

A CASE FOR REMOVAL OF TARIFF PROTECTION

R.L. St Hill

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PREFACE

In this Discussion Paper a case in favour of abolition of import protection for New Zealand industries is presented. The paper was originally written as a consultant's report for Federated Farmers of New Zealand during October 1987.

The main arguments in favour of abolition of protection that are considered include: increased efficiency of resource use that produces once-and-for-all or static increases in Gross Domestic Product and higher economic growth or dynamic increases in Gross Domestic Product; removal of an implicit and perverse subsidy to the main metropolitan areas; removal of an implicit and perverse tax on regional New Zealand; and removal of an implicit regressive tax on low income households.

Some insights into the future of New Zealand as a less protected economy are also provided.

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SUMMARY

This paper is a response to the Tariff Working Party Report to the Minister of Trade and Industry, 1987. Objectives of the paper are to: expand the case for removing import protection; provide some insight into the future of New Zealand as a less protected economy; and emphasise the importance of interpreting the removal of protection in the context of an integrated policy package.

A number of arguments about static effects of import protection are discussed, namely comparative advantage, costs of lobbying and costs of economic slack. The dynamic inefficiency argument is also discussed.

It is shown that removal of protection would have greatly assisted low income households by making the prices of goods that they buy (or would like to buy) cheaper, thereby removing an implicit regressive tax. This would happen without an accompanying long term increase in unemployment.

Some evidence on the perverse nature of import protection as an implicit subsidy paid to the major metropolitan areas and an implicit tax paid by regional areas is presented. It is suggested that removal of protection would be a very positive form of regional assistance.

It is noted that removal of import protection is best implemented as part of a package of policies designed to improve flexibility and efficiency throughout the economy and to maintain a low real exchange rate during the transition period.

The conclusion is that New Zealand's future economic welfare is most likely to be higher without import protection. Complete removal of protection over a period of about five years is recommended.

SECTION 1

INTRODUCTION

This discussion Paper is a response to the Tariff Working Party Report to the Minister of Trade and Industry, 1987. Objectives of the paper are to:

- (i) expand the case for removing import protection;
- (ii) provide some insight into the future of New Zealand as a less protected economy; and
- (iii) emphasise the importance of interpreting the removal of protection in the context of an integrated policy package.

The paper concludes that New Zealand's future economic welfare is most likely to be higher without import protection. Complete removal of import protection over a period of about five years is recommended.

SECTION 2

ADDITIONAL ARGUMENTS FOR DISMANTLING IMPORT PROTECTION

2.1 Background

Chapter 4 of the Working Party Report sets out the case for dismantling protection largely in terms of the comparative advantage argument for free trade. Essentially this argument states that a country should aim at using its resources in such a way as to maximise its total output. To ensure that the right mixture of goods and services is available for consumption, output not required for domestic consumption should be swapped on the international market for goods and services that are required for domestic consumption but are not domestically produced. Under comparative advantage, the test for efficiency is not whether a tonne of product EX can be produced using fewer resources in New Zealand than overseas but whether or not, within New Zealand, a tonne of product EX can be produced using fewer resources than a tonne of product ZED.

Despite the strong intuitive appeal of comparative advantage some empirical research suggests that the comparative advantage gains from removing import protection are quite small. This much is alluded to in Chapter 4 of the Report. In a recent review of research on trade regimes it was found that the comparative advantage effect of removal of import protection seldom increases consumption by more than a few percent (see Lal and Rajapatirana, 1987). New Zealand research confirms this result (see Philpott, 1985 and Pickford, 1987). It might be tempting, therefore, to concede the theoretical point but dismiss free trade as offering very little gain in practice.

Although comparative advantage alone might not offer large gains in consumption there are other arguments for removal of assistance that should be recognised. These include costs of lobbying, economic slack and dynamic inefficiency. Each of these arguments is considered below.

2.2 Costs of Lobbying

Removal of import protection opens an economy to foreign competition. If some imported products are cheaper than domestically produced equivalents some domestic businesses might collapse. In this situation shareholders and employees lose (but not necessarily for ever) and purchasers of imports gain. It is quite rational, in terms of self-interest, for the potential losers to expend resources in lobbying (or rent-seeking, to use the jargon of economists) against removal of protection. Because there are usually relatively few potential losers who think they stand to lose

a lot and relatively many potential gainers who think they stand to gain a little, individual losers often work strenuously to retain the status quo but individual gainers do very little. (A classic work on this aspect of human behaviour is Olson, 1965.)

Resources expended on lobbying represent a "deadweight" loss to an economy. Resources are wasted because they are used to change the distribution of income rather than increase the size of the nation's income. The deadweight loss is only worth bearing if the redistribution of income is in a socially desirable direction.

A recent study of Turkey (Grais and others, 1984) found that if tariffs, but not quotas, were removed there would be little impact on total output. The study found that, if quotas were also removed, total output would increase by between 5 and 10 percent. The conclusion was that, as long as any form of import protection existed, significant deadweight losses associated with lobbying would be imposed on the economy.

2.3 Economic Slack

An ever present danger in a business that is protected from competition (by import protection or any other means) is that it will gradually develop economic slack. In the economics literature this is referred to as X-inefficiency (see Leibenstein, 1980). X-inefficiency can take a number of forms: common forms are failure to innovate in production and management technologies, "sweetheart" agreements with labour unions and perquisites such as lavish offices and luxury motor vehicles for senior personnel. The inevitable result of X-inefficiency is low productivity.

An important study of the costs of X-inefficiency arising from import protection was undertaken in the early 1970s (see Bergsman, 1974). Results of the study are summarised in Table 1 below. It is noteworthy that, although X-inefficiency costs showed variation among countries they were consistently much higher than the costs of ignoring comparative advantage.

2.4 Static Costs of Import Protection

The costs of protection already discussed are all static in the sense that they affect the size of the economic cake at a point in time rather than growth of the cake over time. Nevertheless, they are important. Even if each of the costs - comparative advantage costs, lobbying costs and costs of economic slack - are individually small, together they represent a sizeable total cost. Therefore complete removal of protection would produce a very worthwhile once-and-for-all increase in the size of the economic cake.

Table 1: Costs of Import Protection in Four Developing Countries

Country	Comparative Advantage Cost* %	X-inefficiency Cost* %	Total Cost* %
Brazil	0.3	6.8	7.1
Mexico	0.3	2.2	2.5
Pakistan	0.5	5.4	5.9
Philippines	1.0	2.6	3.6

* Cost is expressed as a percentage of total output as measured by Gross National Product.

Source: Lal and Rajapatirana (1987)

2.5 Dynamic Inefficiency

Import protection can be a source of cumulative output losses, or dynamic inefficiency, because it reduces competitive pressures in a domestic market. It reduces the incentive to innovate at both production and management levels. In the last decade or so statistical investigation of this question has been very extensive, particularly in developing countries. Most researchers have looked for evidence for or against the proposition that free-trading, or "outwardly-oriented", countries achieve high rates of economic growth on a sustainable basis. The Tariff Review Committee Report outlined results of a recent World Bank study (in Chapter 4) but there have been many others. Two important points have emerged from the research.

First, both import protection and export assistance tend to be associated with relatively low rates of economic growth: higher rates of economic growth are observed when there is neither import protection nor export assistance, that is, when trade policy is neutral.

Second, there is wide variation in rates of economic growth among different countries. This latter point is clearly evident from a recent comprehensive study of export performance and output growth in 70 developing countries (see Goncalves and Richter, 1986) and implies that a country's trade policy is an important but not a singular determinant of economic growth. Other determinants include macroeconomic policy, social policy and political stability.

The issue of dynamic inefficiency has also been investigated by relating the proportion of its manufactured output that a country exports to the degree of its manufacturing protection. There is evidence that, the more protectionist a country is, the smaller the proportion of its manufactured output that is exported (see Olson, 1982 and 1984). In Table 2 some relevant data are set out. It is clear from the table that there is a negative relationship between import protection in manufacturing and export of manufactured goods.

Overall, the evidence on exports and economic growth suggests that a country can significantly enhance its potential for economic growth by adopting a neutral trade policy stance.

Table 2: Manufacturing Protection and Manufactured Exports, 1973.

High Manufacturing Protection		Low Manufacturing Protection	
Country	Percentage of Manufactured Goods Exported	Country	Percentage of Manufactured Goods Exported
Argentina	2.5	Austria	32.5
Australia	7.5	Canada	20.0
Brazil	5.0	Denmark	42.5
Chile	2.5	Finland	27.5
Columbia	7.5	Ireland	37.5
Greece	12.5	South Korea	40.0
India	7.5	Netherlands	45.0
Israel	15.0	Norway	35.0
Mexico	5.0	Portugal	27.5
New Zealand	5.0	Singapore	42.5
Spain	16.0	Sweden	37.5
Turkey	2.5	Taiwan	50.0
Yugoslavia	17.5		

Source: From Olson (1984). Original Source: United Nations

2.6 Some Other Important Considerations

In Chapter 5 of the Working Party Report a number of arguments in favour of import protection were advanced. Clearly the Review Committee was not persuaded by these arguments because it stated in its Report that, "As lower and more uniform tariffs are desirable, a properly managed programme of tariff reform building on earlier decisions to remove import licensing and reduce higher tariffs can be beneficial to the economy" (p. 70, emphasis added). Because some of the arguments in favour of import protection have strong intuitive appeal it is important to point out their weaknesses.

First, the infant industry argument suggests that new industries need temporary protection until, through "learning-by-doing" and achieving economies of scale, they attain their true efficiency level. What this argument implies is that society is so short-sighted or ill-informed that it will not invest in new industries that are efficient in the longer term. If this is true there is a case for temporary protection. The most transparent form of protection under this circumstance would be a per unit production subsidy (bounty) paid for a short and non-extendable period of time. Imposition of a tariff or import licence for an indefinite time would be quite inappropriate.

Second, the balance of payments argument suggests that, in the presence of chronic balance of payments deficits on the current account (goods and services), curbs on imports are necessary. However, it is much too simplistic to assume that balance of payments deficits are caused by "too many imports" because they might also be said to be caused by "too few exports". In truth, both problems arise because the foreign exchange rate is too high. The futility of curbing imports to control the balance of payments is illustrated by New Zealand's own economic history. In 29 out of the last 35 years New Zealand has recorded a balance of payments deficit on the current account despite having import controls of varying intensity during that time.

Third, the terms of trade argument suggests that, if a country has enough economic power to influence world prices, a carefully applied system of import and export taxes can reduce import prices and raise export prices at the border. Under this circumstance a country is like a monopoly that can dictate prices to both suppliers of inputs and consumers of outputs.

Small countries seldom have a large enough share in any world market to be able to exercise much economic power. Furthermore, although New Zealand has a large share of the international market for some pastoral products, it is not clear that this confers much economic power. The rest of the world can easily find substitute suppliers and substitute products in the longer term (for example, synthetic carpet yarn is a substitute for wool; white meat is a substitute for red meat).

A further problem is that the system of import and export taxes can only work if the rest of the world does not retaliate. Because there is a widespread perception that import protection (by other countries) is unfair it is naive to believe that there would be no retaliation, even if it imposed high economic costs on all countries concerned.

Fourth, the fairness argument suggests that domestic industries ought to be protected against "unfair" foreign competition. The main sources of unfair competition are cheap labour and assistance provided to overseas producers. The Working Party Report pointed out that the cheap labour argument is too simplistic because what matters is "the relative cost of all factors of production" (p. 44, their emphasis) and the productivity of labour. Cheap labour only represents unfair competition if labour is cheap for non-economic reasons such as repression of the working classes. Even then it is likely that unimpeded international trade would do much to expose repressive political regimes to world opinion and gradually force them to mend their ways.

Compensating domestic industries for assistance to overseas industries sounds like a commonsense thing to do because it accords with most people's sense of "fair play". However, if a country could permanently import products at a lower price because of assistance to overseas producers, it should not restrict those imports but accept them and rejoice that the rest of the world was silly enough to subsidise its consumption. The smart thing to do would be to quietly accept the subsidy and enjoy the higher standard of living that it made possible.

SECTION 3

THE FUTURE OF NEW ZEALAND AS A LESS PROTECTED ECONOMY

3.1 Background

Three important issues have been raised in debate over economic policy in New Zealand. These are:

- (i) economic growth,
- (ii) distribution of consumption among households, and
- (iii) distribution of production among regions.

The first is addressed in Section 2. In this section the latter two issues are considered in the context of the removal of import protection. The conclusion is that, overall, removal of import protection will have positive effects on distribution.

3.2 Distribution of Consumption Among Households

Although the size of the economic cake matters, another important indicator of economic and social success of a country is distribution of that cake among households. The main determinant of the level of consumption an individual household can achieve is its income. In Table 3 some relevant data for New Zealand in 1985/86 are set out. It is clear from Table 3 that lower income households spent more of their income than higher income households. Now, because many consumption items such as clothing, footwear, textiles and motor vehicles receive import protection, their prices to New Zealand buyers are higher than they otherwise would be. Because lower income households spend more of their income than higher income households, but in roughly the same proportion among items, import protection acts as a regressive tax. What this means is that lower income households pay proportionately more import protection "tax" than do higher income households. This tax has not been directly measured in New Zealand but Hickok (1985) found that import protection is a severely regressive implicit tax in the United States.

Table 3: Household Income and Expenditure, 1985-86

Income Group	Annual Gross Income (1) \$	Average Weekly Expenditure (2) \$	Proportion of Income Spent (3) %
1	39,000 and over	699	61
2	28,000 to 38,999	494	66
3	20,000 to 27,999	388	72
4	12,000 to 19,999	298	78
5	less than 11,999	184	80

Notes:

- (1) Regular income from all sources before income tax
- (2) Average expenditure of households in this income group
- (3) See Appendix I for explanation of this column

Source: Calculated from data in Department of Statistics (1987)

The regressive nature of the import protection tax is further illustrated in Table 4. The table shows distribution of purchases by expenditure sub-group and household income for expenditure sub-groups for which lower income households reported significantly fewer purchases than higher income households in the 1985-86 Household expenditure and Income Survey.

For example, 53.0 per cent of households in income group 1 in the Survey reported making mortgage repayments; only 13.7 per cent of households in income group 5 did. It is a fact that most of the items included in the table are subject to import protection which inflates their prices to domestic buyers (see Syntec Economic Services, 1984, Lattimore, 1985, and Appendix 2 of this paper). Therefore it seems that import protection very adversely affects low income households who have to economise by making fewer purchases. Because there is such a huge disparity between the number of purchases of lower and higher income households, removal of import protection could significantly improve the relative lot of lower income households by reducing prices.

Table 4: Expenditure Sub-Groups for Which Low Income Households Reported Few Purchases, 1985-1986

Expenditure Sub-Group	Income Group				
	1	2	3	4	5
	(Percentage of households reporting expenditure)				
Housing					
- mortgage payments	53.0	49.9	43.8	25.1	13.7
- property maintenance goods	73.2	69.5	62.1	61.3	44.2
Household Operation					
- household equipment and utensils	46.2	40.4	38.5	29.2	19.9
- furniture	46.2	45.3	37.9	30.2	22.3
- furnishings	25.9	19.7	15.9	11.3	8.3
- floor coverings	17.5	13.6	11.6	9.3	3.3
- household textiles	39.9	32.1	31.6	24.3	20.9
Apparel					
- men's clothing	49.7	34.8	29.7	9.7	6.6
- women's clothing	63.6	50.0	45.0	36.5	32.3
- children's clothing	21.6	23.5	23.2	15.3	11.9
- clothing supplies and services	34.5	32.7	30.3	23.3	19.6
- men's footwear	19.2	12.3	9.0	4.6	3.6
- women's footwear	20.5	15.0	11.8	7.9	8.8
- children's footwear	7.1	6.9	9.0	5.6	4.4
Transport					
- overseas travel	26.8	17.2	12.9	9.6	8.2
- purchase of road vehicles	51.7	46.2	37.9	23.4	14.8
Other Goods					
- alcohol	75.3	70.0	62.1	49.5	30.8
- toiletries and cosmetics	76.6	77.1	70.2	61.1	49.1
- personal goods	67.3	66.3	60.6	47.1	34.7
- pets, racehorses, livestock	70.5	66.3	61.6	52.0	43.3
- leisure and recreational goods	73.2	65.0	59.4	43.4	27.9
- recreational vehicles	30.4	25.1	19.3	15.8	7.1

Source: Based on Department of Statistics (1987), Table 2.

It might be argued that benefits of cheaper imports would be offset by higher unemployment. The good news on this point is that, apart from temporary unemployment as protected industries restructure, moving towards a neutral trade policy stance does not permanently increase unemployment and can decrease it overall (see World Bank, 1987, Chapter 6). Moreover, retraining and relocation schemes can even ease temporary unemployment. Overall, removal of import protection significantly enhances opportunities for lower income households to achieve their material aspirations; thereby improving distribution of consumption.

3.3 Distribution of Production Among Regions

A feature of import protection is that the import substitutes produced domestically tend to be uncompetitive internationally so that they are restricted to the domestic market. There is a tendency for import substitution industries to set up in the main metropolitan areas so as to minimise costs such as transport and promotion and to be close to the politicians or bureaucrats who allocate import protection. Thus import protection amounts to a perverse form of regional assistance. The main centres like Auckland, Wellington and Christchurch gain at the expense of "regional" New Zealand. Data illustrating manufacturing concentration are illustrated in Table 5. It is clear that most manufacturing (over 57 per cent) is concentrated in the three main centres and that the distribution of manufacturing very closely follows that of population (probably a two-way relationship historically). Preliminary work on the concentration of protected manufacturing industry (including primary product processing) undertaken by the Treasury indicates that the highest rates of assistance are concentrated in the main metropolitan areas (see Treasury, 1987, pp 239-250 and Appendix 3 of this paper).

If import protection was removed many businesses would have to look to overseas markets to expand their sales. Over time this would mean that businesses would relocate in regional areas where resources such as industrial land are cheaper and overall costs of employing labour are lower. There would be little advantage in remaining in the main centres for businesses that marketed overseas because they would be marketing to the "world" population rather than just the New Zealand population. Furthermore, existing manufacturing industries in regional areas would benefit from removal of import protection because there would be downward pressure on costs of things like machinery, transport equipment and building materials. At present nearly half of the output of regional manufacturing industries is primary product based and most of this is exported. Lower costs would encourage further processing within New Zealand thus adding value to exports.

Perhaps more importantly, new businesses would very likely become established in regional areas instead of setting up in the main centres. Changes in the pattern of manufacturing concentration would help revitalise the regions and reduce congestion problems (including high real estate prices) in Auckland and Wellington. Many of these new manufacturing businesses would be primary product based.

It might be argued that the above scenario implies that New Zealand would mainly produce primary product-based output which, because of prevailing protection policies around the world, would be difficult to sell.

Table 5: Concentration of Manufacturing in New Zealand, 1983-84

Local Government Region	Activity Units		Persons Employed		Total Sales		Population at March 1985	
	Number	% of Total	Number	% of Total	\$m	% of Total	Number x 1000	% of Total
Northland	371	2.6	6,321	2.1	544	2.3	124	3.8
Auckland	5,330	36.7	108,812	35.6	8,337	35.8	892	27.1
Thames Valley	202	1.4	3,661	1.2	460	2.0	57	1.7
Bay of Plenty	736	5.1	13,676	4.5	1,181	5.1	190	5.8
Waikato	803	5.5	17,332	5.7	1,626	7.0	232	7.0
Tongariro	110	0.8	1,809	0.6	106	0.5	40	1.2
East Cape	136	0.9	3,420	1.1	154	0.7	55	1.7
Hawke's Bay	492	3.4	13,825	4.5	1,181	5.1	143	4.3
Taranaki	414	2.9	9,579	3.1	953	4.1	107	3.3
Wanganui	232	1.6	5,164	1.7	328	1.4	68	2.1
Manawatu	472	3.3	9,846	3.2	731	3.1	117	3.6
Horowhenua	231	1.6	3,536	1.2	197	0.8	51	1.5
Wellington	1,204	8.3	27,877	9.1	2,323	10.0	320	9.7
Wairarapa	155	1.1	3,193	1.3	136	0.6	39	1.2
Total - North Island	10,888	75.0	228,051	74.6	18,255	78.3	2,439	74.1
Nelson Bays	271	1.9	4,716	1.5	327	1.4	68	2.1
Marlborough	131	0.9	2,159	0.7	116	0.5	37	1.1
West Coast	133	0.9	2,233	0.7	187	0.8	34	1.0
Canterbury	1,769	12.2	36,238	11.8	2,295	9.8	393	11.9
Aorangi	332	2.3	6,467	2.1	392	1.7	82	2.5
Clutha - Central Otago	140	1.0	2,822	0.9	129	0.6	47	1.4
Coastal - North Otago	487	3.4	12,037	3.9	726	0.3	135	4.1
Southland	366	2.5	11,028	3.6	880	3.8	108	3.3
Total - South Island	3,630	25.0	77,790	25.4	5,051	21.7	852	25.9
TOTAL - NEW ZEALAND	14,518	100.0	305,841	100.0	23,306	100.0	3,291	100.0

Source: Based on Department of Statistics, Official Year Book 1986-87, Table 19.6 and 5.7

This would almost certainly not be the case because, although agricultural land is a relatively abundant resource in New Zealand, there is no special reason why all non-primary product based manufacturing activity would disappear. In a recent study of patterns in world trade (see Leamer, 1984) New Zealand resources were ranked in the following order of abundance: land, capital goods, professional and skilled workers, minerals and economic size. It is likely therefore that New Zealand would specialise in producing primary product based outputs but, given its small economic size, this country would also be very well suited to specialising in small production runs of manufactured goods designed for specific market niches. It is worth emphasising here that the tools of modern marketing management are now well enough refined to make international niche marketing an exciting possibility for small countries like New Zealand.

Some industries that are now not internationally competitive might become so as costs of their inputs fell. Industries that are now forced to buy high cost domestically produced inputs would be able to source their inputs at lowest cost from anywhere in the world. Industrial development in Japan, Hong Kong and Singapore points to the potential success of this strategy, the latter two examples more so because of their relatively small populations. Efficient domestic suppliers of inputs need have no great fear of predatory "dumping" either. A recent study by the Organisation for Economic Cooperation and Development concluded that this is actually a rare occurrence. When it does occur it is usually made possible by export assistance to overseas producers provided by their own governments (see Grey, 1985).

3.4 Import Protection as a Tax on Exports: Regional Effects

It is now widely agreed that import protection acts as a tax on exports because it raises domestic prices. A recent review of research suggests that, for a number of countries, about 70 per cent of the increase in prices of import competing products is passed on to other prices, thereby raising the cost structure of the whole economy (see Lattimore, 1986). Therefore, the effect of an across-the-board tariff of 30 per cent would be to raise the price level for the whole economy by over 20 per cent. Because exporters are not able to pass on their cost increases, the tariff is an implicit tax on their activity.

Direct estimates of the degree to which import protection increases the domestic price level in New Zealand vary from around 60 to 80 per cent (see Russel, 1986) to around 40 to 45 per cent (see Evans and others, 1987). Despite the variation in estimates they are all significantly large so they support the idea that import protection acts as an implicit tax on exporters. (An indirect estimate of only 7 per cent for agricultural exports was obtained by Business and Economic Research Limited (1985) implying that a 30 per cent across-the-board tariff would raise the costs of agricultural production by only about 2 per cent. Compared to results of other research in New Zealand and overseas this is an unusually low estimate and should be treated with caution.)

Apart from the domestic price effect of import protection there will also be an exchange rate effect. Regardless of other influences, import protection normally places upward pressure on exchange rates because it reduces the value of imports at the border. (By making imports more expensive within the border protection reduces demand for them). The higher are exchange rates the lower is the profitability of exporting. The exchange rate effect is another implicit tax on exporters.

It is a fact that the bulk of New Zealand's export goods are produced outside the main urban areas. In the year ending June 1987, nearly three-quarters of the goods exported from New Zealand were primary products: mainly wool, meat, dairy products, horticultural products, fish and forest products (Source: Department of Statistics). These exports made up nearly 60 per cent of New Zealand's total receipts on the current account of the balance of payments. It is clear therefore, that regional New Zealand pays a proportionately larger share of the implicit export tax than do the major urban areas. This conclusion is supported by the Treasury work referred to previously (see also Appendix 3 to this paper). Treasury estimates indicate that, the regions with lower levels of assistance attributable to import protection, export higher proportions of their production than do those regions with higher levels of assistance.

The analysis presented here and in section 3.2 makes it quite clear that import protection is both an implicit subsidy to the main metropolitan areas and an implicit tax on other areas. The combined effect has probably been to cause urban drift and regional decline in New Zealand over a long period of time. Removal of import protection should give regions outside the main metropolitan areas a very substantial boost. Indeed, removal of import protection could be a very positive regional development policy.

SECTION 4

THE IMPORTANCE OF AN INTEGRATED POLICY PACKAGE

4.1 Background

No economic policy is developed in a vacuum. Policy should always be interpreted within the broad social, economic and political agenda of a nation's elected representatives. It is a fact too, that the success of one policy in achieving its objective(s) is often influenced by the setting of other policies. There is now a large amount of research available on the consequences of inconsistent policy mixes especially in the context of trade liberalisation. The message that has emerged is that trade liberalisation is best supported by an appropriate policy package. This was made clear by the Working Party Report in its comments on the importance of the "link between tariff reform, liberalisation in other markets, and macroeconomic policy" (p. 53).

4.2 The Appropriate Policy Package

Experiences of a large number of countries that have embarked upon trade liberalisation strategies are summarised in two recent surveys (see Wolf, 1986 and Mussa, 1987). It is clear from the experiences of other countries that rationalisation and lowering of import protection and export assistance must be done rapidly and must be accompanied by rapid reduction of the government budget deficit, a lower (real) exchange rate, and increased flexibility in the labour market. Unless all these are accomplished, short term costs of adjustment will be unnecessarily high. There is no advantage in removing foreign exchange controls until trade has been liberalised and the inflation rate (and high nominal interest rates) reduced. Removing foreign exchange control too early tends to induce net financial capital inflows into a country, making it difficult to cement in a lower real exchange rate. Above all however, a trade liberalisation package has to be credible, that is, everybody should believe that government is serious in its intentions. The Working Party Report stressed that "the success of any (liberalisation) programme is dependent on the credibility of government policies and the implementation of complementary moves aimed at promoting market flexibility, improved information flows, and reduced uncertainty ..." (p. 53). Rayner and Lattimore (1987), who analysed New Zealand's experience with trade policy from 1950 to the present, also concluded that the viability of a trade liberalisation programme depends heavily on other policies. Some of the major policy requirements identified by the Working Party and Rayner and Lattimore are discussed below.

First, a rapid reduction in the government's budget deficit is necessary. This can be achieved in part by removing all industry assistance that is directly paid for by government. In 1983-84, for example, government provided about \$2,000 million in assistance to industry and agriculture (Source: Treasury, 1984, p. 196). This was equivalent to almost two-thirds of the budget deficit for that year. Another important element in reduction of the budget deficit is improvement in the efficiency of government itself. This requires that the provision of government services like health, education, defence, law and order, communications and electricity be cost effective. Government administration and policy advisory services provided by departments such as Agriculture and Fisheries, Labour, Trade and Industry, Social Welfare and Treasury and organisations such as the Reserve Bank, must also be efficient. This is not to say that government should simply apply the "user pays" principle to all aspects of government activity but, even where the discipline of the user pays market is not deemed appropriate, management audits could point to ways of avoiding or eliminating economic waste. The Government's efforts to induce efficiency by means of the State Owned Enterprises Act 1986 are to be applauded but the Act only directly applies to a small part of government activity. Much more needs to be done to ensure that the quality of government expenditure improves.

A consequence of a budget deficit is that there will be upward pressure on exchange rates in the short term. This can occur directly or indirectly. If government borrows from overseas, foreign capital inflow will increase and this will push up exchange rates directly: if government borrows domestically interest rates will rise (as government competes against financial institutions for the pool of domestic savings) and induce foreign capital inflow that, in turn, will push up exchange rates. High exchange rates lower the cost of importing and reduce the profitability of exporting so that New Zealand producers become less competitive. If New Zealand businesses fail as a result, then short term adjustment costs of trade liberalisation are increased.

A second requirement for successful trade liberalisation is low inflation. If the domestic inflation rate is high compared to the rest of the world then the real exchange rate will also be high. The real exchange rate can be thought of as the competitiveness of domestic exports on world markets and of foreign imports on the domestic market. Competitiveness is determined by the actual exchange rate adjusted for costs of production in the domestic economy compared to the rest of the world. A high real exchange rate makes it more difficult for export industries to compete on world markets and for import substitution industries to compete on the domestic market.

In New Zealand the real exchange rate has increased by nearly 50 per cent since the devaluation in 1984 owing to both high domestic interest rates and inflation (Source: Calculated from Bank of New Zealand, 1987). The high real exchange rate is probably New Zealand's most serious impediment to rapid adjustment to removal of import protection.

A third important condition required for successful trade liberalisation is flexibility in the labour market. The Labour Relations Act 1987 makes provision for contracting arrangements that allow for movement away from the national award system. This ought to make it possible to closely tailor terms and conditions (including wages and salaries) of employment much more closely to specific work places. Government could further assist labour market flexibility by ensuring that appropriate retraining and relocation programmes are established.

Fourth, an efficient financial market is likely to assist success of a trade liberalisation programme. Deregulation has been bolder and more complete in New Zealand's financial market than in any other area of the economy. Indeed, New Zealand now has one of the least regulated financial markets in the world. The advantages of a competitive financial market are twofold. First, financial institutions cannot artificially maintain above-market interest rates on loans by acting like a cartel if there is plenty of competition. Second, in order to stay in business, financial institutions will have to offer innovative services and encourage innovation on the part of their clients. With experience, financial institutions and their clients ought to become expert at "picking winners", far more expert than politicians or bureaucrats ever were or could be.

4.3 A Strategy for Removal of Import Protection

Experience in both New Zealand and the rest of the world indicates that, in the short term, some businesses fail and unemployment increases (although by less than is commonly believed) after import protection is reduced. In New Zealand's case some industries are very heavily protected, the real exchange rate is very high and only tentative moves towards increased flexibility have been made in the labour market. Therefore it is likely that overnight removal of import protection would impose high short term adjustment costs. This is not a reason to postpone change because removal of import protection will benefit low income households, regions outside the main metropolitan areas and the economy as a whole. Ultimately, it is up to politicians

to decide whether the beneficiaries of import protection should continue to gain at the expense of the rest of the economy. However, some guidelines for a strategy are available. First, theoretical models of the effects of removal of import protection support the idea that reducing protection to the most heavily protected industries more than others has a greater overall welfare payoff than reducing protection across the board (see Lloyd, 1973). The so-called Swiss formula described by the Working Party Report (pp 64-67) achieves this objective. Under the Swiss formula the tariff in the current time period is given by the ratio $(c.x)/(c+x)$, where c is a constant and x is the tariff in the last time period.

Second, if the trade liberalisation policy is credible and well understood, and if the terminal level of protection is unambiguously defined, (and non-negotiable), businesses will incorporate that information into their plans. A transition period of five years would probably be very suitable under these conditions since businesses rarely appear to formulate detailed plans over longer time horizons. (This comment is based on perusal of a number of published annual reports of businesses that operate in New Zealand.)

Therefore, the Swiss formula applied over five years would be appropriate for New Zealand. This would require the complete abandonment of import licensing immediately, with licences being replaced by tariffs to which the Swiss formula would be applied. For industries under industry plans the Swiss formula should be applied as soon as the plans expire, thus rapidly bringing those industries into line with all others.

Given that the costs of import protection are high and the gains accruing upon its removal are high the most appropriate level of import protection is zero. Therefore, after the tariff reform period, the only restrictions applying to imports ought to be those related to health or safety.

SECTION 5

CONCLUSION

In this paper a number of arguments in favour of removing import protection in New Zealand have been advanced. There are five main conclusions that support removal of protection.

First, gains to an economy arising from comparative advantage are probably small. Other gains, such as reduction in the costs of lobbying and reduction of economic slack, are also probably fairly small. However, added together, these gains would be a worthwhile addition to the size of the nation's economic cake.

Second, gains from removal of import protection are cumulative. Over time an outward-oriented dynamic, innovative economy will experience higher economic growth than an inward-oriented economy.

Third, low income households are adversely affected by import protection. Free trade would reduce prices of many of the goods they buy, thus enhancing their welfare. Free trade would not increase unemployment except in the short term.

Fourth, removal of import protection would remove a perverse implicit subsidy to the main metropolitan areas and implicit tax on other areas. It would encourage relocation of existing businesses and establishment of new businesses in "regional" New Zealand. Many, but not all, of these businesses would be involved in primary product based activities. Lower import protection would be a positive regional development policy.

Fifth, and finally, the short-term adjustment costs of removing import protection (and export assistance) can be minimised if the trade liberalisation programme is credible and accompanied by an appropriate package of other economic policies.

The costs of import protection are high. Gains accruing from removal of import protection are high. The most appropriate level of import protection therefore is zero.

SECTION 6

RECOMMENDATION

The Tariff Working Party Report did not recommend a specific programme for reduction of import protection. However it noted that the greatest net benefits are obtained from reducing the highest tariffs and having a more uniform tariff structure and recommended that the period of tariff reform should be three to five years (pp 77, 78).

The recommendation of this Discussion Paper is that import protection be reduced to zero over a period of five years, according to the Swiss formula.

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APPENDIX 1

Notes on Proportion of Income Spent by Households

In Table 3 some data on proportion of income spent by households is set out. These data are based on the Household Expenditure and Income Survey, 1985-86 undertaken by the Department of Statistics. The Department cautions against using the Survey to compare total expenditure against total income for a number of reasons. The main reason is that the Department cannot verify that reported expenditure for each surveyed household exactly matches its reported gross income less income tax (less saving or plus borrowing).

Data on proportions of income spent that are shown in Table 3 are calculated by expressing average weekly expenditure as a proportion of the top income in each group. Thus, for income group 5 the proportion of income spent was:

$$184 - (11,999 - 365 \times 7) = 0.8 \text{ or } 80 \text{ per cent.}$$

The only exception was for income group 1 in which case an annual gross income of \$60,000 was used so that the proportion of income spent was:

$$699 - (60,000 - 365 \times 7) = 0.61 \text{ or } 61 \text{ per cent.}$$

Using a different rule for determining income changes the proportions of income spent but does not alter the result that lower income households spent a higher proportion of their incomes than most higher income households. Therefore the data support the contention in Section 3.2 that import protection acts as a regressive tax on lower income households.

APPENDIX 2

Estimated Nominal Price Margins Over World Price Levels Due to Import Protection in Manufacturing Industries, Average 1981-1984

Manufacturing Industry Group	Price Margin %
Food, beverages and tobacco	33.5
Textiles	46.5
Clothing	64.5
Furniture	55.1
Printed products	107.2
Leather goods	82.1
Rubber goods	51.1
Petroleum products	47.3
Other chemicals	54.7
Non-metallic minerals	94.0
Metal products	69.5
Electrical products	69.6
Footwear (1)	35.7
Chemical fertilisers (1)	9.3
Basic metal products (1)	6.3
Machinery (1)	36.0
Vehicle assembly and other transport goods (1)	22.7
Miscellaneous	89.4
Weighted Average	61.4

Note:

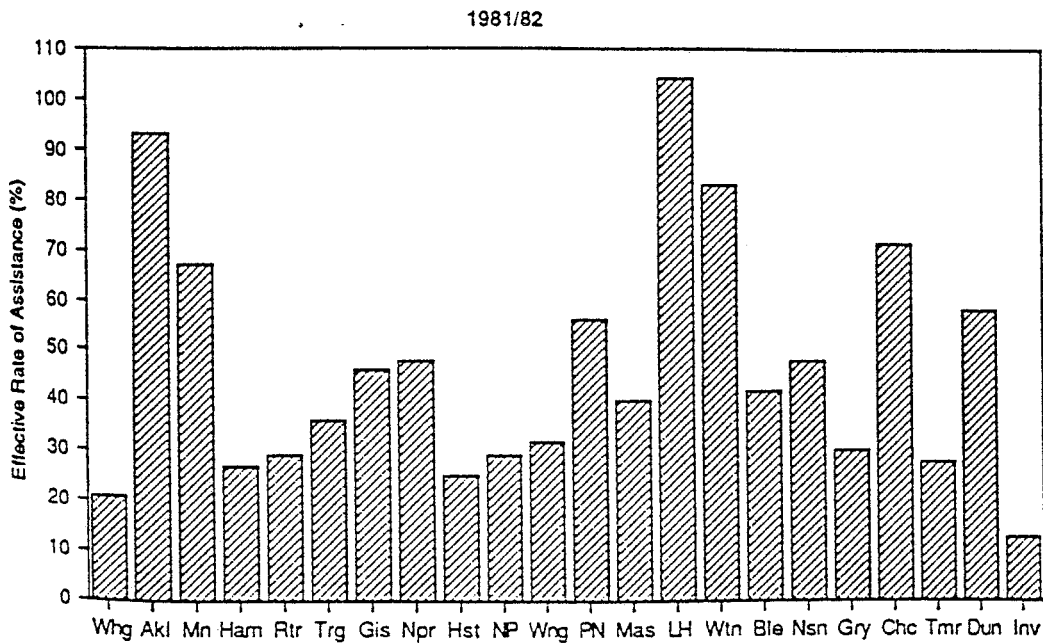
(1) Average 1978/79

Source: Lattimore (1985)

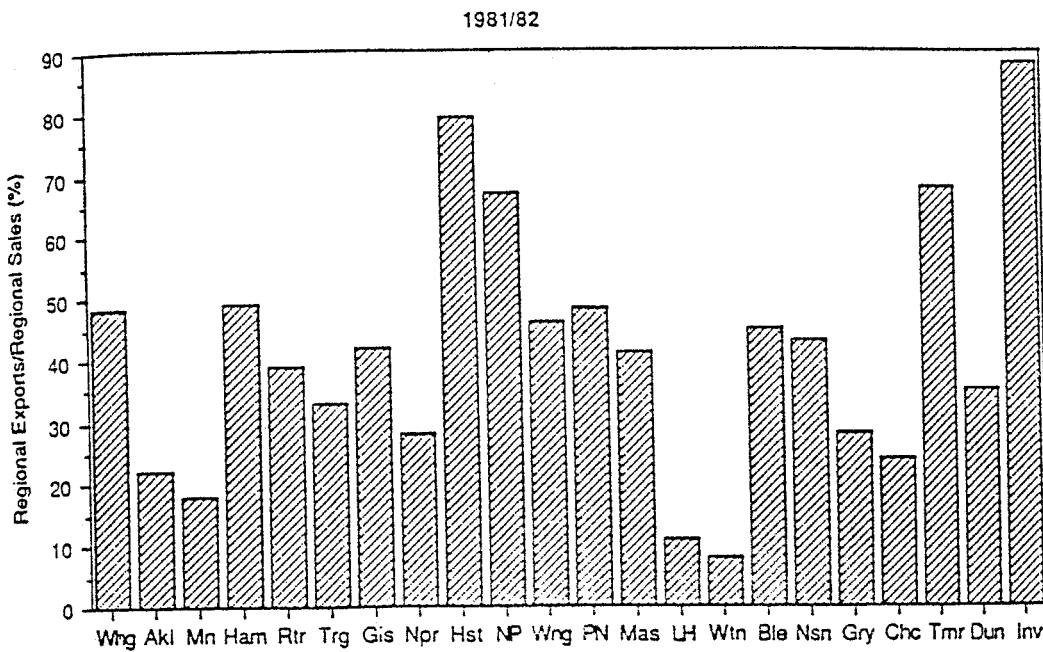
APPENDIX 3

Regional Assistance Patterns and Exports by Region

Regional Assistance Patterns



Exports by Region



Source: Treasury (1987)

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