Rel. to Sub 160
Supp
Submission No: 160.2

NOTES ON CIE REPORT FOR DFAT ON US FTA FOR JOINT STANDING COMMITTEE ON TREATIES

The CIE/DFAT Report presents some results from the application of two quantitative economic models to the proposed Australia-US FTA as negotiated, to determine costs and benefits for Australia.

The CIE/DFAT Report excludes by assumption, or by assertion that effects would be negligible, a number of matters that have been important in the Australian public policy discussion of the US FTA. The exclusions by assumption or assertion include:

1. The potential effects of negotiation of this and other FTAs on the political economy of Australian domestic policy decisions, affecting the likelihood of further progress towards reductions in protection in Australia, and of new policy interventions affecting economic efficiency. The CIE/DFAT Report says that it is not possible for the analysis to consider the political economy effects. However, the Report assumes that there will be no further unilateral trade liberalisation in Australia.

Comment: I have been concerned since the beginning of the discussion of the US FTA that the political economy base for continued economic reform would be weakened, and this seems to have been justified by developments over the past two years, including the recent decisions on sugar subsidies. However, the assumption that there will be no further unilateral liberalisation in Australia is extreme. To the extent that there is indeed further unilateral liberalisation, it would reduce the gains from trade creation associated with the US FTA, and also losses from trade diversion.

While it seems clear that there has been a deterioration of the political economy climate for domestic economic reform as a result of the FTA discussion so far, it may be less clear that the damage could be reversed by Australia choosing now not to conclude the agreement. There is therefore an argument that the damage to Australian policy-making is largely water under the bridge. The most important contribution that could be made to reducing these political economy costs of the FTA discussions would be for the Australian Senate to insist on proper process in final consideration of the agreement. This will make the point that transparent, independent analysis of the economic costs and benefits of trade policy change will continue to be influential in Australian policy-making.

2. The potential effects of negotiation of this and other FTAs on the political economy of international trade policy, and in particular on the health of the multilateral trading system, the prospects for substantial progress on matters of importance to Australia in multilateral trade negotiations, and the emergence of preferential trade that is disadvantageous to Australia in East Asia and elsewhere. The CIE/DFAT Report again says that it is not possible to consider the political economy effects. It acknowledges the possibility of effects, but asserts that even if FTAs have a negative political economy effect, our own behaviour will not affect the likelihood of others going down the path to preferential trade.

Comment: My own view is that the proliferation of FTAs, encouraged influentially by Australia since late 2000, has substantially affected the international trading system in ways that are damaging to Australia. Most importantly, the prospects of liberalisation of agricultural trade in East Asia and globally have greatly diminished as a result of these developments. This is symbolised in the meeting in Europe this week of Trade Ministers of the EU, US and the new "Group of 20" developing countries, without Australia or the Cairns Group, to discuss a new agricultural liberalisation package that can restore momentum to the Doha Round. The dynamics of the Australian and Central American FTA discussions in the United States introduced the possibility of differentiation between liberalisation of agricultural imports from developed and developing countries, with huge potential for damage to Australia. Further, the economies of Northeast Asia with high agricultural protection have used the retreat into FTAs as a means of avoiding consideration of liberalisation in agricultural trade. These costly developments for Australia were predictable and predicted consequences of the drift into preferential trade.

As with the political economy effects on domestic policy, there is a question whether, now that much damage has been done, there would be incremental benefit in a decision now not to follow through with the US FTA as negotiated. It is true that much of the damage is water under the bridge: Australian policy has undoubtedly been influential in the East Asian drift into preferential trade, and an Australian decision now to change course may leave the East Asian drift into preferential trade substantially in place for the foreseeable future. However, the US shift to preferential trade under the Zoellick-Bush administration that has been damaging to multilateral trade and the Doha Round is increasingly being seen as a failure at home in the United States, and rejection of the AUSFTA may accelerate policy reassessment in the US.

3. The proposed new arrangements for management of the Australian Pharmaceuticals Benefits Scheme. The CIE/DFAT Report asserts that "...it is anticipated that AUSFTA measures on pharmaceuticals will have no significant net effect on the PBS or the economy" (p60).

Comment: Whether or not there is any effect on the PBS or the economy will depend on future decisions by Australian Ministers in new circumstances that institutionalise pressure from US pharmaceuticals companies with support from the US Government. I happened to see live on C-Span 2 television in Washington DC in March 2004 the discussion of this matter in the STR's presentations on the FTA to the US Senate Finance Committee. No-one seeing that exchange could have any doubt that there is an expectation in the US Congress that the new arrangements will lead to higher incomes for US pharmaceuticals firms, an expectation upon which future US Governments will be under pressure to deliver. If Australian Governments disappoint US expectations of the FTA, this will be an issue in bilateral relations. The inevitable outcome is some combination of tension in the bilateral relationship and accession to pressure for substantive adjustment to PBS decisions.

4. Intellectual Property. The reinforcement of Australia's existing framework for industrial property protection and strengthening of copyright protection and other changes in Australian arrangements on intellectual property. It is acknowledged in the CIE/DFAT Report that the effects are likely to be negative, but they are difficult to quantify, and so are not taken into account. In relation to several items under this heading, the Report asserts that the costs are not likely to be great.

Comment: There has been serious analysis of these issues in Australia over the past decade and they warrant more careful consideration in the FTA context. The effects may not be "great" by some standards, but neither are they trivial, and they may turn out to be large compared with the net gains from the FTA as a whole that emerges from straightforward application of the logic of the two models upon which CIE/DFAT rely (see below).

5. Media policy. There is no discussion of these matters.

Comment: The FTA as negotiated introduces constraints on Australian legislation in future that may be of considerable importance to Australians at that time. This matter needs to be analysed carefully.

6. Discrimination in FIRB processes. The CIE/DFAT Report recommends that any liberalization of FIRB processes as a result of the FTA should be on a most favoured nation rather than preferential basis. I strongly support that approach. In addition to the reasons presented in the Report, discrimination against Japan would breach Treaty commitments.

COMMENT ON MODELLING RESULTS

I will not spend more time now on any of these important issues that have been excluded from the CIE/DFAT analysis. Rather, I will examine the analysis of those issues upon which the CIE/DFAT Report has chosen to focus.

The Report applies two models to the quantification of the economic effects of the FTA: the well-known GTAP model, as modified by CIE; and the G-cubed model.

These are the two models that generated the results presented in the first CIE/DFAT Report with its $4 billion per annum of Australian benefits on the basis of complete liberalisation of bilateral trade in goods and services.

The results from and the respective roles assigned to the two models are very different in the first and second CIE/DFAT Reports. The GTAP model was the source of the assertions in the first report that trade creation (which enhances economic welfare) would exceed trade diversion (which diminishes economic welfare). There is no statement about the relative magnitudes of trade creation and trade diversion in the second Report. The results in the Executive Summary, including the $6 plus billion which dominated discussion, rely entirely on the G-cubed modeling.

However, Table 7.1, presenting results from the GTAP model on p83 of the CIE/DFAT Report shows that, with the restrictions of liberalisation in the FTA as negotiated being concentrated in industries in which the benefits of improved access to the United States would have been greatest, the Australian welfare losses from trade diversion will actually exceed Australian welfare gains from trade creation.

So from whence came the $6.1 billion benefits? (Actually the Report encourages use of GNP rather than GDP. The maximum increase in the former is $5.6 billion).

Lets look separately at the results from the two models. But first, why use two, when the preferred results are drawn entirely from one of them?

The Report compares the two models and discusses differences in the results on p82. Two differences are mentioned. G-cubed is more suitable than GTAP for capturing the effects of real investment and accumulation. On the other hand, the GTAP model is more disaggregated and therefore likely to pick up more trade diversion than G-cubed.

These two points are correct: the G-cubed model is so highly aggregated in commodities (it has only 12 sectors including only 2 in manufacturing) and countries/regions, (only 9, including only 2 in Asia), that it is structurally unsuitable for analysis of trade creation and trade diversion, which are generated on an industry basis. The CIE/DFAT Report acknowledges that even the GTAP model (57 sectors with 43 in manufacturing) and 66 countries/regions, is too highly aggregated for optimal analysis of trade creation and trade diversion.

But we must make do with the best we have, and for the analysis of trade creation and trade diversion, it is the GTAP model.

Why are trade creation and trade diversion so important?
Economic analysis shows that a world of free trade generates greater economic welfare than a world of protection. It also shows that one country will (with some practically unimportant exceptions) have higher economic welfare if it opts for free trade than if it opts for protection, whether the rest of the world implements free trade or protection. A movement to free trade is associated with relatively low cost domestic production replacing relatively high cost foreign production in foreign markets and relatively low cost overseas production by replacing relatively high cost domestic production in domestic markets. This replacement of high cost production from one country by low-cost production from another is known as trade creation. It unambiguously increases economic welfare in countries experiencing trade liberalisation and in the rest of the world.

Where there is trade creation, the economic benefits have been seen to exceed what one can calculate as the static effects of replacing some high-cost production by some low-cost production. There are additional "dynamic" effects. Economic literature describing and discussing these dynamic effects is cited in the Report (p.20); note that the references are to studies of multilateral liberalisation, where there are certain to be dynamic gains because there is no trade diversion.

While FTAs have the words "free trade" in their names, they are actually very different from the free trade discussed in the previous two paragraphs. An FTA is not free trade but a preferential trade agreement. Movement to bilateral free trade within a preferential trade agreement contains both "free trade" and "protectionist" elements. The protectionist element is associated with trade diversion: the replacement of some low-cost production from a third country with high-cost production from a partner country, because the latter has preferred access to the market.

An FTA is liberalising, that is, it involves movements towards free trade with all of the associated benefits, if the welfare effects of trade creation exceed those of trade diversion. If trade diversion exceeds trade creation it is a protectionist FTA, and movement towards it will lower economic welfare. In this case, any "dynamic" effects deriving from the trade effects of the FTA are negative for economic welfare.

With these points in mind, let us look at the results from the two models reported by CIE/DFAT:

GTAP shows that trade diversion exceeds trade creation in the US FTA as negotiated. Why then are various dynamic gains, leading to a small overall increase in Australian economic welfare ($359 million) reported in Table 7.1? Surely if trade diversion exceeds trade creation the initial income effects are negative, and with them the changes in taxation, technical efficiency and capital accumulation reported in Table 7.1? The explanation for the apparent contradiction seems to be in the Report's acknowledgement that various dynamic gains are assumed into the GTAP calculation on the authority of the G-cubed modelling exercise. So the credibility of GTAP results beyond the calculation of trade creation and trade diversion depends on the credibility of the G-cubed results.

G-cubed generates the $5.6 billion of gains in national income from three sources:

(i) Gains of around $4 billion from abolishing the requirement of FIRB approval for United States equity investments in non-sensitive industries (ie excluding civil aviation, Telstra, banking, media etc) with capital value between $50 million and $800 million. The Report says that it is probably impractical and certainly undesirable to limit the liberalisation to US investment: the application of the same methodology to all investments in non-sensitive industries between $50 million and $800 million would generate benefits over time in excess of $15 billion per annum; and to all investments of any size from any source in non-sensitive industries perhaps twice as high again.

If these really were credible numbers, I would advise the Senate Committee to adjourn these hearings immediately and press upon both Opposition and Government Party rooms the absolute urgency of implementing these reforms. They are in no way tied to the FTA: they are much better implemented on a most favoured nation basis.

Unfortunately they are not credible numbers. Very few if any US investments in non-sensitive industries in the range of $50 million to $800 million have been rejected by FIRB in recent years. Firms seeking to purchase Australian businesses in the size range $50-800 million in non-sensitive industries presume that an application for FIRB approval will be successful. The FIRB processes are a nuisance. They add millions, perhaps a few tens of millions, annually to transactions costs. Unlike, so far as I am aware, the Australian Business Council, the Treasury, DFAT, CIE or most other economists participating privately in the economic reform debate over the past couple of decades, I am on record as saying that the FIRB controls serve no purpose. But as an advocate of abolition of the FIRB, I would claim no huge gains for this minor reform.

(ii) Gains from trade liberalisation of around one billion dollars. But these are generated within the G-cubed model that, because of its aggregation, is acknowledged in the CIE/DFAT Report as being unable to pick up trade diversion effects that are identified in the GTAP model. The trade diversion and trade creation calculations from the GTAP Report are much more reliable, and Table 7.1 shows that these are negative. So the calculations of the gains, from trade liberalisation relies on application of an inappropriate model to calculation of the relative extent of trade creation and trade diversion.

(iii) The balance of the $5.6 billion comes from dynamic gains from trade liberalisation. Unfortunately, these depend on the trade liberalisation gains having been positive. Since the trade liberalisation effects are negative (by a small margin, so lets say zero), the dynamic gains will also be negative by a small margin (say zero).

So rigorous application of the models used in the CIE/DFAT Report and of their results seems to suggest gains not of $5.6 billion, but something near zero. I myself would not assert that there are zero or negative gains from the factors upon which the CIE/DFAT Report focuses until there has been transparent independent analysis by an organisation that has the capacity and time to do the work with authority. Again, this highlights the need for a Report from the Productivity Commission.

RULES OF ORIGIN

I should make one final remark about the CIE/DFAT quantitative assessments. They take some account of the effects of rules of origin, but greatly underestimate their importance. Since the Singapore-US FTA came into effect, virtually no small and medium-sized firms have exported to the US under the FTA. They generally prefer to pay the MFN tariff, because the costs of compliance with the rules of origin outweigh the gains of the lower tariff. Many Australian industries, and not just textiles as assumed in the CIE/DFAT Report, will be unable to meet the rule of origin that is applicable to their product. Even when they may be able to meet the rules of origin, the requirements on keeping records is onerous for small and medium-sized firms. The Singapore Government has set up a new bureaucracy to persuade firms of the benefits of using the FTA, but there are no early signs that Singapore business has changed its behaviour. Even in Canada, most small and medium firms choose to pay the MFN tariff rather seek to comply with the rules of origin for NAFTA. To the extent that high non-American imported content or compliance costs blocks use of the FTA, trade creation will be lower than it would otherwise have been.

The Report takes no account of the trade diversion associated with changes in sources of imports to meet rules of origin requirements.

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2 May 2004