

AUSFTA — A Response to Committee Hearings of 6 July 2004 and DFAT's subsequent written response

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General comments

In the Committee hearings of 6 July, Senator Brandis distinguished three different types of evidence:

- modelling evidence;
- historical and comparative evidence; and
- pragmatic evidence — the opinions of the people who will be actually doing the trading under the agreement.

He then suggested that modelling evidence could be discounted because it was inconsistent and not based on facts. He stated that historical evidence was not inconsistent and was based on real facts, and that the historical and pragmatic evidence both pointed to the same conclusion — that AUSFTA was likely to be beneficial. The evidence was that following NAFTA, trade and investment levels had increased between the partner countries, and that Australian business people were anticipating gains from AUSFTA.

However, the facts do not necessarily speak for themselves. One reason is that we do not observe the counterfactual. We have historical evidence of what the world looks like now with NAFTA in place. We do not have historical evidence of what the world would look like now, had NAFTA not been put in place.

We observe that trade and investment levels have grown over time between the NAFTA partners. But there are many possible reasons for this growth, an

important one being that the partner countries are larger now than they were before NAFTA was formed. To conclude that the trade and investment growth was the result of NAFTA, a person must have an economic model in their head that says that the growth in the size of the partner countries is not an important influence on the size of trade and investment flows between them, but that the formation of a free trade agreement between them is an important influence. However, economic theory suggests that the size of partner countries, along with the distance between them, has a significant impact on the size of trade and investment flows.

The relevant fact is not whether trade and investment flows have grown between NAFTA partner countries, but whether the trade and investment flows could have grown even more, had NAFTA not been formed. Gravity model estimation of the type carried out in the recent Productivity Commission study of a number of recent trade agreements is designed to answer this question, by correcting for other influences such as size and distance.

The conclusion, not just from the Productivity Commission's own estimation, but from a majority of other empirical studies reviewed in that paper, is that NAFTA has caused net trade diversion. Further, the Productivity Commission finds that the trade flows between partners could have been larger, had NAFTA not been formed. So not only did NAFTA divert trade away from third parties, it did not even succeed in boosting trade between partner countries (correcting for the influence of other factors). The paper concluded that the trade restrictions imposed by the NAFTA rules of origin were likely to be an important factor in explaining this result.

The same Productivity Commission study concluded that on the investment front, NAFTA had, along with a number of other agreements, led to net investment creation. It had created more investment than it had diverted from third parties. But this was not an unqualified benefit. While NAFTA was net investment creating, the additional trade that took place from the new investment positions probably added to the trade diversion.

So a final assessment of NAFTA requires the welfare effects of trade diversion to be balanced against the benefits of net investment creation. The empirical techniques used in gravity model analysis are not capable of making that assessment, essentially because economic well-being is not an observable fact.

But the economic modelling of the sort undertaken by the CIE can assess the balance of trade diversion and investment creation on economic well-being,

because both models contain enough economic structure to assess economic well-being, and both include trade and capital flows. Thus the economic models used by the CIE are better tools, not worse tools, to make an overall evaluation of economic well-being.

Are those models based on fact? Yes, to the extent that they have been parameterised to reproduce historical patterns in trade flows. The CIE modelling using the GTAP model deviated from the parameters that had reproduced history. The analysis in my first report to the Senate Committee used GTAP model results in which the parameters that reproduce history had been restored.

Is having a model that is based on fact sufficient to guarantee a reliable result? No, because in assessing a prospective, not-yet-historical event such as AUSFTA, there is still the problem of ‘garbage in, garbage out’. Much of my criticism of the CIE modelling was made on this basis — more on this below.

How does the pragmatic evidence fit in? Economic theory suggests that the evidence of business interests receiving the concessions will be a biased assessment of the likely overall economic effects of AUSFTA. The business interests receiving the trade concessions will clearly gain from a preferential agreement such as AUSFTA. If there are losers, they will be consumers or other business interests that do not receive concessions, and are therefore penalised by tougher competition for resources. The consultative processes of the Department of Foreign Affairs and Trade are designed to canvas the views of the businesses receiving the concessions. The Department does not have the statutory requirement, as the Productivity Commission does, to take an economy-wide view. It does not have the requirement to consult with consumers or those businesses that are indirectly penalised. So its pragmatic evidence is biased in favour of AUSFTA.

Once again, the CGE modelling of the sort undertaken by the CIE is capable of combining the effects on producers and consumers to get an overall, economy-wide assessment of the effects of AUSFTA. Once again, the modelling is a better tool, not a worse tool, for the job.

Having said that, modelling has its limitations, and considerable judgement is required in using modelling results, along with other evidence, to come to an overall conclusion about the economy-wide effects of AUSFTA. The Productivity Commission has an excellent track record of making such judgements, in the context of a broader consultation process and a statutory requirement to take an economy-wide view. In the absence of the Productivity Commission being asked

to make an assessment of AUSFTA, it is up to the Senate Committee to make those judgements and come to that careful assessment. And that assessment should include a careful examination of the extent to which the various modelling results suffer from the problem of ‘garbage in, garbage out’.

Specific comments

The discussion before the Senate Committee on 6 July suggested that I had been unduly dismissive of the potential dynamic effects of AUSFTA, and unduly conservative in dismissing the CIE’s attempt to quantify them.

Two of the three empirical studies of the dynamic effects of tariff reductions used by the CIE were conducted in my branch while I was Assistant Commissioner of the Productivity Commission. I am more eager than most to find convincing evidence of such effects, and more aware than most of the strengths and weaknesses of the currently available studies. As I noted in my previous supplementary note, the methodology required to isolate such effects convincingly is more complex than that used in the studies that the CIE drew on. The required methodology has more in common with the more recent sectoral analyses used by the Productivity Commission to estimate the effects of services trade barriers, work which the CIE also drew on. That suite of services work also took place under my direction, as part of two collaborative projects with Australian National University. It is disappointing that the CIE was not able to use the services work appropriately.¹

Another concern with the CIE’s attempts to quantify the dynamic effects of tariff reductions is that they were drawing on analysis of a period of extensive unilateral, across-the-board tariff reductions in Australia. Economic theory tells us that preferential tariff reductions are different — the gains are at least partly captured by foreign producers, and the additional competition through lower prices is significantly less. Economic theory goes as far as to suggest that if foreign producers are in a position to exercise market power (as many US producers would be), then there is likely to be no effect on local prices at all.² The leverage for dynamic gains from AUSFTA is significantly less than in the studies that the CIE drew on.

¹ My analysis does not deny significant benefits to liberalising services trade barriers when they are cost-escalating. I simply observe that the relevant barriers are not of this type.

² Panagariya, A. 2000, ‘Preferential trade liberalization: The traditional theory and new developments’, *Journal of Economic Literature*, 38(2), pp. 287–331.

At various places, the discussion before the Senate Committee on 6 July also suggested that there would be additional dynamic gains from the non-tariff provisions of the agreement. It is hard to see how these could be significant when the non-tariff provisions in services and investment are largely — though not completely — standstill or status quo provisions, and the bindings (promises not to go backwards) are largely — though not completely — already been made under the WTO. In addition, the Department of Foreign Affairs and Trade has claimed that the substantive services and investment commitments are not preferential. The selective relaxation of FIRB screening clearly is. So too are the majority of the substantive services trade commitments on both sides listed in pages 7–9 of my original report to the Committee.

The discussion before the Senate Committee on 6 July suggested that the scope for trade diversion would be minimal, because the United States was such a competitive producer, and where it was not, it was unlikely to capture market share from competitors such as China, because China's costs were so much lower. The facts are that for 896 of the 1213 product lines at the 4 digit level of the Harmonised System of product classification, Australia's main supplier is currently a country other than the United States. And in the product lines where Australia's tariff peaks occur, the major suppliers include Hong Kong, Taiwan and Korea, as well as China. China may be able to maintain its prime supplier status in the face of preferential tariff cuts granted to the United States — some of the other suppliers may not.

To clarify my arguments about the equity risk premium, this is a concept that captures the effects of *risks* that cannot be *diversified away*. There is a cost associated with FIRB screening — the transaction cost of making the application — but it is a sure thing, not a risk. Diversification requires Australian investors to be able to invest both here and offshore, so that any risks in both places that are negatively correlated can cancel each other out. FIRB screening does not prevent this. FIRB screening might deny US investors the opportunity to offset offshore risks against Australian risks. But given the extensiveness of US offshore investment portfolios, it is difficult to see how Australia would feature in a large way in their diversification strategy. But to the extent that it could, the cost of lost diversification opportunities is born by Americans, not Australians.

Some of discussion on 6 July suggested that local investors could nevertheless face a cost of not being able to sell their investments down the track to a wide range of potential buyers, but only to Australians. It is true that if there were an investment screen in both directions, this could prevent differences in investment returns between countries from being arbitrated away. Then investors in Australia

who were limited to selling their investments to Australians could be penalised (the price at which they would expect to sell an investment would be just the discounted present value of the expected future returns). But FIRB screening is a one-way process. It does not prevent the arbitrage, because Australians still have the option of investing overseas directly. And with arbitrage still able to occur through this channel, there is no penalty to being limited to selling a local investment to Australians only. Note that this argument is one about the average level of return, not the variance of returns. The risk concept measures the variance of returns.

Some of the discussion on 6 July suggested that neither my analysis nor the modelling assessments were able to capture the benefits of having very liberal rules of origin for services. On the contrary, modelling assessments typically always assume very liberal rules of origin, and the CIE's modelling of services and investment was no exception in this regard. Where modelling assessments typically err is in not taking account of rules of origin that are restrictive. The CIE modelling assessment did make some endeavour to do so, and I have argued that they did not go far enough. As noted in my original report and first supplementary note, the most recent research confirms that NAFTA-style rules of origin can add 2 per cent to trade costs, and the rate of utilisation of tariff preferences is significantly less than 100 per cent, *even correcting for tariffs that are zero to begin with*, when restrictive rules of origin apply.

There was some useful discussion on 6 July of the significance of the most-favoured-nation clause in the agreement, and a confirmation that it would not have much effect in the short term, although it would cumulatively over the longer term. The additional point I made in my supplementary note was that it only affected *new* concessions that the United States might make. There would still be significant ongoing costs to Australia from having our *current* preferences eroded as the United States granted these (as well as any new ones) to additional bilateral partners. This is the much more significant ongoing cost of US bilateral opportunism, which the MFN provision does not address.

There was some useful discussion on 6 July about the various mutual recognition agreements that have been achieved in various forums, and how AUSFTA will be able to build on the preexisting APEC engineer program initiative in this regard. This discussion effectively counters the claim made by the Department of Foreign Affairs and Trade in its submission of 22 June that 'in practice, bilateral cooperation is the only effective way to promote recognition of professional services qualifications'. Note too that the AUSFTA provisions make no inroads

into the State-based residency and citizenship requirements, which effectively rule out the cross-border trade to which mutual recognition would apply.

There was some discussion on 6 July about the potential benefits of the government procurement provisions of AUSFTA. The benefits are a function of two things — the total *size* of the government procurement market, and the *share* of it that Australia is likely to gain. The CIE underestimated the size of the market, for example by ignoring State procurement. This does not excuse them from overestimating the Australian share by a factor of 30/4.

There was some discussion on 6 July about the methodology I used to assess the costs of extending copyright. The methodology I used to assess costs was the same one that the CIE had used to assess benefits. If the costs are too high (because copyright material has a shorter economic life than assumed), then so too are the benefits. The net assessment is the same — this provision is not in Australia's interests. There were also assertions made that the true cost of extending copyright would be trivial. This assumes no lasting works of value, and no benefit to having them in the public domain. Consider how much poorer life would be without Bach, Beethoven and Mozart in the public domain.

Finally, there was useful discussion on 6 July about whether the patent provisions of the agreement would encourage evergreening and hence delay the introduction of generic drugs. Now that the enabling legislation has been tabled, it is reassuring to see that Australia will not be providing drug innovators with the ability to take out injunctions. Nevertheless, the provisions do strengthen the enforcement of the current legislative framework preventing the marketing of generics while a patent is still in place. Whether this will have any effect depends on judgements about whether enforcement activity is useful.