

REVIEW OF AUSTRALIA'S GENERAL TARIFF ARRANGEMENTS

AN ANALYSIS OF TARIFF PROTECTION FOR HENSELITE PTY LTD

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An Analysis of Tariff Protection for Henselite Pty Ltd

Executive Summary

The Productivity Commission is currently reviewing submissions for its inquiry into general tariff arrangements in Australia. This report examines one such submission provided by the Melbourne-based bowls manufacturing company Henselite.

The Managing Director of Henselite Bruce Hensell argues that the 3% duty on imported raw materials should be abolished, and that the 5% tariff on imported competing bowls should be maintained. The author agrees with the former argument, but counters the second on the basis of overall loss of Australian consumer surplus. The report analyses the strengths and weaknesses of the Henselite position, and moves on to explore an economist's perspective of general tariff protection for the bowls manufacturing industry. The author ultimately recommends embracing free trade and abolishing both the 5% tariff on imported bowls and the 3% duty on imported raw materials in order to maximise the overall gain to the Australian economy.

Background of Henselite

Henselite is an Australian-owned lawn bowls manufacturer which started in 1930. It is a fourth generation family business employing forty-five personnel. The industry itself contains just three companies manufacturing bowls globally – one in Australia and two in the UK. Henselite enjoys a market share of 70%, and although Australia represents 50% of the global market, the company exports 60% of its bowls.

Until 1998, all factors of production were sourced within Australia. Since then, however, Henselite has been forced to source its raw materials from the sole global supplier in England. These inputs now add cost to the bowls through freight and the 3% duty on imports. Bruce Hensell claims these extra costs are making it harder to compete against UK imports, and are the main reason behind decreasing exports and market share.

The Henselite Argument for Protection

The costs of freight and duty on raw materials put Henselite at a purchasing price disadvantage compared to its competition. To offset this disadvantage, Bruce Hensell argues for protection through the abolition of the 3% duty on imported raw materials and a continuation of the 5% tariff on competing bowls. He uses the following rationale:

To protect Australian industry and jobs:

The Australian Government has imposed tariffs since Federation to protect domestic industries from foreign competition. Since 1998 however, there has been no local industry producing raw materials for bowls manufacture. Henselite is therefore paying a premium price for raw materials which only benefits Henselite's overseas competitors who pay no duty because they source locally in the UK. This defeats the purpose of tariff protection, so the 3% duty should be abolished. Indeed, if it remains and the 5% tariff on imported competing bowls is continued, it may become uneconomical to continue manufacturing in Australia and Henselite may have to shift its production facilities to Scotland, putting 45 Australians out of work¹

An Economist's Response:

The essence of Bruce Hensell's argument regarding the 3% duty is correct. The only party to benefit is the Australian Government through duty revenues. Henselite loses through fewer domestic and international sales at its higher prices, Australian consumers lose by paying higher prices, and there are no local raw materials producers gaining the greater sales we would expect when they compete with expensive imported factors of production. The 3% duty should indeed be abolished.

¹ Page 25 *Productivity Commission Inquiry into General Tariff Arrangements*; Transcript of Proceedings, Melbourne 19/1/00 (refer to appendix for relevant transcript)

His argument for continuation of the 5% tariff on imported competing bowls is less compelling. He has legitimate concerns for the welfare of his employees if the company was to relocate, but this only represents one side of the argument. The other factor to consider is that the net gains to Australian consumers from lower prices (calculated by the increase in consumer surplus) more than offsets the overall costs to the forty-five employees. Even when the gains from tariff revenue are included, a net deadweight loss remains. This is caused by the extra cost of purchasing locally made bowls instead of imports, and from the loss in consumer surplus that would otherwise have been consumed at the cheaper imported price. The number of consumers who gain from tariff reduction will be enormous compared to the losing employees, but the gain per person will be quite small. And although smaller overall, the loss for each Henselite employee would be large. This redistribution of wealth will impose considerable social costs through unemployment and retraining, so welfare remains an important policy, but the argument for continuation of the 5% tariff on the basis of job retention is flawed. Therefore, the 5% tariff should also be abolished.

To increase competitiveness because of high labour rates:

Bruce argues that it is partly Australia's high labour rates that contribute significantly to costs in bowls manufacturing. For this reason the government should support local industry through tariff protection².

An Economist's Response:

Australia has high labour rates because, on average, our labour productivity is high. It is certainly higher in some sectors (such as high technology) than others (such as textiles). The former sectors are those in which we have a comparative advantage to our trading partners. By engaging in free trade in these areas of relative expertise, we increase the production of goods where we have an advantage, and increase imports of goods in which our trading partners have an advantage. The result will make both our trading partners and ourselves better off than we would be by persisting in protecting low-productivity industries.

Continued tariff protection would maintain a higher price of imported bowls and allow Henselite to better compete locally. This would address Bruce's concern about high labour rates, but local consumers would bear the cost, and as explained in the previous paragraph, the Australian economy would suffer a net loss. Furthermore, continuing the 5% tariff will not help Henselite compete overseas.

An Economist's Analysis of Protection

Legitimate Arguments for Protection

In general, there are two legitimate arguments for protection of an industry:

To take advantages of economies of scale

Strategic trade policy suggests that if economies of scale are sufficiently large, then there may be room for only one profitable player in an industry. Australia could then raise its GDP at the expense of a competing importing country. This may be a legitimate argument for the bowls industry, particularly because there is a large domestic market, and if tariffs deter foreign companies from competing, then Henselite would capture the excess returns.

The problem with this argument with respect to the bowls industry is that it currently supports three firms profitably. It is therefore likely that if tariffs successfully deterred foreign competition, new local companies would enter the industry. Then through competition, monopoly profits would be competed away rather than securing excess returns for Henselite. Australia would eventually find itself in the familiar situation of protecting an inefficient local industry with all the costs to consumers that that entails.

In the future, however, this situation may change. As Bruce Hensell alluded to in the transcript of proceedings³, the total bowls market is in decline, and it may eventuate that the market indeed supports only one company profitably. He would then have good reason to request tariff protection, particularly

² Page 24 Ibid.

³ Page 23 Ibid.

during the period of market rationalisation and the result would benefit both Henselite and the Australian consumer.

To take advantage of external economies

In an industry as technical and specialised as bowls manufacturing, there may be a case for support if external economies arise from a spill over of knowledge between firms and industries. Henselite may be unable to fully utilise all the innovative knowledge it creates about plastics manufacturing. If this extra knowledge could be harnessed, there may be a legitimate argument for protection, particularly in Australia where a vibrant plastics industry exists.

But again a problem arises when we try to quantify the gains from the spill over of knowledge. These gains need to offset the loss of consumer surplus caused by protection, but they are elusive and difficult to calculate. Further, protecting the bowls manufacturing industry will mean drawing resources from other high-technology sectors which may provide even more external benefits.

Flawed Arguments for Protection

There are many flawed arguments for protection, and this essay has already discounted the arguments of local job protection and high labour rates. Other flawed arguments are

To raise government revenues

It is true that tariffs increase revenues to governments, but they do so at a deadweight cost of loss in consumer surplus. This can be minimised (but not eliminated) by imposing tariffs on those goods with some element of elasticity of supply. This will cause the overseas producers to absorb some of the tariff in their profit margin.

To protect new industries

This argument is similar to the external-economies case covered earlier, and is valid only if enough benefits spill over into other industries to offset the loss in consumer surplus caused by tariffs. If the benefits are only realised by the protected industry, they set their price/quantity levels based on unrealistic and inefficient market conditions (by global standards). But even if external economies did exist, it is more efficient to grant the new industry a subsidy than a tariff to ensure it operates at efficient levels. This simultaneously allows consumers to continue facing world market prices.

To limit dumping

When a company wants to gain a global monopoly, it may dump product into foreign markets at prices that put local producers out of business. The monopolist then raises its prices and gains the excess returns. Tariff protection may seem a logical solution to this, but again the consumer loses. A better technique is to combat dumping through the application of international competition policy.

To combat poor environmental standards

There is no question it is difficult to compete against countries whose lax environmental policies result in cheaper products. But again, tariffs simply diminish our consumer surplus, and the Australian economy suffers a net loss. It is better to trade with these countries on the grounds that as their income increases, so too does their demand for higher environmental standards. Providing them higher incomes will allow them to implement their environmentally friendly policies.

To restrict exploitation

Many multinational corporations take advantage of the lower labour rates of some economies to compete on the world market. If this was restricted, the poor economies would remain poor. By trading with these countries, demand for their labour increases, and so too does their labour rates. Trade is the best way for these countries to improve their opportunities.

Discussion

Bruce Hensell correctly argues for the abolition of the 3% duty on imported raw materials. The Australian economy is incurring a significant loss while it continues. But contrary to the Henselite position on the tariff, legitimate reasons for continued protection do not apply, and 5% tariff should also go. There appears to be few external economies available to other industries, and while the industry profitably supports more than one manufacturer, there is no argument to recommend a strategic trade policy based on economies of scale. Indeed, even if the bowls industry declined to this level, a strategic trade policy aimed at capturing excess returns for Australian firms would likely provoke some form of retaliatory behaviour. The Australian government would need to examine their commitments made to the World Trade Organisation (WTO) to ensure these are not contravened. In

most cases, a trade war between two interventionist governments will leave both worse off than had they chosen a hands-off approach.

Conclusion & Recommendations

An analysis of the Henselite protection case shows it is in the best interests of the Australian economy and consumer to abolish all tariffs and duties associated with the bowls manufacturing industry. Henselite is likely to lose overall through the abolition of both tariffs, and should monitor the industry decline with a view to requesting government assistance if a potential monopoly situation arises. This help should only be granted if it does not contravene WTO commitments.

On balance it appears the best outcome for Australia is to abolish both the 5% tariff on imported bowls and the 3% duty on imported raw materials to provide our economy and consumer with all the benefits that free trade provides.

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