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## NON-AGENDA

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With the view of causing an increase to take place in the mass of national wealth, or with a view to increase of the means either of subsistence or enjoyment, without some special reason, the general rule is, that nothing ought to be done or attempted by government. The motto, or watchword of government, on these occasions, ought to be — Be quiet. . . Whatever measures, therefore, cannot be justified as exceptions to that rule, may be considered as *non-agenda* on the part of government.

—Jeremy Bentham (c.1801)

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## Export Subsidies Impose Net Losses on Australians

Mary Amiti

In March 1999, the World Trade Organisation (WTO) ruled against the Australian Government's \$55m assistance package to the Melbourne-based automotive leather producer, Howe and Company. WTO rules do not permit subsidies that depend on export performance (WTO, 1999). The Australian Government argued that the payments to Howe were based on sales and investment performance whereas the US argued that it was effectively an export subsidy since Howe exported 90 per cent of its product (Pearson, 1999a). Although the ruling may seem to be a blow, in fact the WTO did Australian taxpayers a favour. The main argument used to justify giving export subsidies — that they increase exports and jobs — is questionable. In general, both export and production subsidies make the Australian public worse off. It is also a myth that increasing exports is always equivalent to increasing welfare, and that subsidies to one firm will necessarily increase employment. Let us carefully examine what these subsidies actually do.

### The Effects of Subsidies

Consider the following figure representing domestic demand, domestic supply, and world demand for Australian leather products. Producers are 'too small' on the world market to influence the world price. In the pre-subsidy situation  $Q_s$  is

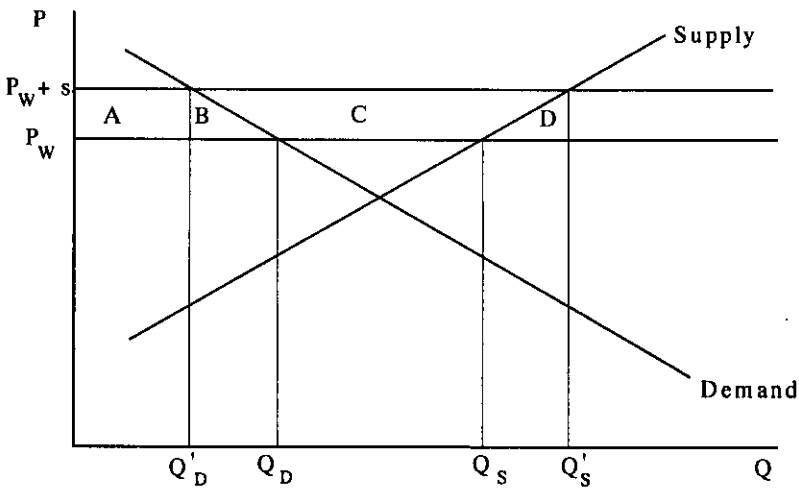
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supplied by Australian producers and  $Q_D$  is demanded by Australian consumers at the world price,  $P_w$ . The difference ( $Q_S - Q_D$ ) is exported. The effect of an export subsidy,  $s$ , is to increase the price that Australian firms receive by the full amount of the subsidy, from  $P_w$  to  $P_w + s$ . The higher price encourages Australian producers to increase their output from  $Q_S$  to  $Q'_S$ .

What happens to the domestic consumer price depends on the costs of importing the same good. If trade costs are zero, consumers could re-import the exported good at price  $P_w$  and hence producers would not be able to charge them a higher price. Since the subsidy is paid only on the units exported, producers would export all of their supply in order to receive  $P_w + s$ . In practice there are transport and other trade costs associated with importing goods. So long as the cost of importing is at least as high as  $s$ , domestic consumers would also have to pay  $P_w + s$ , thus reducing domestic demand from  $Q_D$  to  $Q'_D$ . Foreigners continue to pay the pre-subsidy world price,  $P_w$ .

### The Simple Analysis of Subsidies



- Notes:
- B + C + D represents the export subsidy payment
  - A represents the extra subsidy payment when production subsidy
  - B + D is the deadweight loss of the export subsidy

The subsidy is successful in achieving its objective of increasing the amount exported. However, it is a myth that increasing exports 'at any cost' is a good thing. In fact, when we add up all the gains and losses of the export subsidy, we find that there is an overall net loss to the Australian economy. Producers gain due to the higher price they receive and the extra output produced at the higher price. Australian consumers lose due to the higher price they pay and the lower quantity they buy. The Government loses due to the subsidy it must pay on every unit exported. Some of these losses are just transfers from Australian consumers

and the Government to Australian producers but there is a net loss overall. By artificially increasing the profitability of a particular firm, the Government is helping to attract resources away from other firms within that industry and from other industries (that is, inducing a production distortion). Also, the higher price leads Australian consumers to consume less than what they otherwise would (that is, inducing a consumption distortion).

The costs of an export subsidy would be even greater if the firm had some market power to influence the world price, which could arise due to the differentiated nature of goods exported. In that case the subsidy would reduce the price paid by foreigners below  $P_w$ , inducing an additional loss due to the deterioration in the terms of trade. The price received by the Australian firm would still increase but not by the full amount of the subsidy. Australian taxpayers would be paying for foreigners to have cheap products.

In either case, an export subsidy increases the price received by the firm and hence its profitability. The only winner in Australia is the firm receiving the subsidy. Australian consumers lose due to higher prices. And of course, the Australian taxpayers lose as they pay for every unit exported.

At the WTO case, the Australian Government argued that the assistance package to Howe was actually a production subsidy and not an export subsidy. In that case, the firm still receives the higher price,  $P_w + s$ , but now the Government pays the subsidy on every unit produced. Therefore, Australian consumers pay the same pre-subsidy price as foreigners,  $P_w$ , and consume the same quantity as before. Since there is no effect on the domestic consumer price, the production subsidy does not impose any cost on Australian consumers.

### **Arguments in Support of Subsidies**

If the overall welfare effects are negative, why does the Government persist with subsidies? Five main arguments have been put forward:

First, there is the legitimate economic argument for assistance that arises when production confers some additional benefit to society that cannot be fully captured by the firm (that is, a positive externality). This may arise if there are technological spillovers between firms or learning effects, that is, with increased production of the good other firms are able to learn from the experience, enabling them to produce their goods in a more efficient way. The firm generating the externality will not be able to charge the other firm for the benefits of learning. Whenever such a positive externality exists, the firm is likely to produce less than what may be 'optimal' from society's point of view. So government intervention to increase production provides extra social benefits. This is really an argument for a production subsidy rather than an export subsidy. The cost of the production subsidy is offset by these extra social gains from increased output. If Howe's activities confer any such positive externalities, they are certainly not obvious.

Second, it is argued that export subsidies create jobs since more resources would be required to produce the additional output. It is often assumed that these resources would come from the unemployed pool, particularly since the

unemployment rate is around eight per cent. Even though this may be the case for some skill levels, it cannot seriously be argued that all of the additional resources only come from the unemployed pool. Inputs into the production process are usually a composite which include different skills in the labour force, capital inputs and raw materials, and some of these factors of production will be drawn from other firms. For instance, with these handouts to Howe, the Government has artificially increased its profitability, helping to pull resources away from other firms and industries — a subsidy to one firm imposes costs on other Australian firms.

Third, the old protectionist 'infant industry' argument continues to be put forward. It is argued that firms need assistance in the early stages of development just to get started. The problem is that many of these firms never 'grow up'. And after a century in business, Howe surely would no longer qualify as an 'infant'.

Fourth, governments are sometimes tempted to use subsidies to 'shift' profits from foreign firms to Australian firms in industries that have some monopoly power. This can lead to trade wars resulting in a loss for all countries involved. Moreover, this does not explain why Howe should be subsidised as opposed to some other firm.

Fifth, retaliating against other countries that use subsidies is often used as a justification for us 'to help our firms compete internationally'. It is true that other countries subsidise their industries and this can hurt Australians. An obvious example is the European Union's Common Agricultural Policy (CAP), which provides large subsidies to EU farmers. However, we should not respond by also subsidising our industries and imposing further net costs on Australians. Instead, we should try to persuade other countries to liberalise their trade, opening up markets for Australian producers with a potential for large gains.

We should remember that the Government must raise tax revenue to pay for subsidies, which imposes an additional cost on society. The efficiency cost of raising an additional dollar in tax revenue in Australia depends on the particular tax raised, but most major taxes have a marginal deadweight loss of 20 cents or more (Gabbitas and Eldridge, 1998:passim).

## Conclusions

The assistance package to Howe not only contravenes WTO rules but it also reduces the welfare of Australians. The only beneficiary in Australia is Howe. It certainly is not clear why Howe should receive \$55m (Pearson, 1999a) when the average export assistance grant provided to other firms last year was around \$52,000 with more than 300 applicants receiving nothing.

The recent WTO case against Australia is embarrassing for the Government, particularly when we are the 'forerunners' in trying to persuade other countries to liberalise their trade. For instance CAP is on the WTO's agenda, with Australia a decisive player as leader of the Cairns group (Cook, 1999). Australia is also a key player in Asia Pacific Economic Cooperation (APEC) in encouraging Asian

countries to liberalise their trade, which would greatly benefit Australian industries.

The WTO finding reduces Australia's credibility in future negotiations. For instance, Australia is currently negotiating with the United States on a bill before their Senate which would impose quotas on their steel imports. If the bill were passed it would directly hurt Australia's \$348m steel export trade to the US (Pearson, 1999b). In addition, a US anti-dumping case against Japanese steel makers would hurt Australia's \$5.7 billion trade in iron ore and coal exports to Japan.

Breaches of WTO rules also open the door for WTO approval for countries to retaliate, as demonstrated in the recent case against the EU's import policy on bananas. After winning its case, the US won WTO approval to retaliate by placing import tariffs on a range of European luxury goods (Anon, 1999).

In general export subsidies lead to an overall net loss for the Australian public both directly and indirectly by reducing our credibility in future trade negotiations. If the Government has extra money to spend, it should direct it towards helping all Australians instead of using taxpayers' money to prop up profits of individual firms.

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