Australian Government

Department of Foreign Affairs and Trade

4 June 2004

Mr Brenton Holmes
Secretary
Senate Select Committee on the FTA Between Australia and the USA
Parliament House
CANBERRA ACT 2600

Dear Mr Holmes

I refer to your email to Michaela Browning of 27 May, seeking responses to a number of questions on notice from the Senate Select Committee on the Free Trade Agreement between Australia and the United States of America.

Attached are answers which the Department of Foreign Affairs and Trade has prepared on the basis of the CIE's report (*Economic Analysis of AUSFTA: Impact of the bilateral free trade agreement with the United States*), subsequent consultations with the CIE or from its own resources.

I trust that they will be of assistance to the Committee in its deliberations.

Yours sincerely

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Senate Select Committee on AUSFTA
Questions on Notice to DFAT and the CIE

A. Questions about what has been fed into the models

1. Tariffs. The CIE argues persuasively that production weights are better than import weights for aggregating tariffs. Yet when you aggregate tariffs from the GTAP to the G-cubed level, you use import weights instead of production weights, when you could have got production weights from the GTAP model database. Presumably this biases downwards the tariffs in G cubed?

REPLY:
Production weights are used by analysts to look at or estimate the protective effects of tariffs. However, import weights were used by the CIE in this case so as to replicate the tariffs that would have arisen if only the one model (GTAP) was used (GTAP uses imports weights when aggregating sectors). That is, import weights were used to ensure greater tariff consistency between the two models.

The CIE notes that if production weights had been used, then tariff removal in G-Cubed would lead to relative price changes between imports from different sources larger than the average relative price change across the associated disaggregated commodities in GTAP. Relative to import weighting, there would be larger import tariffs on commodities from sources from which trade diversion is occurring. Consequently, the CIE considers that trade diversion effects would be overstated in G-Cubed if production weights had been used.

2. Tariffs. A question of clarification. Why is the starting tariff on non-durable manufactures in G-cubed higher in the US than in Australia (table 3.3 and table 5.1)? Does this mean that some liberalisation of sugar has been allowed in the US? Table 5.1 doesn't mention that it has been excluded.

REPLY:
The US starting tariff for non-durable manufactures was derived from the schedules provided by DFAT, using the methodology outlined in Appendix A of the CIE's report. The CIE notes that it is higher than the Australian starting tariff for non-durable manufactures because US tariffs are higher (only 3 of the GTAP sectors that are concord to non-durable manufactures are higher for Australia).

Footnote (a) to Table 3.3 and footnote (a) to Table 5.1 note that the tariff on US sugar imports was not included in the modelling. However, there are a small number of tariff lines (called "sugar-related products" in Table 3.3) where the US would liberalise tariffs under AUSFTA and which accordingly were included.

3. Professional services. The CIE has assumed that restrictions on licensing partly create rents and partly raise costs. Yet the Productivity Commission work that you

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cite found that licensing requirements only raised rents, and therefore prices, but they did not raise real resource costs. Doesn't this mean that your welfare gains from services trade liberalisation are likely to have been overstated?

REPLY:
The CIE notes that in a model such as GTAP that does not have an explicit treatment of FDI, it is difficult to model a rent-creating barrier on delivering services through commercial presence. This is, however, the most important means of services delivery in the case under consideration. To attempt to capture the most important effect of removing the rent-creating barrier, the barrier was represented as one which escalates costs, but with a price-elevating effect on the domestic industry only half of the effect estimated in the Productivity Commission's work.

The services barriers assumed by the CIE are quite conservative. Moreover, the analysis in Chapter 8 explored the sensitivity of the results to varying the assumptions about barriers in the only sector where they were assumed to occur for Australia (the "business services (other)" sector). The lower bound assumption in this sensitivity analysis was for no cost reduction at all in this sector.

4. FIRB screening. The CIE has assumed the relaxing FIRB screening will lower the equity risk premium in Australia. But the equity risk premium concept is about the risk of investors losing all their equity through some unforeseen ex post event. FIRB screening happens ex ante, before the event. If an investor is rejected, they will at most lose the cost of lodging an application. They won't lose the value of the equity they would have invested. So is this an appropriate way to model the effects of FIRB screening?

REPLY:
This is a question also posed by Professor Garnaut and was expanded at length in the evidence to the CIE's second appearance before the Joint Standing Committee on Treaties. The Hansard transcript of evidence gives more explanation to why the restrictions on foreign investment were modelled by the CIE in the way that they were.

The CIE has noted that the changes to Australia's investment rules are about more than just FIRB screening and that is what is being represented in the modelling. The changes are also about national treatment and most favoured nation treatment and those things affect the investment climate. Second, the assertion in the question that the equity risk premium is about the investor potentially losing all their equity is not correct. Investors face potential risks that can lower their return on investments and so they demand a premium for that additional risk. They don't necessarily have to lose all their equity for there to be a premium for risk.

The CIE has taken the view that without some discipline on rule changes by governments there is an element of risk, especially where political sensitivities are present, that adverse rule changes will occur affecting a foreign firm's return on capital for which they will

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demand a higher return on their equity to compensate for the risk. The greater certainty given to investment through national treatment provisions as well as easing restrictions creates a more secure investment climate which is reflected in lower risk in both directions. The CIE notes that Australia has also secured a more certain investment climate for our investors into the United States but this aspect is not quantified in its analysis.

The FIRB restrictions also involve costs to firms to get the paper-work together and submit claims. This cost was reported by one multinational to the CIE to be 'onerous'. But it is a cost and has to be recouped from the investment. The CIE's assessment is that it increases the cost of capital in this country. The point about the equity risk premium is that it equates to the cost of capital. So both the extra cost of capital and the extra risk are reflected in the equity risk premium as the CIE has modelled it. In the CIE's modelling, this premium is an extra 0.05 percentage points, which is extremely small. The CIE's sensitivity analysis considers the case where it could be as low as 0.02 percentage points.

5. FIRB screening. Even if it is appropriate to model FIRB screening as having an effect on risk, it will only affect risk premiums if the risk cannot be diversified. But US investors invest all around the world. Why can't they diversify away any effect of FIRB?

REPLY:
The CIE's assessment is that making it easier to invest in Australia also makes it easier to diversify portfolios and find uncorrelated risks, thereby lowering overall risk which will lower the risk premium, as the CIE has modelled it. The model already allows for US arbitrage on alternative investments around the world.

6. Copyright. In discussing the benefits and costs of extending copyright, you assume that an author receives a constant flow of royalties, and use this to come up with a small positive number for the benefits. What would happen if you used the same assumption to put a number on the costs to Australia of having to pay royalties to the US for longer? Would the costs to Australia have exceeded the benefits?

REPLY:
The CIE report makes it clear that the costs of copyright extension depend heavily on the economic life of creative works, particularly whether works are still in demand and where copyright is close to expiry under present rules. A lack of robust data on the average economic life prevented the CIE from quantifying the net impact of extending copyright terms. However, the CIE notes that the Office of Regulation Review suggests that the market life of most copyright material does not exceed a few years. The CIE report concluded that demand for most creative works "is likely to become very small, if non-existent, well before the current copyright term expires". The CIE was also not able to quantify costs from producing new works with input from existing works affected by copyright extension.

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7. Government procurement. Is it reasonable to assume that Australia will do half as well as Canada in penetrating the US government procurement market, when we know that all Canadian trade with the US is disproportionately high because of their common border, and the prevalence of North-South rather than East-West transport linkages?

REPLY:
The CIE's starting point on government procurement was the Canadian share of the market ($650 million, or 0.3 per cent of the market). The CIE then looked at various adjustments to reflect the differences between the size of the Australian and Canadian economies, and the value of US-Canada and US-Australia trade. This suggested that Australian share of the Government procurement market was likely to lie between $50 million and $360 million. The CIE assumed $200 million as the size of the Australian share for its central case.

This is actually less than one third of the Canadian share, not half as indicated in the question. It may well be conservative for two reasons. First, the CIE estimates were based on contracts won by the Canadian Commercial Corporation and did not take account of contracts won by Canadian companies independent of the Corporation. Secondly, the CIE considered only US federal procurement and did not take into account sales to US States which were added to the Agreement after the CIE study. The CIE made the valid point that the degree of Australian business derived from the improved access will depend on how Australian business responds to this new opportunity.

As part of its sensitivity analysis, the CIE explored the impact of changes to its assumptions on government procurement. Australian firms' exports to the US Government were assumed, in this analysis, to vary between zero and $400 million.

8. Government procurement. The CIE states that the administration costs of the government procurement provisions will be minor. But there are many provisions in the agreement that ask for ongoing consultation, working groups and so on. For example, article 2.13, Annex 2C, article 3.2, 3.5, 3.6, 4.3, 5.13, 5.16, 6.5, 7.4, 8.5, 8.6, 8.9, 10.8, 10.13, 11.15, 11.16, 13.11, 13.16, 13.17, 14.2, 14.6, 14.7, 14.8, 14.10, 15.14, 16.5, 19.5, 19.6, 19.7, 20.3, to name just a few. Isn't the cumulative effect of all these provisions likely to impose significant administration costs?

REPLY:
The provisions cited cover a range of obligations dealing with the transparency and development of domestic regulations, opportunities for the parties to consult on specific issues, and the carrying out of a range of work programs. Implementation of these provisions will not impose significant administrative costs, partly because many reflect existing Australian practice, while others provide for consultation arrangements that should provide an effective mechanism for addressing any particular problems that may affect trade or business activities. Many of the consultative opportunities will be undertaken jointly and only when there are problems to discuss, and could provide

important vehicles to protect Australian interests and ensure that the benefits expected from the Agreement are achieved. The provisions dealing with work programs, such as that on the establishment of a Financial Services Committee, will create opportunities that could deliver significant benefits over time through promoting greater cooperation and economic integration between the two countries.

The provisions on transparency and domestic regulation reflect regulatory best practice, and build on similar provisions to be found in various WTO agreements. They are fully consistent with Australian practice, including the National Competition Policy and the Council of Australian Government's Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standard-Setting Bodies.

9. Rules of origin. The CIE is to be commended for taking into account rules of origin. But the problem with them isn't just that some of our exports may not get preferential treatment into the US. An additional problem is that we may start diverting our input sourcing in order to meet the rules of origin. Wouldn't this impose additional costs on the economy? Do you have any indication of the extent to which this may occur?

REPLY:
Under AUSFTA, the rules of origin (ROOs) for most tariff lines involve a change in tariff classification rule. This is sometimes supplemented by additional or optional regional value content (RVC) requirements. Although some trade diversion of inputs may occur under these ROOs, it is generally not expected to be significant, with the ROOs generally providing flexibility to use inputs imported from third countries. Only in the textiles and apparel sector could the CIE find evidence that certain Australian companies would have difficulty meeting the ROOs. Diversion of source of inputs to the US may occur in the case of this sector but, given the small trade in textiles and apparel between the US and Australia and the phasing of textiles and apparel tariffs under the Agreement, the impact in terms of total trade is not expected to be significant.

10. Rules of origin. You say in your report that FCAI and FAPM are not concerned about the ability of local car makers to meet the rules of origin. But aren't there likely to be problems elsewhere, in machinery or electronic equipment for example?

REPLY:
As mentioned in the answer to the previous question, the only sector where it is envisaged there will be a problem in meeting the ROOs is textiles and apparel. DFAT's contact with other industry sectors confirms the view that meeting the rules of origin under the AUSFTA will not be a problem in taking advantage of the Agreement.

11. Rules of origin. Under the CER, it appears that only about 30 per cent of the trade between Australia and New Zealand takes place at the preferential rate, and this partly reflects rules of origin and the complexity even of simple value-added rules. The corresponding number for the ASEAN Free Trade Agreement is said to

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be about 5 per cent. Is it reasonable to assume that AUSFTA will do so much better in the manufacturing area?

REPLY:

The 30% figure creates the wrong impression about the impact of the rules of origin in CER. There are two reasons for this seemingly low figure:

- the MFN tariff on many items traded between Australia and NZ is zero and therefore the preferential tariff is not relevant; and,
- the construction of the statistic may include excise payments on liquor and petroleum products in the duty collected and excise, as a domestic tax, is usually not waived under an FTA.

If those elements are removed from the analysis, the proportion of the relevant trade that enjoys preference under CER is very high; indeed, 99% of the relevant imports from New Zealand into Australia are accorded duty free entry under preference.

12. Safeguards. Has the CIE examined the likely impact of the separate safeguard provisions on textiles, and clothing?

REPLY:
Due to the level of sectoral aggregation at which G-Cubed operates, it was not feasible for the CIE to consider the safeguard mechanisms as they apply to textiles and apparel in this part of the modelling work. It was also not possible to model them effectively within GTAP because the model, as a comparative static model, does not have a "time" dimension. Most of the safeguard measures on textiles and apparel do have a temporal dimension. They can only be imposed for a period of 2 years, with a possible one-off extension for 2 years.

B. Questions about the models

13. The CIE's analysis shows that this agreement is mainly about tariffs. Yet its preferred model, G-Cubed, has only 2 aggregate manufacturing sectors, while GTAP has 24. Doesn't this mean that G-cubed severely understates the tariff peaks in both countries (tables 5.1 and 5.2 suggest this -- the highest non-sugar tariff in GTAP is 19.1 per cent, while the highest non-sugar tariff in G-Cubed is only 5.7 per cent). Doesn't this mean that G-Cubed significantly understates the likelihood of trade diversion?

REPLY:
The CIE notes that effect of aggregation is to replace a set of tariff rates -- some large, some small -- with an average tariff rate for the aggregated commodity. Trade diversion is the switching of imports from sources still facing an import tariff towards the source the import tariff of which has been removed. The CIE has considered the question of whether the removal of an average tariff on an aggregate commodity would cause more

such switching than the removal of a set of high and low tariffs across a more disaggregate set of commodities. Its view is that the answer is unclear in general, and is probably 50-50 either way under the import share weighting scheme used for tariffs going from GTAP to G-Cubed. The CIE's view is that it is not clear that G-Cubed understates the degree of trade diversion.

C. Questions about the model results

14. The GTAP model, which is much more disaggregated and therefore much better able to pick up trade creation and trade diversion, shows that within Australia, the allocative efficiency effects of diversion outweigh creation. Granted that we also get substantial gains from greater access to the US market. But within Australia, it means that any additional import competition comes from less efficient US imports rather than more efficient imports from Europe and Asia. Doesn't this undermine the case for their being any dynamic gains from the agreement, since as you argue, these come from more intense import competition. (Note too that table 7.2, local prices rise, which means import competition is not strong). And doesn't this mean the G-Cubed results are overstated?

REPLY:
This question has been raised before by Prof. Garnaut in the 'round table discussion' held on 5 May 2004. The CIE provided an answer to the Committee, which is available from the Hansard transcript.

Australia's lowering of its tariffs on US imports will lower the price of those imports in the marketplace, which will increase competitive pressure on Australian manufactures. The CIE notes that this is not an issue of whether EU, Asia or US producers are the benchmark, only whether the competitive pressure on Australian producers changes (increases) following AUSFTA. The lowering of tariffs on US products must increase the competitive pressure on Australian producers. The CIE does not consider that dynamic productivity has anything to do with trade creation or trade diversion — they are two separate issues.

The CIE notes that econometric studies suggest that trade liberalisation leads to dynamic productivity gains. The econometric studies typically report the productivity gain from a unilateral tariff reduction. As AUSFTA is a bilateral arrangement, the induced productivity gain in Australian sectors may not be as great as in the unilateral scenario, due to the US potentially not setting the productivity benchmark. The CIE has proxied this by scaling the productivity gain by the share of imports accounted for by the US — if the US accounts for 100 per cent of imports then in the place of uniform tariffs, the US must be the most efficient (lowest cost) producers globally. If the US doesn't account for a large share of our imports, as is the case in TCF, then clearly they are not setting the benchmark and the dynamic productivity gain was scaled (down) accordingly.

15. The CIE is to be commended for doing systematic sensitivity analysis. But its headline GTAP results use the standard GTAP trade elasticities. The CIE has argued elsewhere, including in the work that it did for the Productivity Commission's most recent report into automotive tariffs, that the standard elasticities should be doubled. Your sensitivity analysis suggests that this would worsen the losses from trade diversion? Is this correct?

REPLY:
The CIE has used double the standard GTAP trade (Armington) elasticities, except for "motor vehicles, trucks and parts". The CIE considers that double the standard GTAP elasticities is an appropriate choice for most sectors. In the case of "motor vehicles, trucks and parts", the CIE used standard GTAP elasticities, partly on the basis of industry assessments that Australian and US automotive products are poor substitutes as far as Australian consumers are concerned. The report provides a detailed discussion of this issue (see pp.91-92). If the CIE had used double the standard elasticities in all sectors, the allocative efficiency gains from trade creation for Australia would have been greater, as would losses from trade diversion. The overall welfare gain for Australia (measured as equivalent variation) would be marginally lower, at $349 million as opposed to $359 million.

16. The GTAP results suggest that most of the gains from liberalising services would come from productivity improvements. But isn't this the result of treating at least some of the barriers in professional services as being things that raise costs? The Productivity Commission study on professional services found that licensing restrictions did not operate like that (see also question 3). So does this mean that the likely gains from liberalising professional services are negligible?

REPLY:
As indicated in the response to question 3, the approach the CIE adopted on services liberalisation was conservative. The CIE explored, through sensitivity analysis, the effect of varying the assumption that productivity improvements flow from services liberalisation in the only sector in Australia where they are assumed to occur.

17. The GTAP model shows that the FTAA would reduce the benefits to Australia by about $60 million. What would be the effect of the US signing all the other agreements it is negotiating at the moment? How many of them would it take to erode the total benefit of this agreement to Australia? Doesn't this reinforce the importance of doing things in a multilateral basis?

REPLY:
Table 7.6 shows that the gains from AUSFTA as $359 million if AUSFTA proceeds and the FTAA does not. They are $361 million if the FTAA occurs and Australia enters AUSFTA (the difference between a gain of $295 million if AUSFTA proceeds and a loss of $66 million if it does not in this scenario). Australia thus has an interest in entering the AUSFTA irrespective of whether the FTAA proceeds or not. The CIE has not modelled gains from AUSFTA under scenarios where the US enters other FTAs. However, it

considers that its conclusion that results in its report are not unduly sensitive to regional trade agreements being negotiated elsewhere in the world would still hold.