the LILI index.

In particular, the Commission has assumed that the average cost per person per year was $29,000 based on estimates of average weekly earnings. This figure appears to be too low. If average weekly earnings for employees in manufacturing were used, an average cost of around $36,000 would be more appropriate.

Assuming the Commission's estimates of the number of person years lost due to tariff adjustment is appropriate, a net labour adjustment cost closer to $110 million a year would appear to be more reasonable.

On this basis, the Commission's estimate of the labour adjustment costs could be understated by at least 20 per cent.

The Australian Industry Group submits that the Commission should present a more complete picture of the adjustment costs associated with the removal of tariffs under reference.

Accordingly, the Commission should review its methodology and assumptions, used to calculate the labour adjustment costs and seek to incorporate an estimate of the impact of capital redundancy and loss of capacity in affected industries.

In addition, we urge the Commission to better inform itself of the particular impact of adjustment costs at an individual firm level.

**Impact of Exchange Rate Uncertainty**

The Commission's terms of reference require that it take into account the impact of the floating exchange rate on the competitiveness of Australian industry.

In its original submission, the Australian Industry Group argued that in an environment where import competing firms face uncertainty associated with fluctuations in the exchange rate or terms of trade, and where markets for financial assets are incomplete or imperfect, tariffs may increase economic welfare.

It was noted that from the viewpoint of a risk-averse import-competing firm, the existence of a tariff can offset some of the risk resulting from the impact of volatility in exchange rates on competitiveness. In effect, the tariff may be said to constitute a buffer against exchange rate uncertainty.

The Commission, in the draft report, responded to this point suggesting that capital markets and risk management techniques already provide a wide range of market instruments and business strategies for firms to manage operating risks.

This response fails to acknowledge the reality that for a vast number of import-competing Australian manufacturers, tailored foreign exchange risk management products simply are not provided by the market. Capital markets, in this sense are incomplete and imperfect.

In the absence of other mechanisms, the Australian Industry Group maintains that the general tariff, at 5 per cent, does offer many firms a small but crucial buffer against the impact of exchange rate uncertainty and volatility.

**Modelling an Import Subsidy**

The Commission has *not* demonstrated that a zero tariff is the optimal result arising from the model and the assumptions that it has adopted in its analysis.

A key point arising from Professor Quiggin's critique is the suggestion that, taken to their logical conclusion the Commission's own modelling results could imply that there would be a larger welfare benefit from the introduction of a negative tariff, or import subsidy.

Professor Quiggin has suggested the Commission should as a 'reality check' model the adjustment from a 5 per cent general tariff to an import subsidy of, say, 20 per cent.

The Australian Industry Group urges the Commission to take up this suggestion and to open the results of this modelling to expert public scrutiny.

## INTERNATIONAL TRADE ISSUES

The terms of reference for this inquiry specifically require that the Commission take into account (among other things):

- recent and prospective progress in regional and international trade liberalisation of interest to Australia; and
- other international economic and trade developments.

The Australia Industry Group is concerned that the Commission has not fully and adequately addressed these considerations and that it will need to take into account more recent developments in finalising its report.

In particular, our concerns centre around Australia's relative international standing as an open and liberal trading nation and the prospects of securing future improvements in market access for Australian firms seeking to export.

As the draft report acknowledges there are probably three main considerations bearing upon a decision to link further domestic reform to developments in other markets, namely:

- the cost to Australia of delaying further reform;
- the potential gains to Australia if other countries can be induced to liberalise faster; and
- the probability that other countries can be so induced by Australia delaying further reform.

Even on the basis of the Commission's analysis (discussed above) the costs of delaying further reduction would be very small. Indeed, the Australian Industry Group submits that there could even be a small net cost.

The Commission's draft report appears to be almost completely silent on the scope for Australian industry to gain from increased market access abroad. This is a deficiency which should be addressed in the interests of a complete and robust analysis in the final report.

The Australian Industry Group contends that the gains of increased market access for Australian industry are potentially quite significant. In our original submission we presented evidence that despite reductions in international tariff rates over the last 15 years, there are still many examples of high tariff peaks on significant products, particularly among our significant trading partners within the Association of South East Asian Nations (ASEAN).

The ASEAN Free Trade Area Agreement (AFTA) is scheduled to come into effect on 1 January 2002. It provides for the phased reduction of import tariffs on manufactures, services and investment to 5 per cent or less by this date. The effective date has been moved a year earlier, being originally set at 2003. While there are later implementation dates for newer entrants to ASEAN (Vietnam - 2006, Burma and Laos - 2008, and Cambodia - 2010) these countries have been given the same amount of time to transition as older ASEAN members.

Under the Common Effective Preferential Tariff Scheme (CEPT), intra-regional tariffs have fallen from an average of 12.8 per cent in 1993 to an average of 4.3 per cent in 2000. It is anticipated they will fall again to 3.4 per cent by the revised deadline of 2002 and to 2.9 per cent by the original deadline of 2003.

By 1 January 2000, 82.5 per cent of products (about 43,683 tariff lines) were on the Inclusion list.

ASEAN, Australian and New Zealand Trade Ministers agreed in October 19999 on the formation of a high level Task Force to examine the feasibility of an ASEAN-CER Free Trade Area. The Task Force is chaired by former Philippines' Prime Minister, Cesar Virata. Australia is represented on the task force by former Deputy Prime Minister, Tim Fischer.

The Task Force held its first meeting in Jakarta in February this year. It was agreed that a study be undertaken of the feasibility of the establishment of a combined Free Trade Area by 2010.

The Australian Industry Group supports efforts to achieve closer integration between CER and AFTA. It is clear that AFTA will be a very powerful regional trade grouping. The advantages of preferential access to these markets are likely to be considerable. In the absence of some regional trade agreement Australian exporters will continue to face significant tariff anomalies, relative to their competitors within AFTA. Examples of some of these tariff anomalies are highlighted in Appendix C. They highlight the extent of potential gains that could be secured by pursuing increased markets access in this context.

The extent to which other countries might be induced to reduce barriers to trade and the influence that remaining Australian tariff rates could have in this process is difficult to gauge. However, ASEAN business leaders in a meeting with CER business leaders, in April this year, questioned the benefits of and AFTA-CER link on the basis that Australia's market was already open to them. If we unilaterally remove the last remaining 5 per cent tariffs the lack of balance in Australia's trade negotiating position will be further exaggerated.

The Commission suggests that further reduction of tariffs would enable Australia to receive 'credit' in forthcoming multilateral trade negotiations and enhance its efforts to bring about future trade liberalisation of benefit to Australian industries. In this regard it seems to have accepted or endorsed the views expressed by the Department of Foreign Affairs and Trade (DFAT) in its submission.

The Australian Industry Group rejects this notion. While, as the Commission says, most multilateral trade negotiations are formally conducted on the basis of bound tariff rates, rather than applied rates, it strains credibility to suggest that other countries would not take into account the extent of the gap which exists between bound and applied rates. Indeed, in a practical sense it is the applied rate which has the most pervasive influence

For most Australian tariff lines the bound rate exceeds the applied rate. It seems improbable that other nations would give Australia 'credit' for further increasing the extent of redundancy already built into many of our bound tariff rates. It is more likely that their estimation of Australia's negotiating strength would be diminished.

Recent statements by the Minister for Trade, Mark Vaile, suggest that DFAT's submission may not be entirely consistent with the policies of the Government of the day. In a media interview during the lead up to the recent APEC Trade Ministers meeting held in Darwin, for example, he was quoted as follows:

> *QUESTION: Minister, one more point on the Productivity Commission's report. Just as a point of principle, does having a 5% tariff going into a negotiating round give you leverage, as is the argument of some of the industry groups? I mean you, as Trade Minister, do you believe that gives you negotiating credibility if you still retain in this case 5%?*
>
> *MARK VAILE: Look, my view on that is — the answer to that is yes. I mean, if you've got a few extra trumps in your hand they're always valuable. ...In some of the circumstances that we end up in terms of some decisions within the WTO, it's very handy from time to time to have more cards to play with rather than less.*

The full significance of these comments only recently became clear with the announcement of the terms of a bilateral settlement, resolving a four year trade dispute with the United States over exports of automotive leather by Howe and Company Pty Ltd.

A key element of the settlement with the United States involved the removal of 30 separate tariff items on a range of products not manufactured domestically. Had the Commission's draft recommendation already been accepted, Australia's bargaining position would have been clearly weakened, to the potential detriment of the company involved and Australian industry more generally.

State and Territory Ministers attending the annual National Trade Consultations held in Brisbane earlier this month have also indicated their support for remaining tariff reductions to be linked to future progress in international trade negotiations. The joint statement issued after the meeting says:

> *"In noting the recommendations in the draft Productivity Commission report for the unilateral removal of the remaining general tariff, State and Territory Ministers urged that any reductions only be undertaken within the framework of ongoing multilateral trade negotiations which provide improved market access".*

The Australian Industry Group submits that there are substantial grounds to link any future reduction in general tariffs to improved access to overseas markets for Australian exporters. Such a policy can be justified on the following grounds:

- there is no real economic benefit to be gained from further unilateral reduction in Australia's 5 per cent general tariffs.
- there are clear benefits to be gained through increased access to overseas markets, not only on a multilateral basis, but also through regional and bilateral agreements.
- Australia should seek to use remaining tariffs as leverage in the process of international trade negotiations. It is likely that other countries largely discount the existing gap between bound tariff rates and applied rates. Thus, further unilateral reduction of applied rates would, likely, undermine Australia's negotiating position.

## APPENDIX A

# MEDIA RELEASE

### PRODUCTIVITY COMMISSION'S TARIFF RECOMMENDATIONS UNWELCOME

Statement by: Bob Herbert, Chief Executive

The Productivity Commission's stated 'preference' in its Draft Report released today, that general tariffs of 5 per cent be removed from 1 July 2001 is opposed by the Australian Industry Group.

The Group reiterates its position put to the Commission that there is no scope for an immediate reduction in the general tariff from 5 per cent to zero.

The benefits of such a move simply do not outweigh the costs in terms of lost production, lost jobs and lost investment.

Independent analysis undertaken on behalf of the Australian Industry Group shows that the benefits of the Commission's proposed reduction in tariffs would be worth about $3 per person a year. That's about the price of a chocolate bar.

Offsetting this small benefit are significant costs to the economy.

The results of a survey of members by the Australian Industry Group show that 56 per cent thought a reduction in these tariffs would result in lost employment, 46 per cent said it would reduce investment. The average expected reduction in employment was more than 15 per cent, while for investment it was nearly 26 per cent.

This sort of impact would obviously have very serious consequences for the Australian economy, particularly in regions where previous surveys have found extremely high levels of unease about the impact of lower tariffs.

The first and urgent priority for future reform of tariffs has to be the removal of the 3 per cent duty that was imposed on business inputs imported under the Tariff Concession System. This impost adds to business costs but does nothing to protect Australian industry, because there is no domestic manufacture of these inputs. The Australian Industry Group supports the Productivity Commission's recognition of this fact.

Beyond that, any further reductions in Australia's tariffs should be contingent upon reciprocal and proportionate action by our trading partners.

The Australian Industry Group will be making further strong submissions to the Productivity Commission to amend its recommendations in its final report due to go to the Government in July this year.

**Contacts:**


| | |
|---|---|
| Bob Herbert, Chief Executive | (02) 9466 5566 / 0419 301 764 |
| Leigh Purnell, Executive Director – International | 0418 262 622 |
| Andrew McKellar, Senior Adviser Industry Policy | 0407 616 611 |

**APPENDIX B**

# THE PRODUCTIVITY COMMISSION'S DRAFT REPORT: COMMENT

JOHN QUIGGIN
Professor of Economics
James Cook University

**Key Points**

- The Commission's modelling assumptions and interpretation of model results displays an in-built bias against import-competing manufacturing.
- Nevertheless the modelling confirms the central point in the AIG analysis, namely that the allocative efficiency benefits of eliminating the general tariff would be smaller than the adjustment costs associated with tariff cuts.
- The Commission relies on hypothetical and unproven claims that removing protection will automatically raise productivity
- The Commission disregards terms of trade effects even though its own modelling shows them to be substantial
- The Commission fails to address the point in its terms of reference relating to the uncertainty associated with floating exchange rates
- If taken seriously, the Commission's modelling approach would imply that the best policy is not merely to eliminate tariffs but to subsidise imports substantially.
- The study on which the Commission's assumptions rely notes that its results have no firm theoretical basis and contradict the results of previous studies.

## The Commission's analysis and the AIG submission

The AIG analysis showed that the allocative efficiency benefits of eliminating the general tariff would be smaller than the adjustment costs associated with tariff cuts. The modelling associated with the Draft Report confirms this conclusion. The efficiency benefits of eliminating the tariff are estimated at 0.01 per cent of GDP, while the adjustment costs are estimated at 0.02-0.03 per cent of GDP over the period of analysis. Both results are consistent with the AIG analysis.

The conclusion in the Draft Report that there would nonetheless be a net benefit from eliminating tariffs arises from special features of the Commission's modelling approach which generate an in-built bias against import-competing manufacturing.

This bias arises from two main sources:

(i) a bias in favour of capital-intensive export industries

(ii) the assumption that reductions in assistance to manufacturing will generate costless improvements in productivity.

The bias in favour of capital-intensive industries has been noted on many previous industries. In reporting its modelling the Commission habitually focuses on the impact of policies on gross domestic product, rather than on welfare-relevant measures such as national income or consumption. The result is that policies that subsidise capital-intensive activities such as mining appear beneficial, since they result in increased investment and output financed by overseas borrowing. The correct approach would be to net out the cost of servicing foreign-owned capital. Even when the Commission attempts this, the bias towards capital-intensive industries is maintained because it is assumed that foreign investors care only about pre-tax returns to investment. Hence, an increase in the supply of foreign-owned capital is assumed to generate additional tax revenue and a net welfare increase for Australians.

The assumption that tariff cuts will generate increased productivity is crucial to the Commission's conclusions. As is shown in the Supplement to the Draft Report, Table 1.1. dropping this assumption reverses the main conclusions. Without the assumed productivity growth, reducing tariffs would lead to a reduction, rather than an increase in real household consumption (the only variable relevant to economic welfare that it is reported). The growth in GDP would fall to 0.02 per cent, less than the estimated adjustment costs.

The productivity assumption was criticised by several participants at the Modelling Workshop held by the Commission. Among the points raised were:

- The productivity gains are assumed to represent 'cold shower' effects arising from reduced effective assistance but there are no offsetting 'warm sun' effects for industries that receive higher effective assistance as a result of the tariff changes, including TCF, agriculture and mining.
- The assumed productivity gains are based on an industry-wide average derived from a previous Commission study, but that study found the largest productivity effects in the TCF sector, which is excluded from the present case.
- It is assumed that benefits arising when protection is reduced from high levels can be extrapolated in a linear fashion and applied to a reduction from 5 per cent to zero.

A number of these points are mentioned in the Draft Report. One point, made at the Modelling Workshop, but ignored in the Draft Report is that a 'reality check' could be undertaken by modelling the introduction of a negative tariff, that is, an import subsidy at a rate of, say, 20 per cent. Because of the linearity assumption, it is clear that the Commission's approach to modelling would show such a policy to be beneficial.

**The Chand study**

As noted above, the Commission's assumption that reducing tariffs will increase productivity is based in empirical estimates made by Commission staff and published as Chand (1999). Publication in a refereed journal, such as the *Economic Record,* is important in raising confidence in the quality of work reported in an article. However, it is equally important to note that the Chand article contains a number of points which would certainly be insisted on by qualified referees, but which are not referred to in the Draft Report. Publication of empirical work in a refereed journal requires reference to the theoretical basis of the work being undertaken and to previous empirical work on the same topic. Chand (1999) notes that:[1]

- There is no theoretical basis for an assumption that reductions in protection will lead to improvements in productivity.
- Previous empirical work has yielded no conclusive result.

Neither of these important points is referred to in the Draft Report, although both were made in the AIG submission.

The refereeing process guarantees certain quality standards, but does not guarantee the absence of error. Most importantly, Chand (1999), failed to take account of selection bias. Apparent productivity improvements probably reflect the fact that the weakest firms have been forced out of the industry.

The explanatory variable used in the Chand study is the effective rate of assistance. As noted in the Draft Report Table 4.4, p. 58, the removal of the tariffs under reference would produce negative effective rates of assistance for several sectors. Hence, use of the Chand study to model productivity effects is justified only if the results of the study are applicable for both positive and negative effective rates of assistance. Thus, if the Commission has confidence in its modelling, it should be willing to apply the same methods in modelling import subsidies. As argued above, this would probably produce the absurd result that subsidisation of imports of manufactures would be economically beneficial.

## Optimal tariffs

The Draft Report disregards optimal tariff arguments, saying:

> *"The terms of trade effect is of limited practical relevance to tariff policy in Australia. This is because Australia accounts for a small share of most areas of world trade and has little, if any, capacity to influence world prices (especially of its imports). As Caves and Jones (1977) have observed, 'for a small country that cannot influence the world prices of what it buys and sells, the optimal tariff is zero'. Even for products where Australia supplies a significant share of world markets, it is unlikely that the government could obtain a terms of trade gain by imposing, or retaining, tariffs. This is because the industries involved typically have an oligopolistic structure with few exporters. Hence, price responsiveness considerations are an integral part of their overseas marketing operations".*

These arguments are contradicted by the Commission's own modelling which shows substantial terms-of-trade effects. The Appendix suggests that the Commission would have liked to change the parameters of the Monash model to

[1] The theoretical literature does not yield an unambiguous prediction on the direction of change, the onus therefore rests on empirical studies to estabish any such effects ... Empirical studies in turn have failed to show an unambiguous association between trade policy and growth. A number of studies .. have failed to establish an unequivocal positive relationship between trade reforms and productivity growth 9 Chand (1999, p30)

eliminate these effects, but did not have time to do so. This is indicative of a precommitment to the free-trade answer, whether or not it is supported by evidence or analysis.

The claim about oligopolistic structures is not true of wool or coal, which are the most important industries where Australia supplies a significant share of world markets. The discussion also exploits the ambiguity associated with the term 'small'. In ordinary usage Australia has a small share of most world markets, but in the quote from Caves and Jones, the term 'small' is used in a technical sense that means 'infinitesimally small'.

**Uncertainty, exchange rates and tariffs**

The Commission fails to address this important element of its terms of reference. The section of the Draft Report on floating exchange rates makes the correct observation that variations in exchange rates have a substantial impact on competitiveness, but contains no discussion of the implications of this uncertainty for the setting of tariffs. The Draft Report makes no response to the points raised by the AIG submission on this point. A substantial body of peer-reviewed literature is dismissed as 'a theoretical point'. The Commission prefers instead to rely on a 'suggestion' made in a single non-refereed publication. Again, the prejudgement of issues is evident.

# APPENDIX C

## ASEAN FREE TRADE AGREEMENT (AFTA) TARIFF VARIATIONS

**Top Twenty Indonesian Imports of Australian Goods facing over 5% Tariffs.**

| HS Code | Avg. Trade Value (A$000) | Trade Weighted Ad Valorem + | AFTA CEPT Tariff # | Tariff Line |
|---|---|---|---|---|
| 7606.12 | 27345.8 | 12.5% | 5% | Aluminium plates, sheets & strips; thickness exd 0.2mm, rectangular (inc. squared), alloyed. |
| 7308.9 | 14777.6 | 12.5% | 3%* | Other structures (exc headno.9406)& parts-iron/steel of corrugat. Sheets, plates; hoop & strip, whether or not of plate. |
| 4707.3 | 10421.4 | 10% | 0%* | Over-issued newspapers. |
| 7210.12 | 9902.6 | 15% | 3%* | Flat-rolled pdt of iron/non-alloy steel, plated with tin of a thickness of <0.5mm ctg by wt >0.6% of C. |
| 3902.1 | 9224.8 | 15% | 1%* | Polypropylene in the form of dispersion. |
| 8708.99 | 8387.8 | 25% | 10% | Crown wheels & pinions for tractors |
| 8703.33 | 5918.8 | 152.5% | 0%* | Ambulance, with compression engine of acyl capacity exd 2500cc |
| 7308.1 | 5395.8 | 15% | 3%* | Bridges and bridge-sections |
| 8544.6 | 5265.2 | 15% | 3%* | Power transfer wire, cablebars, strip etc. nat. or syn. Rubber insulated for a voltage exd. |
| 3302.1 | 4958 | 87.5% | 1.5%* | Compound alcoholic preparations. |
| 8544.59 | 4610.2 | 15% | 3%* | Other telephone and telegraph cables for submarine |
| 7326.9 | 4457.4 | 10% | 3%* | Parts for goods falling under sub-heading nos: 7310101000.731021100 & 731029100. |
| 3824.9 | 4410.4 | 10% | 3%* | Copying pastes with a basis of gelatine. |
| 8530.8 | 4113.8 | 6.25% | 0%* | Other equip. for railways/tramways |
| 8544.2 | 4086.6 | 15% | 3%* | co-axial and other co-axial electric conductors, nat or syn rubber, insulated |
| 8504.34 | 4070.2 | 10% | 3%* | Matching transformers achieving a power capacity exd 500 kva. |
| 8517.5 | 3886 | 10% | 0%* | ELE telephone sets |
| 7210.9 | 3859.4 | 15% | 3%* | Universal plates of iron/non-alloy steel of o/t painted, varnished or plastic coated ctg by wt >0.6% |
| 8704.1 | 3610.2 | 22.50% | 5%* | Dumpers designed for off-hwy use, ckd. |
| 3902.3 | 3577.4 | 6.25% | 3%* | Propylene copolymers in primary forms |

+ An Ad Valorem tax is expressed as a proportion of price
*AFTA Common Effective Preferential Tariff (CEPT) schedule shows MFN rate as equal to CEPT rate.
# Not trade weighted.

**Top Twenty Malaysian Imports of Australian Goods facing over 5% Tariffs.**

| HS Code | Avg. Trade Value (A$000) | Trade Weighted Ad Valorem + | AFTA CEPT Tariff # | Tariff Line |
|---|---|---|---|---|
| 8901.1 | 21313.33 | 8.33% | 10% - 20% | Cruise ships, excursion boats & sim vessels for transport of persons, >255 gross tonnage |
| 805.1 | 21288.67 | 10% | 3%* | Oranges, fresh. |
| 7208.9 | 15244.67 | 12.5% | 10% | Other uni. plates, not in coils of iron/non-all steel, hot rolled, ctg by wt >0.6% of carb. |
| 7606.12 | 14146.67 | 30% | 2.5% | Aluminium plates, sheets & strip; thickness exd 0.2mm, rect. (inc sqr), alloyed |
| 8703.23 | 11255.67 | 92.67% | 0%-20% | Ambulances. |
| 808.1 | 9021.67 | 10% | 3%* | Apples, fresh. |
| 806.1 | 8919 | 10% | 3%* | Grapes, fresh. |
| 3206.11 | 7398.67 | 15% | 3%* | Pigments & prep based on titanium dioxide. |
| 7216.1 | 7276.67 | 20% | 5% | U, I or H sections of iron/non-alloy steel, hot-rolled or extruded of a height <80mm & a thickness of <5 |
| 7210.49 | 7023.33 | 8.33% | 10% | Other uni. plates of iron/non-alloy steel o/w plated with zinc of o/t corrug., ctg by wt >0.6% |
| 7209.18 | 6732.33 | 8.33% | 10% | Coiled flat-rolled PDT in coils of iron/non-alloy steel |
| 406.3 | 6461.33 | 10% | 3%* | Processed cheese not grated or powdered. |
| 808.2 | 5813.33 | 10% | 3%* | Pears & Quinces, fresh |
| 4805.1 | 4459.67 | 15% | 3%* | semi-chemical fluting paper (corrugating medium) |
| 7210.7 | 4302.33 | 8.33% | 10% | Uni. plates iron/non-alloy steel painted, varn. or plas. coated, ctg by wt. >0.6% of car. |
| 7210.9 | 3999.33 | 8.33% | 10% | Uni. plates of iron/non-alloy steel, painted, varn. or plastic coated, ctg by wt. >0.6% of O. |
| 7210.61 | 3946.67 | 8.33% | 10% | Other uni. plates of iron/non-alloy steel o/w plated with zinc of o/t corrug, ctg by wt >0.6% carbon. |
| 8481.9 | 3726 | 13.75% | 10% - 20% | Hous. for sluice of gate valves of id exd 5 cm but n.e. 40 cm |
| 7308.9 | 3676 | 23.33% | 10% | Other structures (exc head no 9406) & parts-iron/steel of corr. Sheet, plate: hoop & strip, whether or not pl. |
| 8708.99 | 3636.33 | 17.2% | 2.5% - 15% | Crown wheels & pinions for tractors. |

+ An Ad Valorem tax is expressed as a proportion of price
# Not trade weighted
*AFTA Common Effective Preferential Tariff (CEPT) schedule shows MFN rate as equal to CEPT rate.

**Top Twenty Philippine Imports of Australian Goods facing over 5% Tariffs.**

| HS Code | Avg. Trade Value (A$000) | Trade Weighted Ad Val + | AFTA CEPT Tariff # | Tariff Line |
|---|---|---|---|---|
| 2701.12 | 61718.33 | 10% | 0%* | bituminous coal |
| 202.3 | 42172.00 | 20% | 5%* | Bovine animals boneless, frozen |
| 403.9 | 17615.33 | 6.5% | 3%* | Other fermented/acidified milk and cream, flavoured, swt or cont added fruit (incl jam) in hermetically |
| 406.9 | 11488.67 | 10% | 3%* | other cheese |
| 7606.12 | 8654.00 | 6.5% | 25%* | Aluminium plates, sheets & strips; thickness exd 0.2mm, rectangular/square, alloyed |
| 1701.11 | 8337.67 | 57.5% | 0%* | Cane sugar of a polarisation exd 99 deg. |
| 8901.1 | 7347.00 | 6.5% | 7% - 40% | Cruise ships, excursion boat & sim vessels for transport of persons, >255 gross tonnage. |
| 1103.11 | 6372.67 | 12.5% | 0%* | groats and meal of wheat |
| 1806.31 | 6195.00 | 10% | 3%* | chocolate in blocks, slabs or bars filled |
| 1701.99 | 5466.33 | 57.5% | 0%* | Other sugar, not ctg added flavouring or colouring, of a polarisation exd 99.5 deg |
| 713.31 | 5323.00 | 15% | 3%* | beans, shelled, whether or not skinned. |
| 6810.91 | 4870.67 | 15% | 3%* | Prefabricated structural components for building or civil engineering of cement, concrete or of ART ST. |
| 3902.1 | 4609.00 | 15% | 0%* | Polypropylene in the form of dispersion |
| 7408.19 | 3935.67 | 10% | 3%* | Other copper wire or refined copper. |
| 3603 | 3220.33 | 6.5% | 5% | safety fuses, detonating fuses. |
| 6811.2 | 3045.33 | 15% | 3%* | Roofing, facing & partition sheets of asbestos-cement, cellulose fib cement or the like. |
| 4911.99 | 2972.67 | 11.5% | 15% | Partially ptd stationery (inc invitation cards) unused. |
| 3923.9 | 2811.67 | 15% | 3%* | Other ATL for the conveyance or packing of goods, of plastics |
| 1602.5 | 2796.67 | 50% | 20% | Prepd or Presd meat of bovine animals, for infant food, in airtight containers |
| 7213.91 | 2396.33 | 10% | 25% | Bars and rods, hot-rolled, in irregularly wound coils, of iron or non-alloy steel |

+ An Ad Valorem tax is expressed as a proportion of price
# Not trade weighted.
*AFTA Common Effective Preferential Tariff (CEPT) schedule shows MFN rate as equal to CEPT rate.

**Top Twenty Thai Imports of Australian Goods facing over 5% Tariffs.**

| HS Code | Avg. Trade Value (A$000) | Trade Weighted Ad Valorem + | AFTA CEPT Tariff # | Tariff Line |
|---|---|---|---|---|
| 3004.9 | 29812.33 | 6% | 0%* | Veterinary medicaments of mixed or unmixed prod. Of anthelmintic preps. |
| 2609 | 19915 | 10% | 5% | Tin ores and concentrates |
| 3702.54 | 18759.67 | 20% | 5%* | Film of a width ext 16mm but n.e. 35mm & of a length n.e.30m, O/T slides: cinematograph. |
| 7403.11 | 17322 | 6% | 20% | Cathodes sections of cathodes of refined copper. |
| 7606.12 | 12602.33 | 10% | 5%* | Aluminium plates, sheets & strip; thickness exd 0.2mm, rectangular (inc square), alloyed. |
| 8544.7 | 12060 | 40% | 5%* | Optical fibre cable. |
| 8703.23 | 11227 | 46.2% | 3 - 7% | Ambulance, with spk-ign eng, of cyl cap. Exd 1500cc but n.e. 3000cc. |
| 7801.1 | 9305.67 | 10% | 3%* | Refined lead, unwrought |
| 2710 | 8407.33 | 7.33% | 5% | Petroleum Oils, partly refined (inc topped Crudes). |
| 7106.92 | 7852 | 20% | 0%* | Silver semi-MFD |
| 7901.12 | 6375.33 | 10% | 5% | Zinc slugs, unwrought, not alloyed, ctg by wt<99.99% of zinc. |
| 4104.22 | 6119.33 | 7.50% | 0%* | Bovine leather o/t pre-tanned. |
| 1901.1 | 6045 | 15% | 5%* | Prep of flour, meal, starch, whether or not CTGcocoa PDR, by wt <50% for infant use and retail sale. |
| 4907 | 5014 | 15% | 5% - 10%* | Unused postage revenue or sim stamps or current or new issue in the country to which they are destined. |
| 2309.1 | 4981.67 | 10% | 3%* | Prep of a kind used in Dog or Cat food, put up for retail sale. |
| 7210.7 | 4774 | 10% | 5% - 10% | Univ. plates of iron/non-alloy steel, painted, varnished or plastic coated, CTG by wt. >0.6% of car. |
| 3703.2 | 4641 | 20% | 5%* | Other film for colour photography of paper & paperboard. |
| 306.13 | 4175.33 | 60% | 70% | Shrimps and Prawns (frozen). |
| 7901.2 | 4135 | 10% | 5% | Zinc slugs, alloyed. |
| 7407.1 | 3952.67 | 10% | 30%* | Bars and rods of refined copper. |

+ An Ad Valorem tax is expressed as a proportion of price

# Not trade weighted.

*AFTA Common Effective Preferential Tariff (CEPT) schedule shows MFN rate as equal to CEPT rate.