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ECONOMIC EVALUATION OF THE PROPOSED FREE TRADE AGREEMENT BETWEEN AUSTRALIA AND THE UNITED STATES

Submission to

Parliament of Australia, Joint Committee on Treaties

Inquiry into the proposed Free Trade Agreement between Australia and the United States

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Summary

The main points of this submission are:

1. The most important distortions of agricultural trade practised by the US are unaffected by the FTA and are, in effect, endorsed by Australia's signature to the agreement.

2. Considered in isolation, there is little to commend the proposed agreement. As regards goods, the agreement fails to address the main distortions, such as the US Farm Bill and the protection of the US sugar market while imposing a substantial loss on Australian taxpayers in the form of reduced tariff revenues. Impacts on services are modest.

3. The main adverse impacts of the proposed agreement lie in areas that ought to be outside the scope of a trade agreement. The most notable, as regards the commitments actually entered into, is intellectual property.

4. A Free Trade Agreement between Australia and the United States should be confined to the removal of barriers to trade in goods and services. Issues relating to economic integration should be dealt with in a multilateral context and in a manner that does not prejudice the democratic rights of Australians to control their own social and economic institutions.

5. Parliament must assert its capacity and responsibility to determine Australian law, rather than being bound by the conclusions of closed-door negotiations. Objectionable provisions of the FTA requiring legislative change, such as the extension of copyright, should be rejected. It would then be up to the US Congress to decide whether to accept an agreement which, while still weighted in favour of US interests, was less unbalanced than the current proposal.

ECONOMIC EVALUATION OF THE PROPOSED FREE TRADE AGREEMENT BETWEEN AUSTRALIA AND THE UNITED STATES

The FTA should be assessed in two ways. First, it is necessary to consider the specifics of the agreement as it currently stands. Second, and more importantly, this agreement must be viewed as the beginning of a process of economic integration with the United States. It is necessary to consider both the desirability of such a process and the likely terms on which it would develop. The terms of the proposed FTA provide important evidence regarding the likely terms of future integration, and, in particular, the policy areas that would be subject to negotiation.

ANALYSIS OF THE CURRENT PROPOSAL

Liberalisation of trade in goods

The situation before the Free Trade Agreement

Australia has very few barriers to trade in goods, and even fewer that are significant in relation to our trade with the United States. Our general tariff of 5 per cent is at a level which can be justified under the revenue tariff provisions of the GATT. The main areas of higher tariff protection, the motor vehicle industry textiles, clothing and footwear industry are areas where the United States has little capacity to export to Australia. There has been some criticism of Australia's quarantine policies, but these policies are designed to focus on science-based analysis of disease threats rather than on protection for domestic producers.

Similarly, Australia has very few policies that subsidise exports or otherwise distort international market prices. Most agricultural industries receive minimal assistance. Single-desk selling policies for some agricultural commodities have been criticised as anti-competitive, but the cost of such policies, if any, is borne by Australian producers. Thus far, most producer groups have concluded that benefits such as the pooling of risk outweigh any costs from forgoing a choice of export marketers.

By contrast, the United States has a wide range of barriers and distortions, particularly in the agricultural sector. The most important set of distortions are the broad-ranging production and export subsidies contained in the Farm Bill passed in 2002. This Bill provides for $US190 billion in subsidies over 10 years to US agricultural industries including grain, cotton, wool and dairy. Subsidised exports of

these commodities depress world prices and harm all Australian producers, regardless of whether they are in direct competition with subsidised exports.

By comparison, although they have received more attention, restrictions on imports to the US are of less significance. The most important barriers relate to sugar, beef and dairy products, and there are a range of less significant barriers.

As in Australia, the US also provides significant protection to a small group of manufacturing industries. The pattern is largely symmetrical, with motor vehicles and TCF being notable beneficiaries. This symmetry reflects the fact that, in both Australia and the United States, these industries have declined as a result of competition from Asia.

The bilateral balance of trade shows a strong surplus for the US. Conversely, Australia currently collects substantially more revenue from tariffs on imports from the US than does the US from tariffs on Australian exports. This is important in assessing the distribution of costs and benefits from the FTA.

The content of the proposed FTA

As has been widely publicised, the proposed FTA removes most tariffs and trade barriers, but makes no change in US restrictions on imports of sugar from Australia and only modest and gradual changes with respect to imports of beef and dairy products.

More importantly, no changes are proposed to the US Farm Bill. Not only is the general system of subsidies unaffected (it would perhaps have been utopian to hope for broad-based reform) but there does not even appear to be any commitment to avoid the use of export subsidies that directly harm Australian exporters in particular markets. Indeed, it appears that the issue of the Farm Bill was raised in the negotiations. **The most important distortions of agricultural trade practised by the US are unaffected by the FTA and are, in effect, endorsed by Australia's signature to the agreement.**

Reflecting the symmetrical nature of the two countries' patterns of comparative advantage and disadvantage, there are exceptions to the general pattern of complete removal of tariffs, notably with respect to TCF.

Economic analysis

Economic analysis of policy proposals may be based either on first principles or on economic modelling. The proposed FTA is too complex to be analysed simply in terms of first principles. Nevertheless, a great deal of insight can be obtained from

simple parametric models of various aspects of the proposal.

As compared to a large-scale simulation model, this approach has the advantage of clarifying the processes leading to estimates of costs and benefits. A large-scale model offers greater precision and the capacity to model policy outcomes for particular regions and industries. However, where there is a large divergence in estimates of aggregate outcomes between simple and elaborate models, this divergence is rarely a consequence of greater precision in the elaborate model. More frequently, the divergence is the result of differences between the economic assumptions used to 'close' (that is, derive an equilibrium for) the elaborate model and the economic assumptions used in the simple model. Hence, there should be no automatic preference for the results of more elaborate models. What matters is the validity of the core assumptions.

In the debate over the proposed FTA, many commentators have sought to make arguments based on first principles to show that the proposed agreement must be beneficial, even if the United States retains significant barriers. The implicit model is that of a small country unilaterally reducing tariffs on a non-discriminatory basis. In this case, the world price is unchanged by tariffs, so the entire burden of the tariff falls on domestic consumers. Provided that the tariff revenue can be matched by a less distorting tax, reducing the tariff unilaterally will improve welfare.

Unfortunately these commentators fail to take account of crucial qualifications in the above statement that make it inapplicable in the context of the proposed FTA.

In this case, in general, the benefits of the cut in Australian tariffs will be shared between consumers in Australia and exporters in the US, while the cost will fall on Australian government revenue. The final incidence depends on the share of imports supplied by the US and on the extent to which imports from the US and other suppliers are substitutes. Since the US share of imports is fairly small, and substitutes are available in most cases, it is likely that most of the benefit will go to US exporters. This is a special case of the larger literature on trade diversion and trade creation, all of which casts doubt on the claim that bilateral free trade deals will be economically beneficial to the parties concerned.

A straightforward first approximation to assessing the issues in the case of the US-Australia FTA is to look at the reductions in tariff revenue. Since the US supplies about 20 per cent of Australia's imports and the revenue from general tariffs is around $2 billion, the likely cost is around $400 million per year.

It is, of course, necessary to take account of the corresponding benefits to Australian exporters. The benefits estimated by CIE before the conclusion of the agreement rested heavily on trade diversion, and in particular, increased Australian access to the highly-protected markets for sugar, beef and dairy products. Given that the final agreement

In fact, it is arguable that the agricultural components of the deal should be given a negative value rather than a small positive one. By accepting a long-term agreement on such unfavourable terms, Australia precludes the possibility of negotiating a more favourable agreement with a subsequent government, and reduces the likelihood of securing broader access through multilateral processes.

Services and investment

The impact of the proposed FTA on services is relatively modest. Although there are some provisions in both Australia and the US that discriminate against noncitizens, these are relatively modest. Moreover, some of the most important policies of this kind, such as restrictions on airline services, have been excluded from the scope of the agreement.

The main interest therefore relates to possible future developments, going beyond the removal of overt discrimination against noncitizens. These are discussed below, particularly in relation to the Pharmaceutical Benefits Scheme.

It should be noted that the services sector was responsible for a substantial proportion of the gains from an FTA estimated by the Centre for International Economics. In view of the modest scope of the actual agreement, it seems likely that these gains have been overestimated.

Similar points apply in relation to investment. It appears that the threshold for Foreign Investment Review Board review will be raised, but this will have little direct impact since hardly any proposals are rejected. The main issue is the "standstill" approach central to the agreement, which allows for the creation of new rights for investors in future, but makes it almost impossible to withdraw rights that have already been granted.

Of more concern is the possibility that some future agreement will create a right of foreign investors to seek 'review' of decisions they allege to be discriminatory against them. This provision, embodied in NAFTA and the aborted Multilateral Agreement on Investment is said to be justified on 'level playing field' grounds, but actually produces discrimination in favour of foreign investors, since

domestic enterprises have no comparable rights.

Intellectual property

Under the proposed FTA, Australia is required to adopt American policies on intellectual property, policies that are economically unsound even in the US context, and entirely adverse to Australian interests. Australia currently sets the term of copyright fixed at fifty years after the author's death and publishers interested in making public-domain works accessible to the general public are increasingly taking advantage of this. By contrast, the United States has steadily extended copyright terms. The proposed FTA sets a minimum copyright term of 70 years, but set no maximum.

Many of the relevant issues arose in the case of Eldred vs Ashcroft, decided recently by the US Supreme Court. This case was a constitutional challenge to a recent Act of Congress which extended the term of copyright protection from fifty years after the death of the author to seventy years (ninety-five for corporations). The 'Copyright Term Extension Act' is often referred to as the 'Mickey Mouse Act' because of the observation that the term of copyright is extended whenever the Disney copyright on Mickey is about to lapse.

The constitutional challenge failed, but the case did elicit an unusual degree of interest from American economists , seventeen of whom submitted a brief to the Supreme Court opposing the Act. The list is striking not only because of the eminence of the signatories (five Nobel Prizes and more to come) but because it represents all shades of economic opinion from free-market luminaries like Buchanan, Coase and Friedman to interventionists like Akerlof and Arrow.

The central theme of the economic critique is that copyrights and patents cannot be appropriately analysed in terms of the protection of 'intellectual property'. Copyrights and patents are monopoly rights. It is necessary to strike a balance between the incentive to inventive and creative work provided by copyrights and patents and the economic costs of monopoly rights over ideas. Current US policy is excessively favorable to monopolies.

This is also an area of concern in relation to future developments in the process of economic integration with the United States. The current agreement does not require Australia to match widely-criticised US policies such as the Digital Millennium Copyright Act. However, given the strength of the entertainment industry and related lobbies in the United States, there can be little doubt that there

will be continuing pressure for measures to enhance the monopoly rights of owners of intellectual property.

Effect on Australia's international standing

The proposed agreement has been widely criticised, as encouraging agricultural protectionism. For example, the *New York Times,* February 14, 2004 editorial, said

> The deal with Australia is a huge setback in the process of liberalizing global agricultural trade. Poor nations whose only viable exports are agricultural goods are hampered by excessive protectionism. And by making a deal with Australia that leaves out sugar, Washington has jeopardized chances for meaningful progress on a hemispheric Free Trade Area of the Americas, and the latest round of negotiations at the World Trade Organization. As part of this effort to lower trade barriers, developing countries are rightly insisting that rich nations stop subsidizing their farmers and open up their markets to competition.
>
> The agreement sends a chilling message to the rest of the world. Even when dealing with an allied nation with similar living standards, the administration, under pressure from the Congress, has opted to continue coddling the sugar lobby, rather than dropping the most indefensible form of protectionism. This will only embolden the case of those around the world who argue that globalization is a rigged game.

Similarly negative observations were made by US and international commentators, including the *Washington Post,* the *Singapore Straits Times,* and the *Miami Herald.*

Despite official protestations, it is obvious that the agreement severely erodes Australia's credibility as a leader of the Cairns group. It is not hard to imagine the reaction of the EU, for example, to any future Australian government criticism of EU sugar policy. For a country supposedly committed to liberalization of agricultural trade to make a bilateral deal with one of the leading practitioners of protectionism, leaving the most egregious examples of protectionism in place, is exactly analogous to a member of a wartime coalition making a separate peace.

Summary

Considered in isolation, there is little to commend the proposed agreement. As regards goods, the agreement fails to address the main distortions, such as the US Farm Bill and the protection of the US sugar market while imposing a substantial loss on Australian taxpayers in the form of reduced tariff revenues. Impacts on services are modest.

The main adverse impacts of the proposed agreement lie in areas that ought to be outside the scope of a trade agreement. The most notable, as regards the commitments actually entered into, is intellectual property.

TRADE AND ECONOMIC INTEGRATION

Much of the debate thus far has been based on misperceptions about the nature of the proposed Agreement. As the main proponent of the agreement, Alan Oxley of Austa has noted, the use of the term 'Free Trade Agreements' is ' a misnomer in a world of lower tariffs . Oxley writes (http://www.austa.net/reports/report1.htm) 'The World Bank prefers to describe them as regional integration agreements. Free Market Arrangements would be an even more appropriate term'.

In general, an integration agreement involves the adoption of common, or at least compatible, economic policies on a wide range of issues, including intellectual property, public ownership of infrastructure, and competition policy. Ultimately, integration is likely to extend the provision and financing of health care and education.

However, 'integration' is a misleading term in the context of a bilateral agreement between Australia and the United States. Given the relative size of the two countries, and the fact that the United States has adopted a general strategy of seeking bilateral agreements on trade and other issues on a 'pattern bargaining' model, it is clear that any agreement will involve Australia adopting American institutions and not *vice versa.*

This does not represent a difficulty for advocates of an FTA such as Austa. Austa publications indicate a strongly-held belief that the economic and social institutions of the United States are superior to those of Australia, and that we will therefore benefit from an agreement which binds us to replace our existing institutions with those of the United States.

In the case of the proposed agreement with the United States, there is a

further reason why the term 'Free Trade Agreement'. The most important barrier to trade between the United States and Australia is the set of production subsidies, export subsidies and restrictions on US agricultural imports generally referred to as 'the Farm Bill'. Although some marginal concessions may be made, there is no serious prospect that the Farm Bill will be repealed or modified in such a way as to eliminate its adverse impacts on Australian farmers.

It would be preferable any Free Trade Agreement between Australia and the United States should be confined to the removal of barriers to trade in goods and services. Issues relating to economic integration should be dealt with in a multilateral context and in a manner that does not prejudice the democratic rights of Australians to control their own social and economic institutions.

Other integration agreements

A survey of previous integration agreements reveals two basic points that are applicable to the proposed economic integration agreement. First, the scope of such agreements is invariably much greater than is suggested at the time they are originally negotiated. Second, once signed they are effectively immune from political scrutiny. The result is a massive 'democratic deficit', in which citizens lose the capacity to choose or control the economic and social institutions that shape their lives.

The democratic deficit has been recognised as a major problem in the European Union, where it has generated a vigorous debate regarding constitutional reforms to the European Parliament, the European Commission, and the Council of Ministers. In relation to National Competition Policy and the World Trade Organisation, issues of democratic accountability were ignored until the absence of accountability produced a violent backlash.

Whether or not there is a backlash, it seems hard to see how any form of democratic accountability could be imposed on an economic integration agreement between Australia and the United States, short of Australia seeking to become a US state itself.

The precedent of National Competition Policy

Australia has had recent experience of the use of intergovernmental agreements, negotiation behind closed doors as a method of producing binding commitments to far-reaching policy reforms. National Competition Policy, also known as 'Hilmer and related reforms' was introduced in 1995, as a result of the

meeting of the Council of Australian Governments (COAG). This meeting resulted in the passage through all Australian parliaments of legislation which fundamentally affected all aspects of Australian life, from the opening hours of shops to the employment conditions of workers. Yet until 1998, the majority of Australians had never heard of National Competition Policy and only a tiny minority were aware of what the policy involved.

This situation changed dramatically with the 1998 Queensland election, where the vote for the One Nation Party was attributed, in large measure, to resentment at the perceived effects of National Competition Policy. In the resulting backlash, critics blamed NCP for everything from unemployment to the decline of country towns.

Unlike previous microeconomic reform initiatives, National Competition Policy was a comprehensive program, which has been imposed from the top levels of government without any consultation with those affected, and which was not subject to significant democratic accountability or control.

Another top-down aspect of National Competition Policy is the strict subordination of local government to State government. The operating arrangements of local government authorities have been removed from the control of the governments concerned and required to conform to policies laid down by State governments in accordance with Competition Policy.

Finally, National Competition Policy has been largely exempt from democratic accountability. It is, of course, open to the Commonwealth Parliament to amend or repeal the Competition Policy Reform Act. But apart from this theoretical possibility, it does not matter whether policy changes required under National Competition Policy have majority public support or, indeed, any public support at all.

The WTO

The debate over the World Trade Organisation has followed a pattern very similar to that of the public response to NCP. The WTO was designed as part of a comprehensive free-market reform agenda for the world economy, replacing the more limited General Agreement on Trade and Tariffs. In the words of its secretary, Renato Ruggiero, it was to provide 'the new constitution of a single global economy'.

The WTO is unelected and its processes are opaque and bureaucratic. Its

decisions, affecting government policies on a whole range of issues, are made in secret by panels of trade lawyers. However, since national governments have signed off on the relevant treaties, the WTO claims a democratic mandate.

As in the Australian debate over competition policy, the advocates of the free market had most of the running at first. A steady stream of articles, speeches and books pointed out that in the new world of the single global economy there was no alternative to comprehensive reform and the abandonment of old-fashioned policies of government intervention. In particular, the new economy necessitated wholesale privatisation, 'the end of welfare as we know it' and the abandonment of restrictive labour market policies like minimum wages and unfair dismissal laws. Environmental and food safety policies, seen by the free-marketeers as pretexts for rent-seeking and protectionism, came in for particular attention. An article in the pro-WTO Brookings Review, commenting on a WTO decision striking down part of the US Clean Air Act, expressed the hope that trade reform and domestic policy reform would go hand in hand.

The turning point came with the semi-secret attempt to negotiate a Multilateral Agreement on Investment, which would have required signatory countries not to discriminate against foreign investors. As the example of the WTO showed, this would have meant that any policy that adversely affected a multinational company (whether or not any discrimination was intended) could be challenged and overturned in closed tribunals. National governments began demanding exemptions in areas where they were unwilling to accept MAI dictation - culture for France, indigenous rights for Norway, and so on. The growing list of exemptions simply pointed up the all-embracing nature of the proposed agreement, and swelled the international wave of protest until the MAI was abandoned.

The European Union

The European Union is noted by Austa as a model for integration agreements. It illustrates the tendency for the scope of such agreements to expand over time and the difficulty of resisting such expansions. The original European Coal and Steel community was established in 1951, with the aim of preventing a recurrence of war between France and Germany,

As late as the 1980s, the then European Community was, for practical purposes, a Western European customs union whose main policy initiative was the Common Agricultural Policy. These were managed by an unelected Commission, analogous to the WTO, and a Council, in which each national member had one

representative and an effective right of veto.

In 2002, the customs union, the Commission and the CAP are still there, but the European Union is more like a federal government than a trade bloc. New members of the European Union must implement 31 chapters of the treaty, covering everything from fiscal policy to the protection of workers rights. In effect, the treaty requires its signatories to become social democracies.

The anti-democratic features of the gradual loss of national sovereignty in the European Union have been a source of much concern. The response has been to convert Europe from a trade bloc to something approaching a federal state (the term 'confederation', used by the American colonies before the adoption of the Federal US constitution is perhaps more appropriate. Europe already has many of the standard trappings, including a flag, a currency, passports, a parliament and the beginnings of an army. The directly-elected European Parliament is still weak, but its power and legitimacy is growing. The replacement of the national veto by 'qualified' majority voting is gradually changing the character of the Council, from a venue for intergovernmental negotiations, to something more like the original version of the US Senate.

No such response will be available in the context of the democratic deficit associated with economic integration with the United States. The US jealously guards its national sovereignty and has shown itself unwilling to cede any, even to its NAFTA partners, Canada and Mexico. Australia, a country of which most Americans are barely aware, will have even less capacity to influence events.

Bilateralism and multilateralism

Concerns about the relative merits of bilateral and multilateral agreements have been raised in relation to trade in goods and services.

The issues are much sharper in relation to economic integration agreements. In principle, Australia could negotiate separate agreements with, say, the US, ASEAN and the EU to remove tariffs and other barriers to trade in goods and services. By contrast, the natural outcome an economic integration agreement creates a bloc. If Australia has an economic integration agreement with the United States and New Zealand does not (as seems likely) there will come a time when the requirements of the US agreement are inconsistent with those of Closer Economic Relations with New Zealand.

Although details remain unclear, it appears that the Japanese government

believes the proposed FTA to raise issues in relation to existing agreements between Australia and Japan, particularly as regards Most Favoured Nation treatment of investment. Since our economic relationship with Japan is of considerably more importance than that with the United States, it is highly undesirable that it should be disrupted. However, conflicts of this kind seem likely to multiply under a bilateral approach.

Health

Health, including food safety, was central to the negotiating demands of the United States in the current FTA. Although the concessions made by Australia were (at least apparently) minor ones, they open the door for further demands in the future.

As in the case of intellectual property, the outcome of any agreement that would satisfy the US will be the replacement of successful Australian policies by economically and socially unsound US policies that benefit only powerful lobby groups.

In relation to genetically modified foods, for example, Australia reached a sensible compromise between the extremes represented by the US and Europe. Under the labelling laws adopted here, consumers are free to choose between traditional and GM foods. The US negotiating position proposes that we should be forced, like Americans, to consume GM foods without knowing it.

Similarly, the Pharmaceutical Benefits Scheme will come under continued attack. As noted by Alan Oxley of Austa in a 3CR interview recently, the PBS has been the subject of vigorous attack by US pharmaceutical companies and their Australian subsidiaries. While the scheme is not directly attacked in the proposed Free Trade Agreement, its fate will be sealed once the agreement is signed.

Looking ahead, it seems inconceivable that Medicare will be safe from attack under the provisions of an agreement. The private insurance lobby in Australia has opposed Medicare since its exception, and would be strengthened immeasurably by the much large and stronger US industry. The single-payer and bulk-billing provisions of Medicare, already under severe strain, could be rendered unworkable by legal challenges under an FTA.

RESPONSES

Unlike the situation in the United States, treaties entered into by Australian governments do not require ratification by Parliament. However, some provisions

of the treaty will require legislative changes.

Not coincidentally, since the provisions requiring legislative changes are precisely those that go beyond trade into matters of domestic law, the provision requiring domestic legislative change include a number of the least satisfactory components of the agreement. An example is the extension of copyright to 70 years after the author's death.

If the changes were the price of an agreement that was otherwise highly beneficial, it might be reasonable to treat them as a package deal. As has been shown above, however, the benefits of the trade component of the proposed FTA are at best marginal and possibly negative. **In this context, it is important for the Parliament to assert its capacity and responsibility to determine Australian law, rather than being bound by the conclusions of closed-door negotiations.**

Objectionable provisions of the FTA requiring legislative change, such as the extension of copyright, should be rejected. It would then be up to the US Congress to decide whether to accept an agreement which, while still weighted in favour of US interests, was less unbalanced than the current proposal.

Concluding comments

As has been noted by its strongest proponents, the term 'Free Trade Agreement' is a completely misleading description of the proposals currently under negotiation. Many of these proposals will be economically harmful to Australia. But even if they are not, they should be subject to vigorous public debate rather than being negotiated behind closed doors. At present, the vast majority of Australians are either are under the impression that, as its name implies, it is concerned primarily with such issues as tariffs barriers to agricultural trade. As with National Competition Policy, there is likely to be a severe backlash if and when Australians discover that secret negotiations have made radical economic and social reforms a *fait accompli.*