

Stan Kelly Lecture

Free trade agreements: Why are they happening and what are they worth?

Insights from theory and modelling on rationale, welfare gains and political heat

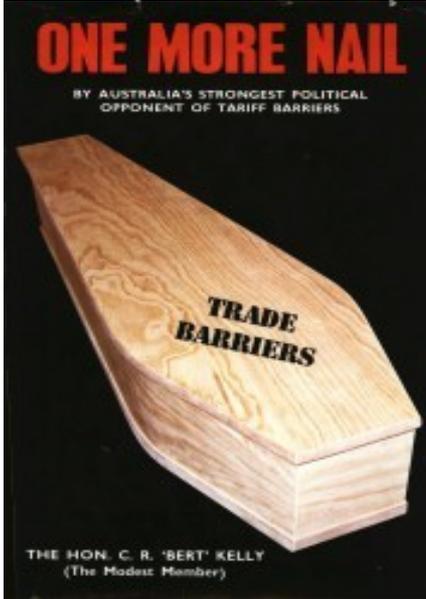
by

Peter B. Dixon

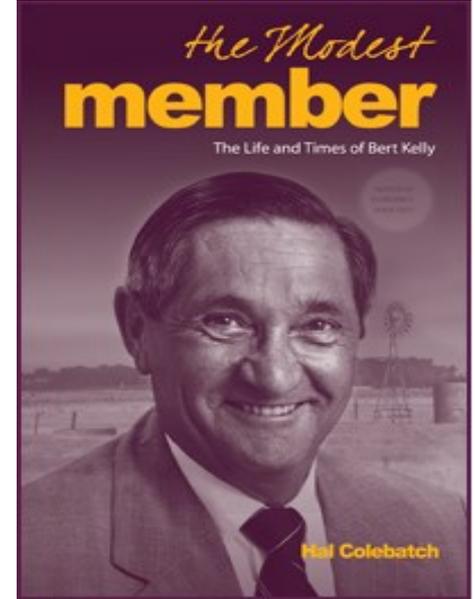
**Centre of Policy Studies
Victoria University**

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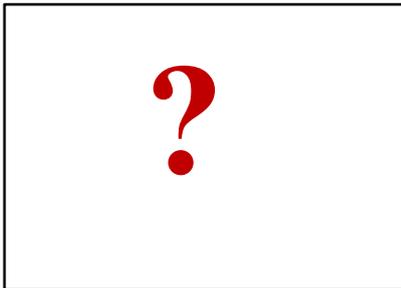
Stan and Bert Kelly: remarkable people



← Bert's famous book

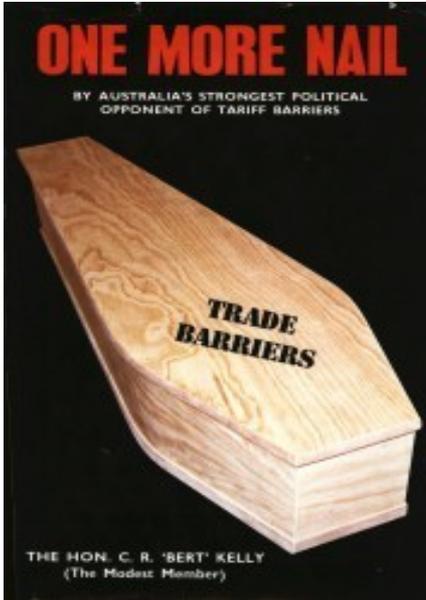


Bert →

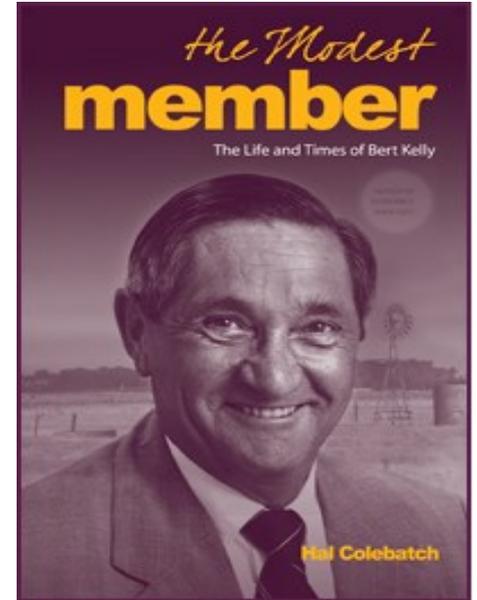


← Stan, too shy for a photo?

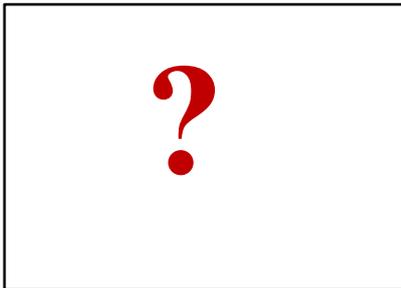
Stan and Bert Kelly: remarkable people



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Bert →



← Stan, too shy for a photo?



John Hyde →

Lupins →



260 FTAs in force world-wide



Nearly all negotiated since 1990

Australia has 10 FTAs, 8 created since 2003

- 1. Why have FTAs become the dominant vehicle for many countries through which trade reforms are implemented?**
- 2. How important are FTAs in delivering gains in economic welfare?**
- 3. Why is there so much political heat surrounding FTAs and trade policies more generally?**

Why free-trade agreements?

Political (cynical) answer

- **lucrative employment for diplomats, public servants, lawyers and economic consultants**
- **kudos for politicians**
- **can potentially swing some seats**

Economic answer

- **unilateral reductions in protection produce efficiency gains and terms-of-trade losses**
- **the losses beat the gains when tariffs are low**

Efficiency gains

Pre-tariff price of imported car	\$10,000
Tariff rate 60%	
Post-tariff price of imported car	\$16,000
Least efficient domestic producer survives with costs per car of	\$16,000

*Now cut tariff slightly so that 1 more car is imported
and 1 less produced domestically:*

\$16,000 of resources (capital & labour) are released from car production, **\$10,000** of resources are required in export activities to pay for the imported car.

\$6,000 of resources are available for standard-of-living enhancing activities. This is the efficiency gain.

Terms of trade losses

To pay for the extra car, we have to export more. This will reduce the price of our exports.

To achieve a **\$10,000** increase in exports we may have to devote a quantity of capital & labour to export activity that would have produced **\$12,000** of exports at the original prices

This is a **\$2,000** terms-of-trade loss.

Instead of having \$6,000 of released resources to increase our standard of living, we have only **\$4,000**.

Efficiency gain	\$6,000
Terms-of-trade loss	<u>\$2,000</u>
Net Gain	\$4,000

Efficiency gains exceed terms-of-trade losses only if tariffs are high

Cut tariff sufficiently to import one more car at \$10,000

Initial tariff rate	60%	10%
Efficiency gain	\$6,000	\$1,000
Terms-of-trade loss	<u>\$2,000</u>	<u>\$2,000</u>
Net Gain	\$4,000	-\$1,000

Efficiency gain depends on the height of the tariff.

Terms-of-trade loss is independent of the tariff.

Unilateral tariff cuts increase welfare if tariffs are high but reduce welfare if tariffs are low.

Trade negotiations

Once tariffs are low, further progress towards free trade requires negotiation: unilateral reductions are welfare reducing.

An economically rational approach would be via global agreements, but too hard.

FTAs are a piecemeal second-best approach

Disadvantage of FTAs

- expensive negotiations**
- adds complexity to trade (e.g. complying with ROOs)**
- lack of transparency**
- causes trade diversion**

FTAs: how big are the gains?

“If Bill Shorten and the Labor Party try to reject the China-Australia Free Trade Agreement they will be sabotaging our economic future and they will be turning their back on one of the greatest opportunities our country has ever been offered.”

Tony Abbott, Australian, 1 September 2015

Economic modelling by CIE for the Department of Foreign Affairs and Trade estimates the gain to Australia from the 3 North Asian (China, Korea & Japan) FTAs at 0.4% of private consumption.

How can we make 0.4% sound more exciting?

Call it an annual gain of \$3b

Call it an annual gain of \$300 per household or \$130 per person

Call it a total gain of \$50b

.... but whatever way it is dressed up, it is still 0.4% or about 2.4 months of economic growth.

What is the source of the 0.4% gain ?



Not from efficiency effects - the reductions in our tariffs are negligible

New Zealand, Chile and other countries already have FTAs with the North Asian countries. Our FTAs with the North Asian countries will rectify our competitive disadvantage in North Asian markets for agricultural goods.

CIE estimates that our FTAs with the North Asian countries will improve our terms-of-trade by 1.2%. This translates into a welfare gain of about 0.4%.

What about the employment effect?

Commenting on the CIE study, the Trade Minister claimed that because of Australia's FTAs with the North Asian countries,

“...Australian jobs would grow by 9,000 per year to be 178,000 higher in 2035 ...” Andrew Robb, *Sydney Morning Herald*, 16 June, 2015

What the CIE study actually shows is that jobs would be 5,434 higher in 2035.

FTAs and trade policies more generally are not about aggregate employment - a point well understood by Stan Kelly.

Good trade policies increase our average wage rates.

CIE estimates that the North Asian FTAs will add 0.3% to Australian wages

What about Foreign Direct Investment?

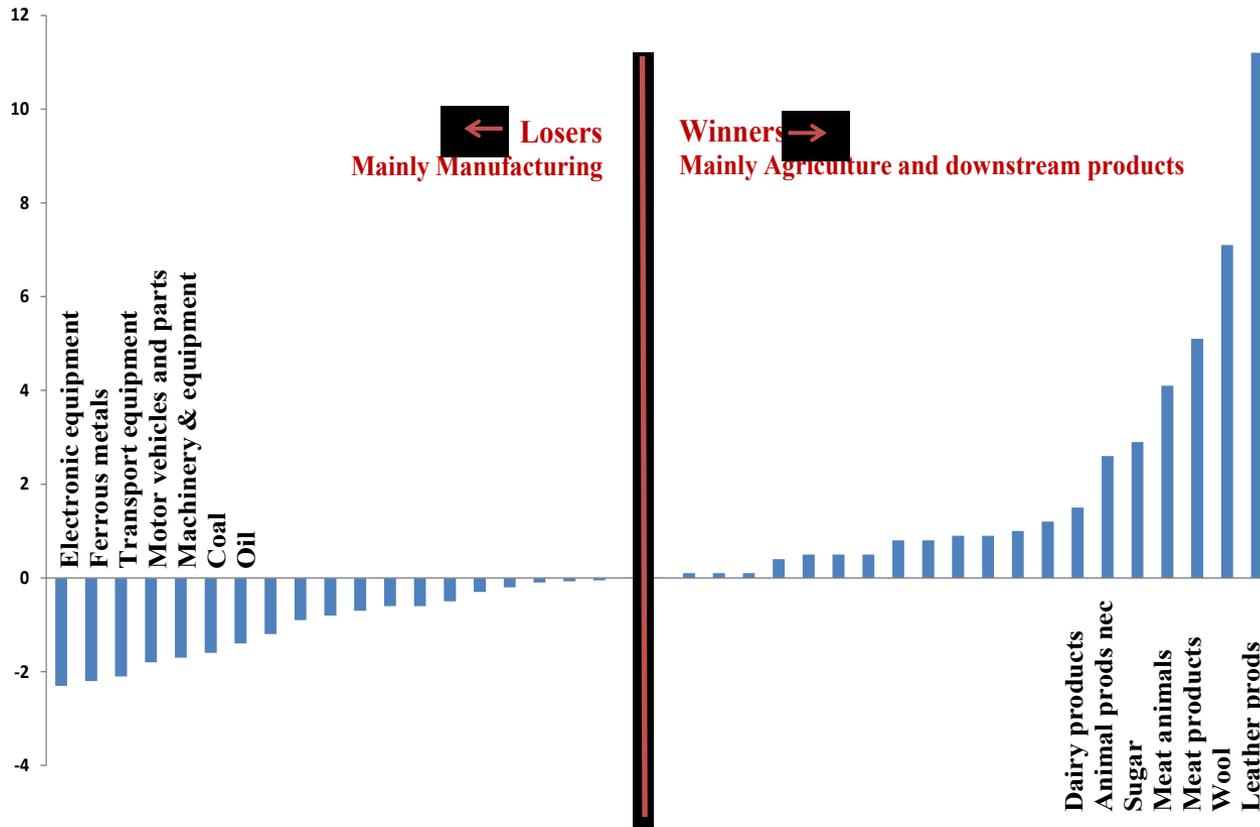


CIE's view is that there will be no discernable effect from the 3 North Asian FTAs in either direction.

Why do trade policies create political heat?

Winners and losers with only a modest national benefit

Percentage impact on Australian output of FTAs with North Asian countries



Conclusions: general

The theory of efficiency gains and terms-of-trade losses can explain the proliferation of free-trade agreements (FTAs).

FTAs are a second-best path towards global free trade.

FTAs and trade policies more generally are divisive - winners and losers.

Conclusions: specific

With regard to Australia's FTAs with China, Korea & Japan :

- 1. there will be a modest welfare gain for Australia;**
- 2. the gain will be mainly from terms-of-trade improvement, not employment;**
- 3. the Government is exaggerating the likely gain;**
- 4. there will be losers as well as winners;**
- 5. the Opposition is well within its rights to question labour-market aspects of the agreement; and**
- 6. the formation of FTAs is likely to be a continuing process and the Government would best serve the Australian public by encouraging evidence-based discussion and providing answers to legitimate queries.**

Paper will be made available

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