AUSFTA — A Response to Comments by the Department of Foreign Affairs and Trade

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In a letter of 22 June, the Department of Foreign Affairs and Trade filed a supplementary submission to the Senate Select Committee on the Free Trade Agreement between Australia and the United States, which commented on an assessment I had made of the agreement for the Committee. The purpose of this note is to respond to the Department's comments.

1. The Department states that I have underestimated the significance of the market access gains in the agreement. On the contrary, I have accepted the market access gains claimed by the CIE in its GTAP-based assessment of the agreement, subject only to a reservation about Australia's ability to meet the rules of origin (more on this below).

2. The Department states that I have ignored the significance of the most-favoured-nation provision in the agreement. Two comments can be made.

   First, the substance of preferential trade agreements is often in the annexes rather than the chapters. In my original report I drew attention to the exceptions to the MFN clause claimed by both parties in their exceptions annexes — both parties reserve the right to accord differential treatment to countries under any international agreement in force of signed after the date of entry into force of this Agreement involving (a) aviation, (b) fisheries, or (c) maritime.

   Second, the significance of the MFN clause should not be exaggerated. It ensures that if the United States gives *better* treatment to new trade partners in the future, then the benefits will be extended to Australia. But as the comparison of AUSFTA with other agreements makes clear, the United States typically does not grant *better* treatment to new trade partners — it grants the *same* treatment to new trading partners. There is typically no margin of

additional benefit to new partners to be granted to Australia, but our preferences with the United States are still eroded. The MFN clause does not achieve multilateralisation, and it is only multilateralisation that can protect Australia from future US bilateral opportunism. Multilateralisation would require the United States (and its new trading partners) to extend the *full* benefits of new agreements to *all* third parties, not just to Australia.

3. The Department states that I have not given sufficient recognition to the strong provisions on investment protection and to the provisions limiting performance requirements. On the contrary, my report noted that these provisions were already secured in part through existing WTO agreements.

4. The Department states that my report did not mention the very liberal rules of origin in services. On the contrary, these were acknowledged in that I did not reduce the CIE's modelled benefits of services trade liberalisation on this score.

5. The Department states that 'binding the status quo … is highly valuable, and is a major reason for carrying out trade negotiations'. If this is true, then why did the CIE not model the benefits of such bindings? Further, my report noted that many of the bindings are not new, but have already been granted in the WTO.

6. The Department notes that AUSFTA binds the status quo as it stands now, rather than where it stood ten years ago when our WTO commitments were made. This is correct, and where reservations were taken out ten years ago that are not taken out in AUSFTA, my report acknowledges this as a genuine liberalising achievement of AUSFTA. However, many of the reservations that were taken out by both parties ten years ago under the WTO are still taken out under AUSFTA.

7. The Department notes that by taking a negative list approach, AUSFTA covers new products and new services as they are developed. This is correct. But the WTO also takes a negative list approach to its non-discriminatory principles in goods trade. And in services, the GATS contains an important *general* obligation (ie not limited to those services listed under the GATS positive list approach) that qualifications requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services. Such domestic regulatory measures are often the most important ways in which new services are protected.

8. The Department states that my report does not acknowledge that both the United States and Australia have taken out reservations on regional measures. This is not correct — this is noted at the head of Table 1 in my report.

9. The Department states that my report claims that the United States has made more concessions to Singapore and to Chile than to Australia. The main point I made was the opposite — that Singapore had made relatively more concessions to the United States than to Australia.

10. The Department states that my report does not acknowledge that domestic regulation is often the main barrier to services trade, and does not discuss the work program to promote integration of financial services sectors through examining issues related to cross-border trade in securities. On the contrary, a substantial portion of the services trade barriers listed in the tables in my report are regulatory barriers. And the point remains that agreement has yet to be reached to facilitate cross-border trade in securities.

11. The Department states that AUSFTA is the first agreement where the United States has committed to a major work program in professional services recognition, and that there is no serious multilateral initiative to promote recognition in the WTO. These claims are misleading or incorrect.

    As noted in my report, the United States has committed to work programs on professional services, legal consultants and engineering services in its agreement with Chile. These commitments are significant, because they commit the United States to work towards common procedures throughout its territory for the authorisation of foreign consultants, thus working to eliminate the State-based citizenship or residency requirements that remain a major impediment to services trade.

    In multilateral or plurilateral forums, there is a WTO paper on disciplines in domestic regulation in the accountancy sector that has been adopted by the Council for Trade in Services. Ways are being sought to extent this to other professional services. The APEC Engineer program has been established in eleven APEC member economies to facilitate cross-border mobility of professional engineers. Effectively there is an international standard established for accreditation of the engineering teaching programs and recognition of degrees and experience. The APEC Group on Services is discussing a proposal by Indonesia to develop APEC professional standards for nursing, in order to facilitate the movement of professional nurses within

APEC. Harmonisation of nursing standards has already been implemented in Caribbean, and in East, Central and Southern Africa.

12. The Department states that AUSFTA achieved more than the Uruguay Round in agricultural market access, and that it achieved far more than the Doha Development Agenda will. The significant achievement in the Uruguay Round was putting agriculture on the negotiating table. If Australia does not achieve significant market access in Doha, it will be because we are likely to achieve something far more valuable — significant reductions in the domestic support that undermines the prices we receive for all our existing agricultural trade.

13. The Department states that my report does not recognise the reality of the international trading environment, that without the agreement, Australia's position will be eroded by bilateral opportunism. On the contrary, my report notes that Australia will be the victim of US bilateral opportunism, irrespective of whether it signs AUSFTA. The only protection against such opportunism is for both parties to multilateralise the gains.

14. The Department seems to deny that AUSFTA is precedent-setting, by noting that each negotiation is subject to its own special circumstances. But AUSFTA clearly is precedent-setting, because in it Australia has taken a stand on issues where previously its position was open. This will clearly limit Australia's future negotiating options.

15. The Department notes that AUSFTA's many consultation mechanisms add to policy transparency. But policy transparency is of value anyway, not to be granted grudgingly in trade negotiations. The consultation mechanisms mean that the AUSFTA trade negotiations will not be over, even after the agreement passes into force. And not all the consultation mechanisms are already in place, as claimed by the Department. Some, like the additional review mechanism within the PBS, are new.

16. The Department states that the costs of extending the term of copyright estimated in my report were overstated, because the economic life of most copyright material is short.

    My estimation used the same assumptions as were used in the CIE/DFAT report to estimate the gains from extending the term of copyright. If the costs are overstated, then so too are the benefits. The relatively remains the same. The fact remains that this provision is not in Australia's economic interests.

The Department also claims that the estimates costs are sensitive to the assumptions made, and claims that with a lower depreciation rate (5 per cent instead of 7 per cent), the costs would be lower. This shows a complete misunderstanding of net present value calculations — with a lower discount rate, future costs are discounted less heavily, so the discounted sum, ie the net present value, would be greater, not smaller.

17. The Department discounts the observation in my report that the patent provisions have the potential to increase drug prices by delaying the introduction of generic drugs by noting that 'AUSFTA will not prejudice the operations of the Pharmaceutical Benefits Scheme'. This observation may or may not be correct, but it is beside the point.

A key feature of the PBS is that the market power of the pharmaceutical companies is balanced by the countervailing power of having a single government procuring agency. So long as this remains, pharmaceutical prices in Australia are unlikely to be as high as they are in the United States.

AUSFTA adds an additional review mechanism into the PBS, and it remains to be seen whether this additional review mechanism will alter the operations of the PBS.

But the operations of the PBS, with or without its additional review mechanism, are not the only influence on drug prices in Australia. The timely availability of generic drugs is another important influence.

Even when faced with a countervailing market power, the major pharmaceutical companies can increase their profits if they can do two things:

(i) use existing mechanisms (eg those designed to compensate for marketing delays) to extend the term of patent protection on their proprietory drugs; and

(ii) ensure that generic drugs do not enter the market in the meantime.

AUSFTA delivers them precondition (ii). Observing that the pharmaceutical companies have not made extensive use to date of existing mechanisms to extend patent terms is no guarantee that they will not do so in the future. Only with AUSFTA in place will they have the full set of conditions in place to make it worthwhile.

So the threat to pharmaceutical prices in Australia does not lie with the PBS provisions of the agreement, but with the patent provisions. It is notable that the Government is not claiming that AUSFTA will have no effect on pharmaceutical prices in Australia, only that it will have no effect on the operations of the PBS.

18. The Department counters the argument in my report that the rules of origin are likely to be more restrictive than assumed by the CIE by noting that a change of tariff classification is easier to administer than a simple value added rule. This is acknowledged in my report. It is the tailor-made, product-by-product variations in the AUSFTA rules that reveals their protectionist intent. Such rules are responsible for adding 2 per cent to the costs of exporting in Mexico. And recent studies that have carefully corrected utilisation rates for whether tariff rates were zero to begin with have confirmed that the utilisation of preferences is significantly less than 100 per cent when rules of origin are restrictive.[1]

19. The Department claims that the intent of the WTO's causality requirement for general safeguard measures is written into the AUSFTA language. This begs the question of why the WTO clause was not incorporated into the agreement in its entirety, the way it was in the Australia-Singapore Agreement. Its omission can provide unnecessary ammunition for trade lawyers.

20. The Department states that the CIE's assumptions regarding Australian penetration of the US market for government procurement are likely to be conservative, because the market *size* may be bigger than assumed by the CIE. Nevertheless, empirical evidence suggests that their estimate of Australia's likely market *share* is significantly overstated.

21. The Department states that it believes G-Cubed to be a better model than GTAP because it fully captures the dynamic effects of capital accumulation. But G-Cubed is a bottoms-up model — its capital accumulation is a response to the underlying shocks to tariffs and other legitimate trade policy levers. If the tariff levels are significantly wrong because of aggregation bias, and if the wrong policy levers are used (as when a relaxation of FIRB screening is modelled as something affecting the equity risk premium), then so too will be the capital accumulation results. The GTAP model had been adapted by the

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[1] Stefano Inama, 'Quad trade preferences for LDCs: a Quantitative Analysis of Their Utilisation and Options to Improve It', and Fabien Candau, Lionel Fontagné and Sébastien Jean, 'The Utilisation Rate of Preferences in the EU', both papers presented at the Seventh Annual Conference on Global Economic Analysis, Washington DC, 17-19 June 2004.

CIE to include a capital accumulation mechanism, and that mechanism was calibrated to have the same responsiveness as in G-Cubed. So the GTAP modelling application had essentially the same capital story as G-Cubed, but with a far superior treatment of the underlying tariff and trade policy shocks.

The Department also states that the CIE had investigated the aggregation issue, and claims that it was unclear whether aggregation bias was a problem in going from GTAP to G-Cubed using import share weights. Two points can be made. Import weights are the wrong weights, as the CIE acknowledges. And the critical policy question is not whether further aggregation matters, but whether *dis*aggregation matters. The CIE methodology simply demonstrated that using same incorrect weighting scheme in two different models generated the same incorrect set of aggregated results. It did not demonstrate that aggregation did not matter.

22. The Department defends the CIE's treatment of FIRB screening by noting that complying with the provisions is seen by investors as being onerous. This is acknowledged in my report, but it does not demonstrate that FIRB screening is a risk issue. Foreign investors may incur significant costs in preparing a screening application, but they lose those costs whether or not their application is successful. In the literature, an outcome that is the same in all states of nature is called 'a sure thing'. FIRB screening may impose transactions costs, borne by foreign applicants, but it will not affect the equity risk premium and will not have spillover effects on Australian investors.

23. The Department points to a 'wealth of econometric evidence' supporting the existence of dynamic gains from trade liberalisation. The CIE report refers to three studies, one of which is an updated version of another. These studies are 'reduced form' studies that look for direct links between tariff levels and productivity. But it is now much better appreciated that the channels by which trade policies may have dynamic effects on productivity or growth are likely to be indirect, and that studies that look for direct evidence are likely to confuse trade policy effects with other effects.[2]

24. The Department defends the CIE's treatment of the gains from services trade liberalisation by noting that, although they had incorrectly treated the trade barriers as cost-escalating rather than rent-creating, they had halved the size of

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2 See, for example, R. Levine and D. Renelt, 1992, 'A sensitivity analysis of cross-country growth regressions', *American Economic Review*, 82(4), pp. 942–63, and R, Wacziarg 2001, 'Measuring the dynamic gains from trade', *World Bank Economic Review*, 15(3), pp. 393–429.

the trade barriers to compensate. However, the effects of rent-creating barriers are leveraged off the increases in trade brought about by an agreement, while the effects of cost-escalating barriers are leveraged off the entire volume of existing trade. Because existing trade is far bigger than increases in trade, the required compensation factor is far more than a halving. My own research on this issue suggests that the correction I offered in my report is far closer to the correct one. This was to ignore the productivity gains from services trade liberalisation altogether.