

Submission to the PC's study on Bilateral and Regional Trade Agreements in response to the draft report of July 2010

Introduction

I make this brief submission to the study in my own capacity. It expresses my personal views and does not necessarily reflect the views of ANU Enterprise or any other agency.

My main purpose is to urge the Productivity Commission to elaborate on its recommendation that before a Preferential Trade Agreement (PTA) is signed, 'an independent and transparent assessment of the likely impacts and community wide benefits of the proposed agreement be undertaken'. In particular, I argue that the PC should provide additional guidance on the preferred manner in which any modelling will be undertaken and on how past limitations arising from omissions and modelling short-cuts (or 'fixes') that do not accord with best practice can be avoided. In the interests of continued PTA modelling development, I also wish to encourage continued effort by PC's modellers in this study and beyond term to capture certain political and administrative realities neglected in past modelling work.

Elaborating on the transparency recommendation

Facing up to the past

Notwithstanding the draft report's frank statements that DFAT has exaggerated the likely gains from intended PTAs, and that available models do not capture everything, several other lessons of the recent past are not drawn out. Further, while these statements are accompanied by some welcome suggestions about how transparent analyses should be undertaken in the future (eg, in section 14.3), in their present form these suggestions are too vague for most readers to grasp what problems need addressing from a modelling point of view. Unless better defined, the intended disciplinary purpose of these recommendations could be sidestepped and past mistakes repeated.

The draft report's recommendation on domestic transparency is welcome, as far as it goes. The automatic process proposed could make an important contribution to transparency. But as presented, the proposal appears to confine the transparent assessment of agreements, as negotiated, to the final step before they are presented to Parliament.

Transparency should be embedded more deeply than this. It should also cover the generation of PTA proposals and the whole of the negotiation process. These lead-up activities are just as prone to special interest pressures as the later ones and are therefore just as much in need of a transparency discipline as the later stages of PTA decision

making. Indeed, they may be more prone to special interest pressures than later steps, given that historically diplomats have kept secret the lead-up negotiations when the main agendas are being set, on the grounds that to do otherwise would undermine Australia's bargaining coin. Some would find that plausible in the case of PTAs, because what is bargained in PTAs is applied (ie actual) tariffs rather than WTO bound tariffs. Applied tariffs are what really matter. Yet, the idea that cuts in protection, applied or bound, be delayed to preserve bargaining coin is perverse because the majority of the gains from trade liberalisation for a country like Australia will come from cuts in its own protection, rather than through improved export access granted by others. Appropriately, in the text (eg, page 12.4), if not in the Overview, the Commission's draft is dismissive of bargaining coin excuses.

Quantitative analysis, including the part that uses large formal economic models, has a potentially important role to play in the transparent assessment of proposed PTAs. This seems to be recognised in the language used in the PC's transparency proposal.

Yet, oddly, the draft has little discussion of what that role might be. Further, the modelling undertaken for the study so far has been illustrative rather than targeted, and the PC draft report stresses a number of times the non-applicability of its quantitative work to any particular Australian PTA.

It is possible the PC has ham-strung itself on the quantitative analysis front by taking the view that it would have to withhold the write-up of the quantitative workshop, held on 17 May 2010, until after the 'caretaker government' period. While the draft report stated the write-up was due for release at 'around the end of July' (draft, page 1.3), it has not yet appeared. Although the May workshop fell well short of being a critique of past quantitative efforts, in general it conveyed a humble impression of the state of play with the quantitative analysis of PTAs, and generated some meaningful suggestions for further work that could usefully be repeated alongside the PC's transparency proposal.

Irrespective of whether the caretaker period was relevant, one could understand the PC not wishing to be very outspoken in the draft given the inherent complexity of formal quantitative modelling, the significant time and resources required for new work, and the modest achievements of modellers on some topics so far.

However, reticence on this subject is a double-edged sword.

There are important past lessons in relation to quantitative modelling which should be built into the transparency proposal. A prerequisite for doing so is to face up squarely to past modeling failures. This was one of the key messages of Professor Ross Garnaut's (video conference) address at the ANU Coombs Policy Forum on the PC Draft Report held on 25 August 2010. As it stands, the PC's draft report does not really review the past record on PTA modelling - not even to the extent of discussing the crucial modelling fix issues that the PC has researched in detail and reported over the last decade.¹

¹ See for example:

Health warnings required

The main problem is that the PC's draft transparency proposal is conveyed without any 'health warnings' about how the quantitative contributions to 'an independent and transparent assessment of the likely impacts and community-wide benefits of the proposed agreement' ought to be conducted. The assessment process would be mere window-dressing if it were confined to modelling as limited in DFAT-commissioned studies to examine proposed agreements with the US, China, India and Indonesia, for example. The modelling in all those cases has been plagued both by gaps in coverage (some deliberate) and by technical 'fixes' that, whether intentionally or not, have generally worked to flatter the proposed deal.

Two modelling difficulties with GTAP attracting attention in recent years are what might be termed the 'productivity issue' and the 'terms of trade' (or 'Armington elasticities') issue. With both, modellers have experimented with 'fixes' to overcome perceived model limitations that were producing counter-intuitive or theoretically unbelievable results. While the Armington issue at least has been addressed more robustly recently, the same cannot be said of the productivity issue. Neither matter is adequately discussed in the draft report.

There are other modelling problems too and while the draft report discusses some past controversies (eg, in section 9.2, pp 9.8-9.10), no judgements as to the preferred approach are offered. In short, the Commission seems reluctant to accept any quality control responsibility.

Quality control is important if transparent assessments of PTAs are to be given new weight in the decision-making process. Crude fixes still seem to be common in government-commissioned GTAP-based PTA simulations. A recent example is a 2008 exercise undertaken for AusAID on the impact of a bilateral agreement with Indonesia which introduced an exogenous productivity fix and then claimed productivity improvements as 'explaining' 27 per cent of the predicted GDP gain².

In all assessment exercises, besides ensuring that the PTA ultimately examined is the one actually agreed, careful attention must be paid to establishing the appropriate

-Zhang, X.G. 2006, 'Armington Elasticities and Terms of Trade Effects in Global CGE Models', Productivity Commission Staff Working Paper, Melbourne, January;

-Lloyd, P.J. and Zhang, X.G. 2006, 'The Armington Model', Productivity Commission Staff Working Paper, Melbourne, January;

-Zhang, X.G. 2008 'The Armington General Equilibrium Model: Properties, Implications and Alternatives', Productivity Commission Staff Working Paper, Melbourne, February;

-Zhang, X.G. and Osborne, M.A. 2009, 'Developing an Armington-Heckscher-Ohlin Database: Splitting Global Trade (GTAP) Data into Homogeneous and Differentiated Products', Internal Research Memorandum, 09-02, Productivity Commission, Melbourne, March, unpublished; and

-Patrick Jomini, Xiao-guang Zhang and Michelle Osborne 2009, 'The Armington- Hecksler-Ohlin model – an intuitive exposition', Groupe d'Economie Mondiale Working Paper, 5 February

² See Annex 5 of Peter Van Dierman, M Catib Basri and Enrich Sahan, 'Trade Aid and Development in Indonesia: An analytical paper prepared for AusAID – Indonesia Branch', April 2010, p17

counterfactual – ie, defining the circumstances that would exist without the PTA being assessed. In past work, the prospect that the relevant alternative would be some kind of Australian unilateral action (say, covering a similar product range but for imports from all countries) seems always to have been ignored, for example.

Also, it is important to recognise in the counterfactual or base case all existing PTAs and those in the pipeline. The impact of any one PTA, whether that be on the size of any trade flows or on net costs or benefits to the nation, is likely to be significantly diluted by the existence of other agreements. Failure to allow for this when assessing a series of PTAs could greatly exaggerate their effect, and relevance. The key underlying insight is that the economic benefits of individual PTAs are unlikely to be simply additive – compared with initial PTAs, later agreements may have an insignificant impact or benefit.

In its final report could the Commission be more forthright about the standards that should be observed?

More work on the PTA administrative nightmare and associated rent-seeking

The Commission should also play a greater role in the final report in identifying missing elements which it considers future modelling work should address.

In my view, the PC should pay more attention to the dysfunctional politics of PTAs, when discussing the limitations of quantitative analysis and modelling priorities for the future. The draft report does discuss some valuable pioneering work it has undertaken on the administrative nightmare that details like rules of origin create for businesses and government officials. However the parallel incentives that such complications provide for wasteful rent seeking (by some of the same people) should also be explained.

The PC's draft itself tends, like many observers, to say that 'the devil of PTAs is in the detail'. I would say the real problem is the other way around – discriminatory detail (in terms of country of import, country of export, product range, tariff and subsidy rates, timing, provisions for protection of the preferential margin, rules of origin, etc) begets 'devils'. Each is a decision point, which adds geometrically to the difficulty of achieving a beneficial PTA (in a manner analogous to that famously described by RG Lipsey and Kelvin Lancaster in the 1950s³). Most importantly, more detail, more devils, in the form of opportunities for special interests to bend the outcome to their own purpose at community-wide expense.

The politics of PTAs is driven by the administrative complexity associated with discrimination. The intricate details of PTAs provide multiple opportunities or 'margins' for industries and firms with special 'needs' to quietly seek privileged treatment from extra discrimination in their favour. Thus PTAs stimulate a rent seeking process that both (a) absorbs time and energy that from an Australian viewpoint would be better spent

³ See for example their 1956 classic: 'The General Theory of Second Best,' *The Review of Economic Studies*, 24(1), pp. 11–32

on something else and (b) further distorts outcomes through the extra discrimination that successful lobbyists gain.

In short, PTA complexities tend to embed the advantages of well organized (and, one can predict, often already highly assisted) lobby groups, and thus widen assistance disparities, causing efficiency losses and the modelled economic benefits of PTAs to be overstated.

In view of these features, it might not be going too far to say that PTAs are the trade policy equivalent of the home insulation or 'pink batt' scheme. With both:

- from the outset, the social worth of their stated purpose is not clear;
- delivering on their stated purpose, regardless of its worth, is far more complicated than first thought; and
- their paucity of governance breeds administrative slack and favouritism.

The art of economic modelling is all about capturing the essential things that explain how economies change when 'shocked' by natural events or policy initiatives. Much of the skill lies in choosing a model structure which includes the key variables and excludes the less important. The ideal model will depend on the task at hand. In complex models, learning how to distinguish between important and unimportant variables is an evolutionary process.

The standard GTAP model used for most Australian PTA simulations has many gaps in coverage. Some owe more, or as much, to technical difficulties about how to incorporate them as to any certainty that they are unimportant explanators. Circumstantial evidence, for example, suggests that the unmodelled administrative short-cuts and rent-seeking behaviour that occur during the lead up and following PTAs are important to how they turn out in practice.

Economists generally are not very accustomed to allowing for the ongoing effects of the domestic political pressures and administrative limitations that help shape the status quo when they predict the outcomes of recommended policy changes. Even many government economists regard such pressures and limitations as none of their business. For their part, economic modellers commonly place themselves, or are sometimes deliberately placed by those who commission them, even further from the policy frontier. So typically they have not concerned themselves with the way old pressures will be politically deflected or accommodated, not just through exemptions or exclusions of 'sensitive' sectors, but also perhaps through last-minute or on-the-run variations in the announced forms of some components of PTAs like rules of origin or perhaps through the operation of parallel standing policy mechanisms like anti-dumping or through other trade agreements that are simply left out of the analysis. Because of this, they abstract from some potentially important features of the way democracies populated by real people actually work.

Even costing the administration of a familiar PTA, like ANZCERTA, would be a formidable task. The PC's 2009 study of ANZCERTA and related agreements⁴ indicated that most Tasman trade occurs at MFN and not concessionary rates. Concessionary rates apply to just a few items. But non tariff barriers, some prohibitive, still cover hundreds of potential import categories, including services like media and air services. Some essentially lie outside the agreement, like plants and plant products subject to quarantine.

On balance a PTA may act as a brake on true liberalisation, quite the opposite of its advertised role as a gesture of more liberal trade. Many traders do not use the concessions available in ANZCERTA because they consider they are more trouble than they are worth. So by appeasing those who can afford the 'paperwork' required to gain a concession, an agreement like ANZCERTA may in effect entrench the barriers faced by everyone else, in the sense that politically those barriers are able to continue for longer than otherwise. Further inertia may occur because through the agreement both countries have, in effect, tied their prospects for liberalising their two-way trade to reciprocal action. Also, in ANZCERTA as in other PTAs, there has been a tendency for the committees initially established to explore liberalisation opportunities to evolve towards being reform suppressants. The ANZCERTA committee relating to plant quarantine for instance rarely meets. It was described 'moribund' by the 2009 PC study on ANZCERTA and related agreements referred to above.

These references to quarantine bring to mind a general quantitative issue I have with the draft - its tendency, especially in its first half, to present some DFAT information of dubious quality and relevance in an uncritical way. A striking example is Table 5.1 on page 5.8 of the draft report relating to coverage of recent PTAs. Generally, it exaggerates their true breadth. The idea that Australia's recent agreements have all 'covered' quarantine, for instance, is quite misleading. In reality practically all recent PTAs do the opposite – ie, quarantine concessions between the partners are said not to be part of the signed agreement. Readers would get a truer picture if the types of caveats which appear in later chapters (such as the warning that economic integration is not of itself an economic benefit) were presented in the same place as the DFAT material.

Summing up

If the PC's proposal for a transparent and independent assessment is to achieve its disciplinary purpose, in the final report the proposal will need to be accompanied by a more complete acknowledgement of past modelling limitations and provide some health warnings about how any modelling used in the assessments should be undertaken. Issues to be considered include:

- how to ensure that any modelling is 'best practice' and takes account, for example, of the PC's own published and unpublished modelling research;
- who should commission and perform the work; and

⁴ http://www.pc.gov.au/__data/assets/pdf_file/0007/85759/mutual-recognition-schemes.pdf

- what role modelling should be given in the PTA assessment.

The draft report's coverage of these issues in the Overview, Draft Recommendations and Chapters 13 and 14 is deficient.

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