Submission to the Productivity Commission on the Draft Report REVIEW OF AUSTRALIA'S GENERAL TARIFF ARRANGEMENTS

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I strongly support Draft Recommendation 1 of the Draft Report, that the General Tariff rates on goods under reference be reduced to Free sooner rather than later, preferably on 1 July 2001.

The observation of the relationship between economic performance and trade policy in many countries over many years has led me to the view that the gains from reducing General Tariff rates to Free would be larger than suggested by the Commission, and larger than on any 5 percentage point reduction in the tariff on a similarly extensive range of goods along the path that Australia has followed from high to relatively low protection over the past several decades, and especially since the mid-1980s. The processes through which these additional gains are generated are subtle, and not amenable to precise measurement, but they are widely recognised by analysts of the process of economic development.

It is a widely observed reality that the gains to economic output that follow trade liberalisation are well in excess of those predicted by what might be described as static economic models, of the kind used in the Draft Report to estimate the gains from reducing the tariff rate on the goods under reference to Free. This is not to criticise the models: they do very well what they profess to do, that is , to estimate the changes in the value of economic output deriving from a reallocation of resources from some activities to others as a result of tariff changes. Neither is it to belittle the value of the gains from the resource reallocation indicated by the models: close to half a billion dollars per annum of additional output should not be thrown away without good reason.

Rather, there are additional gains that in their nature cannot be incorporated into quantitative economic models in a convincing way in the current state of art.

By way of illustration of the general point, the improvement in Australian economic performance during the period of trade liberalisation since the mid-1990s exceeds that predicted by the advocates of trade liberalisation. The 1990s is the first decade since the Australian Federation when average growth in productivity and output per person has been well above the average for developed countries, and by a wide margin the only period when the Australian economy has been performing at the top level of developed countries. Much has been made of the exceptional sustained economic growth of the United States, absolutely and relative to other OECD countries since the recession of 1990-91. Australia has outperformed the United States on these measures over this period . Real GDP increased by an average of 3.04 percent in the United States and 3.96 in Australia over the period 1991-2000; GDP per capita by 2.00 and 2.77 percent respectively. While the improvement of Australian economic performance in recent times has many proximate causes, to a significant extent the other proximate cases have been driven by Australian economic decision-makers at every level in society realising that they are operating in an international market, and that world class performance is necessary for success in this environment. The move towards free trade has been crucial to this transformation of perceptions.

The removal of the last remaining tariffs on the goods under reference would further strengthen the perception that world class performance was necessary for economic success in Australia, amongst other things by strengthening the perceptions that the protection policy changes of recent decades were irreversible.

Much of the expansion of world trade over recent years has involved fine specialisation and intra-industry trade , with components crossing borders many times prior to assembly in an internationally competitive location and supply to global markets. There has been an explosion of such trade wherever official barriers to trade have been completely removed for a relevant range of economic activities. Prime examples can be seen between Mexico and the United States and Canada and the United States since the North American Free Trade Agreement, between mainland China and Hong Kong since the Chinese authorities removed by administrative discretion (in itself an undesirable process) many of the barriers to intra-industry trade across the border, and across many of the European borders. Here the specialisation is too fine to be easily predicted by analysis based on standard industry classifications. Where it has occurred, such developments have given strong impetus to the competitiveness in open international markets of components as well as final products from countries participating in the process of fine specialisation. Even low tariffs are a deterrent to developments of this kind. A low tariff involves transactions and compliance costs which are difficult to measure, but substantial, and as large as for a high tariff. A low tariff also deters fine specialisation in intense, low-margin trade through the perception that it develops that international is more difficult and costly than domestic trade.

Australia is at a disadvantage in many of these areas of trade as a result of its small size and isolation from the world's main centres of economic activity, and a low tariff is a substantial additional deterrent to the fine specialisation that might otherwise occur with countries in East Asia. Here it should be added that the "double import tax" on goods subject to the tariff since the introduction of the GST, with the two "taxes" being applied on different tax bases through different administrative structures compounds the problem. The removal of the General Tariff would reduce the transactions costs of trade. One measure of its relative disadvantage is that despite the liberalisation of trade in recent times, the trade intensity of Australian production , adjusted for economic size, remains far lower than the average for developed countries , and is roughly as far below the regression line relating trade intensity of GDP to economic size as it was 3 decades ago.

I note the various points that were made in submissions to the Commission about the effects of unilateral liberalisation on other countries' protection decisions. I would like to underline the point that negotiations in a WTO context are about "bindings" and not levels of tariffs, so that no formal bargaining coin is given away by reductions in tariffs that are actually applied. More importantly, the main gains from liberalisation accrue to the liberalising country, whether it is Australia or another. The main game in international trade diplomacy is the encouragement of other countries to apply trade policies consistently with their own interests. I have no doubt that in the current state of Asia Pacific and global discussion of trade negotiations, that , to the extent that Australia is influential at all (and it has some influence in the Western Pacific ), it would be more likely to influence the decisions of others favourably by demonstrating its confidence that earlier Australian trade liberalisation had been in the national interest, by continuing the process of unilateral liberalisation.