

Note for the Senate Select Committee on the Free Trade Agreement between Australia and the United States

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This note has two parts: an answer to a question asked by Senator Cook at the hearing on Monday 7 June, and a brief statement on methodological issues which might be helpful as an introduction to our further conversation on 22 June.

1. Why should governments support high-technology manufacturing?

The brief answer to this question is that high-technology manufacturing is similar to education and infrastructure provision, in that its ultimate benefits to the economy are considerably greater than its immediate financial rewards to the owners of high-technology manufacturing businesses. In addition, the risks of high-technology investment to the investing business are considerably greater than its risks to the economy as a whole. These two characteristics underlie the case for government support, especially through the pooling of risk. If support is not provided and investment is purely market-determined, the level of investment will be less than desirable from the point of view of the whole economy.

The case may be put more formally in terms of the cost-benefit methodology used by the World Bank and other institutions involved in development project finance, including AusAID. This methodology extends neoclassical economics by taking into account benefits from investment not received by the investor, and likewise costs not borne by the investor. Using this methodology, the difference between economic and financial rates of return can be calculated for particular projects, and by extension for industries as a whole. The divergence can be positive, as with infrastructure provision, or negative, as for gambling. Practical studies show that leading-edge technologies have high positive divergence, justifying public support.

This argument is nothing new. It has nineteenth-century roots in the public education and public works policies of all the Australian colonies. In the twentieth century it was much discussed in terms of the infant industry argument for protection. However, current best-practice policy diverges from twentieth century industry protection, under which support tended to become institutionalised and to persist after the case for it had disappeared. In current practice, support is tied to leading-edge technology, often taking the form of assistance with research and development. If the leading edge disappears support is automatically switched to other industries offering high economic and social rates of return.

Current Commonwealth policy in these matters seems to be driven by two judgements.

1. Estimates of the divergence between economic and financial rates of return are extremely narrow. The Commonwealth has failed to adopt even the conservative methodology favoured by the World Bank for identifying cases of divergence.
2. The Commonwealth appears not to appreciate that support can be provided in forms tied to the continued existence of positive divergence between economic

and financial rates of return, and hence excessively fearful that support will spill over to cases where it is not warranted.

In National Economics view, both of these judgements are hindering Australian economic growth, which is well below that which Australia could achieve were it to adopt World Bank practice.

2. Summary of methodological issues

By the standard of most of the twentieth century, trade between the United States and Australia is already remarkably free. This means that the trade barriers removed under the Free Trade Agreement are relatively minor. The major innovations of the agreement lie in the treatment of intellectual property, overseas investment and government procurement. The lack of precedent in these areas introduces enormous uncertainty to the assessment of the agreement.

National Economics' preferred methodology for policy assessment is to use our econometric models to prepare a base case projection, running out year by year into the uncertain future. We then compare this projection with an alternate projection which includes the policy changes we are assessing. Unfortunately this methodology is difficult to apply to policies where there are no precedents, and where the results are necessarily uncertain. In assessing the agreement, we accordingly decided to simplify the basic methodology drastically and concentrated instead on charting the range of uncertainty.

The drastic simplification was to abstract from realistic projection of the growth prospects of the Australian, United States and world economies. As Dr Brain remarked in Melbourne, both Australia and the United States currently face major economic difficulties. Both countries are running unsustainable balance of payments deficits, in the US associated with a public sector deficit and low national savings rate and in Australia associated with a land boom, high household debt and a low national savings rate. In our view, correction of these problems will mean that both Australia and the United States will sustain low rates of income growth over the next decade, possibly including serious recession. These low rates of growth will tend to limit the benefits of the agreement, but we have not taken them into account.

Over the longer term, the United States and Australia, along with other high-income countries, are participating in a slow and very uneven process of global income convergence. In a process of income convergence, it is not particularly pleasant to have one's income converge downwards, but this is a real prospect, particularly for those Australians whose skills are directly competitive with skills now readily available in countries like China and India.

The methods by which low-income countries have taken off into sustained growth, and by which high-income countries have sustained their advantage, involve public private partnerships in the broad sense. Our main concern about the agreement is that it hinders the formation of such partnerships, particularly in Australia. In the United States the main relevant partnerships are beyond the scope of the agreement, since they are hidden in defence contracts or in state and local government operations not covered by the agreement. In Asian countries, and increasingly in Europe, they are even further from the reach of agreements of the type negotiated.

Our abstraction from real-time projections means that we have assessed the agreement in relation to the current structure of the United States and Australian economies, without any allowance for the certainty that these structures will change during the currency of the agreement. This is very similar to the CIE's assumption, and allows trade effects to be assessed using estimated responses to changes in relative prices, plus the effect of changes in American quotas. Not surprisingly, our results for this aspect are very similar to the CIE's. We hasten to add that these results are vulnerable to retaliation by third parties excluded from the agreement, in which case trade diversion effects could easily be much higher and less favourable, as indicated in other evidence to the Committee. We have tried to allow for this by defining a range of reasonably probable impacts.

In the areas of intellectual property, government procurement and foreign investment the agreement limits the formation of public private partnerships for economic development. The exact limits are uncertain, since the agreement is vague on many points and invites litigation, which is itself a cost. Given that partnerships with direct government participation are the only proven way of maintaining income in high-income countries, the potential cost of these limits is very large indeed. However, we recognise that the current Commonwealth government, almost alone among high-income countries, eschews partnerships. Given our assumption of current economic structure, the main effect of the agreement will be to limit state government policy. For each major area we provide a best possible outcome, which is generally that the agreement turns out not to restrict economic development policy. We estimate a worst outcome, based on prohibition of all current and recent past partnership policies which might be affected by the agreement. We also present a most likely outcome. These results are conservative, in that we have not been able to cover all areas. We could also generate a far worse worst outcome by assessing the restrictions in the agreement against the adoption in Australia of the complete range of partnership policies as practised in, for example, Singapore and the EU.

Finally, the agreement contains provisions for unrequited gifts from Australia to the US. These are most obvious in the copyright extensions, but the changes in the conduct of procurement for the PBS also fall into this category.

We have taken the best, worst and most probable impacts for each area and, assuming they don't interact, generated most probable and upper and lower likely impacts on Australian incomes.

The CIE also recognises that the agreement will have very uncertain effects, and gives a range of possible outcomes. Our range is wider. Our most probable result is negative, and the balance of risks is distinctly downward. These differences from the CIE results arise because we have assessed a much wider range of effects, and have also defined separate probability distributions for each area before estimating the range of total impacts.