ECONOMICS

The Effects of Protection of the Domestic and Global Economy

Local industries and firms receiving protection gain in the short term because they are able to raise prices, increase output and maintain or increase their market share.

The macroeconomic effects of protection are felt in the medium to long term as the effective rate of assistance (i.e. the percentage of local value added given in protection) impacts on resource allocation and income distribution.

The major macroeconomic effects of protection on a domestic economy are negative.

For example, in Australia resources are misallocated because they are directed away from efficient and competitive industries such as agriculture and mining and into inefficient and uncompetitive industries such as passenger motor vehicles (PMV) and textiles, clothing and footwear (TCF).

Employment and production grow in inefficient industries that are supplying only the domestic market, and not exporting to the global market.

Capital resources are also wasted, and the returns to all the factors of production will necessarily be lower than they would be if they were allocated to their most efficient uses in the economy.

Inflation may result from the distorting effect of tariffs on import prices, which can be passed into the domestic cost and price structure.

This may lead to additional wage demands by employees to maintain their real wages.

Those industries using the outputs of protected industries as inputs in their production process (such as imported capital and intermediate goods) will pay a higher price for these goods because of tariffs.

Efficient export industries such as mining and agriculture are penalised by paying higher prices for capital equipment, and since they cannot pass on these costs in world markets as they are 'price takers', their competitiveness may be reduced.

This effect is known as negative protection.

Economic growth is retarded by protection because resources are not being used efficiently in protected industries.

Capital and labour may not be utilised intensively, if output is geared only to the small domestic market in Australia, where it is difficult to reap economies of scale in production.

Export earnings are lower than optimal since protected industries tend not to seek overseas markets because they may be inward looking and abnormally risk averse. Coupled with this is the lack of competitiveness with imports despite protection. Import spending in Australia is highly income elastic and growth in domestic income leads to 'import binges' which have created a large current account deficit. Australia's export growth and share of world trade have therefore been impeded by protection.

The microeconomic effects of protection tend to be negative on the performance of protected industries.

The Australian car and textile industries for example, engaged in ‘rent seeking’ behaviour where resources were devoted to the unproductive activity of lobbying the Australian government for the maintenance (or increase) in existing levels of protection.

Rather than these resources being used to boost efficiency, exports and profitability, many protected firms continued to spend funds on political lobbying.

The management and labour forces in protected industries used outdated work practices and had low levels of productivity.

Furthermore, the willingness of protected industries to innovate by adopting the latest cost reducing technology was minimal, because they were not exposed to the competitive forces of the international market place.

The culture of protection bred an inefficient and inward looking Australian manufacturing industry not willing to adapt to changes in consumer preferences and technology.

For example, Australia, like other Cairns Group countries, is an efficient wheat producer, not reliant on wheat subsidies to be internationally competitive, unlike US and EU wheat farmers.

World trade, particularly trade in agricultural commodities (such as wheat, dairy and sugar) has been retarded because of the proliferation in non-tariff barriers (NTBs), especially the use of farm and export subsidies in the EU, USA, Japan and Korea. Agricultural subsidies reduce Australia’s net farm export income by depressing world agricultural prices and denying market access to Australian farm exports.

The use of export subsidies by the EU and USA lowers the price of their agricultural exports and therefore depresses world prices and denies market access to more efficient producers like Australia and the Cairns Group.

The Uruguay Round of GATT negotiations was held between 1986 and 1994 and resulted in an agreement by the EU and the US to cut their agricultural subsidies by up to 36%.

The Doha Round of WTO trade talks in 2001 built on this, with one of the main agenda items supported by the Cairns Group and developing countries, being further reductions or even the total elimination of agricultural subsidies in the EU and USA.

However the Doha Round has not been concluded to date.

The Australian Department of Foreign Affairs and Trade (DFAT) noted in 2003 that despite fifty years of trade reforms, remaining global trade barriers still impose considerable costs on both developing and advanced economies.

International trade barriers hinder developing economies from specialising in production and exporting products they produce most competitively, and from reaping the maximum gains from free trade.

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The trade policies of advanced economies like those of the EU, the United States, South Korea and Japan finance huge agricultural production and export subsidy schemes that depress world agricultural prices by an estimated 12% (US Department of Agriculture, 2001).

These subsidies significantly undermine the agricultural export income of developing countries.

Developing countries' trade policies also damage each other through the use of protection. Even though their markets are smaller, developing countries on average impose up to three times higher trade barriers than advanced economies.

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The OECD (2001) has estimated that agricultural policies in OECD economies cost consumers and taxpayers around US$300b every year.

The removal of agricultural protection would generate US$111b per year in additional welfare for advanced economies, due to consumers being able to buy lower cost agricultural products and increasing their spending on other products.

Most rich countries apply higher tariffs to agricultural goods and simple manufactures (e.g. textiles), which are the type of goods that developing countries can produce and export cheaply to world markets.

In agriculture the tariffs of OECD countries are heavily biased against low priced farm products produced by developing countries.

Tariffs against developing country manufactures also remain high. In the 1990s the average OECD tariff on manufactured goods from the developing world was 3.5%, more than four times the average of 0.8% on OECD manufactures.

Whilst there have been tariff reductions in agriculture, textiles, metals and chemicals since the Uruguay Round, there remains greater scope for tariff reductions in the EU and the United States for agricultural goods.

This also applies to reductions in quotas and export subsidies for agricultural goods in these countries.

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Furthermore the World Bank (2002) has suggested that advanced economies would gain even more than developing economies from reducing their own trade barriers.