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## 9 Trade and economic effects: services and investment

Bilateral and regional trade agreements (BRTAs) contain provisions addressing barriers to services trade and international investment (chapter 6). As with merchandise trade, the Commission has sought to explore some of the potential impacts of BRTAs on service trade and investment flows and the broader economy.

Where BRTAs have material impacts on barriers to trade in services and investment, assessing their economic effects requires meaningful measures of the barriers themselves and the likely effects of changes to them. This is more problematic than is the case for trade in goods, however, due to difficulties in obtaining appropriate estimates of services barriers and the shortcomings in available estimates of services trade flows (box 9.1).

The difficulties in identifying impediments to services trade and international investment, and in separately identifying the effects of provisions in bilateral and regional agreements, apply both to *ex ante* assessments of what the potential impacts of a BRTA might be and to *ex post* assessments of the impact of provisions once implemented. There is also only limited quantitative analysis of the effects of bilateral and regional agreements on services trade and investment. There are more qualitative studies with some indications that, in some instances, reductions in barriers are not being widely utilised by businesses (chapter 7).

This chapter draws on the available studies of the impacts of reducing barriers to services trade, information submitted to this study and, in the case of investment, some new economic modelling by the Commission, to assess the economic implications of BRTAs on services trade and investment. Section 9.1 examines the trade and economic effects of reduced services barriers, while section 9.2 considers the potential effects of reduced investment barriers.

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**Box 9.1 Some difficulties in identifying and assessing barriers to services trade and investment**

Services trade is typically associated with the need for buyers and sellers to directly interact, with the barriers to that trade typically implemented through the regulation of the activities of businesses and individuals, and the movement of people. In broad terms, the public interest case for services sector regulation is to solve problems of market failure, including: lack of information and natural monopoly; and the need to achieve broader economic and social objectives (such as stabilisation of financial markets, income distribution or issues related to service quality and cultural matters).

Assessments of the trade and broader economic impacts of change need to take account of the extent to which regulations address such problems and both the potential costs and benefits of reform.

Although barriers to services trade can exist 'at the border', as is typically the case with barriers to merchandise trade, many barriers to services trade occur 'behind the border', that is, they are implemented through the regulation of activities within an economy. As discussed in chapters 6 and 7, there is a trend towards BRTAs including provisions on services which extend past what is included in WTO agreements (so called third-wave provisions).

Because of the nature of services transactions, it is difficult to access reliable data on services flows, or to obtain accurate estimates of impediments to services trade and assess the impact of regulatory change. For example, improved communications technologies may make it possible to deliver services via cross-border supply (GATS mode of delivery 1 (box 3.1)), whereas before those technological and supporting institutional developments, trade might have required the establishment of a commercial presence, or the temporary movement of persons (GATS modes 3 and 4, respectively). Regulation of technologies and the way firms do business therefore could have a significant impact on the nature of services trade, not just on the costs of individual transactions (as would a goods tariff in the case of merchandise trade) complicating assessment of the impacts and potential benefits of reform.

## 9.1 Services trade

### Potential impacts from services reforms

A number of studies have examined the potential impacts that flow from reforms to barriers to services trade on a non-preferential basis. In general, changes modelled which increase competition encourage firms to reduce costs and expand outputs in their areas of greatest competitive advantage, increasing the potential for trade in services and improvements in welfare (box 9.2).

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## Box 9.2 Studies of potential gains from services trade liberalisation

A number of studies have estimated the potential gains from (non-preferential) reductions in services barriers. In those studies, it was suggested that increases in world GNP from services liberalisation were driven by a number of effects, including:

- Allocative efficiency gains: policy changes that remove distortions in the use and movement of resources, allowing them to shift to the areas in which they will be the most productive, increasing welfare.
- Changes in the return to capital endowments: an increase in the return on capital due to freer movements in FDI results in a rise in the real world gross product.
- Increases in product variety: increased product variety benefits consumers by expanding their choice of consumption options (Dee and Hanslow 2000; Verikios and Zhang 2001).

In Dee and Hanslow (2000), a computable general equilibrium model was used to determine the impact of various trade liberalisation scenarios, including liberalisation of services trade. Because of large barriers relative to other countries, the results indicated that liberalisation of trade in services across the world would raise services activity particularly in China (whose services sector was projected to expand by approximately 33 per cent after liberalisation) and in a number of other Asian economies. Services sectors of a number of other countries, such as Australia, Canada, New Zealand, and the United States were projected to become slightly smaller than otherwise, partly due to low existing barriers to trade, because of the expected expansion in services activity in the newly opened Asian countries.

Verikios and Zhang (2001) analysed the impact on trade and welfare from complete liberalisation of financial services and telecommunications. For the two sectors, three trade liberalisation scenarios were examined. The first consisted of removing restrictions on national treatment (national treatment referring to the practice of treating foreign goods and services equally after they have entered the national market), the second consisted of removing barriers to market access, while the third related to a combination of the first two scenarios, and thus represents complete liberalisation.

For both sectors, the scenario of complete liberalisation led to the greatest gain in world real GNP — approximately 0.1 per cent for each sector (Verikios and Zhang 2001). Most of the gain in telecommunications was estimated to come from removing restrictions on market access, while the removal of restrictions on national treatment were relatively less important. The opposite conclusions applied for the simulation involving financial services.

In an empirical study, Kalirajan found that the imposition of regulatory regimes which apply more restrictive treatments to foreign firms than to domestic firms experienced increased production costs compared to those regimes which provide equal treatment (Kalirajan 2000). In the case of food distributors, it was also found that in 18 different countries, that the cost-raising impact of restrictions on the establishment of foreign firms was up to 8 per cent.

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### Box 9.2 (continued)

In a recent study prepared for DFAT, the CIE modelled the effects of global ‘overnight’ liberalisation of all barriers to trade in services delivered via cross border supply of services and commercial presence using the CIE-G-Cubed CGE model (CIE 2010). Globally, around 85 per cent of international trade in services is estimated to occur via these two modes of supply.

In preparing the study, the CIE noted a number of difficulties entailed, particularly in regards to obtaining accurate measures of barriers to trade in services. The issues identified included the fact that barriers are self-reported by each country, that only MFN barriers were reported (no treatment of preferential barriers) and that non-policy institutional or informal restrictions were not included.

To allow for the possibility of dynamic productivity gains associated with services trade liberalisation, the CIE’s estimates included dynamic productivity gains arising from increased import competition, learning by doing in export markets and FDI related transfers of technology.

The modelling results suggested that substantial increases in dollar terms in global production could be achieved through liberalisation of trade in services. Under the modelling scenarios considered by CIE, these could amount to an increase of 0.4 per cent in global production above the baseline after 15 years (ie by 2025 in the modelling). Production in developed countries was projected to increase to 0.20 per cent above the baseline while production in developing economies was projected to increase to 0.90 per cent above the baseline. GDP in Australia was projected to increase to above the global average (0.81 per cent).

The results also suggest that reductions in barriers to trade in services delivered via commercial presence have the potential to deliver greater economic gains than reductions in barriers to trade in services delivered via cross border supply (although the report suggests this may also reflect inadequate estimates of barriers to Mode 1 services trade).

As pointed out by DFAT, the gains depicted in many economic modelling studies capture only those ‘static’ impacts from changes in policy settings. DFAT has argued that from overall trade liberalisation, and more so services trade liberalisation, dynamic productivity gains are possible (sub. 53). In September 2010, DFAT released a study by the CIE which examined the potential benefits of global services trade liberalisation, with the modelled gains embodying improvements in productivity (box 9.2).

Ultimately, studies both with and without the inclusion of dynamic productivity gains indicate that welfare gains are possible from all countries reforming their service trade barriers on a non-discriminatory basis. This is consistent with the Commission’s assessments of behind-the-border domestic reforms in Australia, such as those delivered through National Competition Policy (PC 2005).

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## Impacts of BRTAs on services trade

While there is little doubt that there are potentially material gains from services trade liberalisation, the extent to which these can be secured through BRTAs depends ultimately on whether such agreements reduce the type of barriers that materially impede services trade in a way that enhances welfare. This is dependant on a range of factors.

### *Nature of impacts*

One consideration is whether the barriers amenable to reform are ‘cost increasing’ for businesses or ‘rent creating’. Some services barriers are primarily cost increasing in that they raise the real resource cost of producing a given quantity of output. Many of these barriers may arise from broad competition policy settings that are non-discriminatory in a trade sense, whereas other barriers have the potential to be discriminatory, such as retraining and accreditation costs incurred by foreign businesses and professionals wishing to operate across borders.

On the other hand, barriers to services trade such as quantitative restrictions that artificially restrict supply can be viewed as primarily rent creating. Reductions in these barriers (whether on both a preferential and non-preferential basis) may have limited economic welfare impacts, especially when compared to gains from reducing cost raising barriers. Indeed, Adams et al. (2003) and Dee (2005) note that the possibility of net welfare losses due to trade diversion arises under PTAs — but only if the barriers involved are rent creating, rather than cost increasing. Bosworth and Trewin commented:

... allowing foreign investment in a statutory monopoly could reduce the country’s national welfare by distributing rents overseas and to the preferential partner if done under a PTA. The adverse efficiency effects of providing preferential access through commercial presence can be substantial and long-term since the advantages of being ‘early into the market’ are significant in many major services sectors. (sub. 32, Attachment 1, p. 5)

The ultimate impact of restrictions on services trade is likely to be more complex. While the findings are provisional, Dee and Dinh (2008), when analysing the insurance sector of a number of countries, estimated that services trade barriers are both cost increasing and rent creating. In a similar vein, Dinh (2009) found a mix of cost raising and rent creating effects in the banking sector.

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### *Likelihood of BRTAs influencing barriers to services trade*

Another consideration is the extent to which BRTAs can address such barriers. Elek submitted that most services trade barriers which are likely to be the type that are cost raising generally cannot be eliminated through bilateral negotiations. Instead, for the most part, these can be addressed only through domestic competition policy reforms:

Negotiations can hope to eliminate some particularly restrictive regulations, for example to agree on mutual recognition of some professional qualifications. However, complex legislative changes, such as better competition policies cannot be enforced by negotiation. (sub. 44, p. 16)

Francois and Hoekman (2010) argue that one reason for the limited scope afforded by BRTAs to drive services-trade reforms is the lack of domestic constituencies. They note that, with the exception of the European Union, most services-policy reforms to date have been domestically driven:

Achieving domestic reform of services markets through external trade agreements has proven difficult in practice. ... One factor explaining the limited use of trade agreements by governments to support and anchor policy reforms in services may be that export interests are weaker than in manufacturing or agriculture because services are more difficult to trade. (pp. 677–8)

Even where opportunities exist through BRTAs to overcome bilateral barriers that inhibit services trade, some participants have suggested that trade agreements are likely to have had only a limited impact, while others have commented that either opportunities have not been pursued, or that there remain impediments to service trade not covered in BRTAs (see chapter 7). DFAT (sub. 53, p. 27) also noted that BRTAs to date, have had limited success in reducing barriers and opening up new opportunities, and instead were more likely to bind existing levels of openness (see chapter 6). In a similar vein, Bosworth and Trewin drew on research to suggest that while BRTAs have the potential to go beyond multilateral reform in services trade reform, this seems to have been relatively limited in practice:

While it is generally acknowledged that the GATS – with few exceptions, such as in telecommunications and commitments of certain countries negotiating WTO accession — has performed little actual liberalization, ... PTAs suffer to a greater degree from the same weaknesses. (sub. 32, Attachment 1, p. 18)

### *Some international empirical evidence*

A few studies have examined changes in services trade following the formation of a BRTA, or the potential impact from preferential liberalisation scenarios (box 9.3).

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### Box 9.3 Studies of the impact of BRTAs on services liberalisation

Roy, Marchetti and Lim (2007) examine the extent to which services liberalisation undertaken preferentially goes beyond the parties' GATS commitments. They find that while some PTAs do go further than GATS, particularly those agreements to which the United States is a party, 'the picture is nevertheless nuanced, as there are areas where the value-added of PTAs is more limited'. In particular, they note that agreements between larger countries (for example, China, the United States, Japan, EC, India and Brazil) or agreements between smaller developing countries and larger developed countries (other than the United States) appear to provide a more 'limited set of GATS commitments' (p. 39).

Miroudot, Sauvage and Shepherd (2010) examined the impacts of BRTAs on observed services trade through a quantitative study of changes services trade costs between members of PTAs and differences in these costs for non members. Focussing on services delivered via cross border supply and consumption abroad, they find that trade costs for services trade is about double that for goods trade. They also found that the BRTAs examined 'did not offer clearly improved market access for foreign service providers' (p.19).

In a recent study conducted by the OECD (Miroudot, Sauvage and Shepherd 2010), the effects of more than 200 BRTAs on the costs of international trade in services was examined to test whether or not BRTAs reduced services trade barriers.

The study found that BRTAs did reduce service trade barriers, but to a much lesser extent than those seen for goods. Unsurprisingly, it found that the more extensive the provisions in the BRTA relating to services, the greater the likelihood of barrier reductions.

The authors also found that the ability for BRTAs to reduce barriers preferentially was much more limited than for goods trade. The authors believed that while this result was driven *partly* by the liberal rules of origin for services within most agreements; it was primarily driven by the nature of barriers to services trade, which means that:

... at the end of the day, it is unilateral and non-discriminatory policy reforms that matter most in services markets: they are effectively the basis for anything that happens at the regional and multilateral levels. (p. 22)

In an earlier qualitative study of services BRTA provisions, Roy, Marchetti and Lim (2007), while also emphasising the importance of such domestic reforms, argued that PTAs could bring benefits where they facilitate them:

Preferential deals can bring benefits to participants by allowing them to undertake important reforms leading to the removal of costly domestic restrictions. (p. 40)

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### *The Australian experience*

The approach of Australian agreements to services trade has been to use both negative and positive lists to determine the coverage of services in an agreement. Agreements that adopt a negative list approach (including ANZCERTA, SAFTA and AUSFTA) cover a more extensive range of services than other agreements (such as TAFTA) which adopt a positive list approach (chapter 6). The potential impact of any particular agreement is likely to depend on the approach taken and matters such as the level of economic development of agreement partners. As noted though, while reforms to services in such BRTAs may cover barriers in a range of services industries, the benefits obtained depend in large measure on the subsequent uptake of opportunities by business, which in turn will depend largely on the extent to which the services barriers addressed in the BRTAs are important for facilitating commerce.

Some potential impacts from bilateral services trade liberalisation, modelled as resulting from Australia's agreements, have been examined in a number of feasibility studies. The majority of studies have been conducted by the CIE, so the approach to measuring the potential benefits has a number of common elements.

In those studies, the CIE modelled the impact of prospective preferential trade agreements as possible reductions in costs. Using this modelling approach, the CIE estimated that the prospective agreements could have significant impacts on production and trade. For example, in an early study of the potential impact of reductions in services barriers for a prospective Australia–New Zealand–ASEAN free trade area, it was estimated that services production could increase in 2012 in the order of US\$1.5 billion for Australian and New Zealand, and close to US\$2 billion for ASEAN countries compared to the baseline (CIE 2000).

The CIE also noted that the most-favoured-nation provisions around services trade in the AUSFTA limited the potential trade diversion of subsequent agreements (CIE 2004a). Given the existing liberal regimes of the partners, only specific areas included in the agreement were modelled — professional services; financial and insurance services; and transport. For the areas examined, with the impacts modelled as reductions in costs (as done in its earlier work), services trade liberalisation accounted for close to 37 per cent of the gains from overall trade liberalisation (merchandise goods, services and government procurement).

However, these analyses are *ex ante* and do not take into account the potential difficulties that service providers face in accessing other markets, even when 'on paper' barrier reductions are achieved. Further, it is likely that the assumption that such barriers are all cost increasing will overstate the potential benefits. These

aspects suggest that the benefits achieved to date from service trade barrier reforms with BRTAs are likely to be significantly less than the potential gains put forward in the feasibility studies.

Changes in services flows, as measured in the balance of payments, pre and post the establishment of Australia's bilateral trade agreements could provide some indicative evidence of their actual impact (table 9.1). For each of the agreements which came into effect over the period for which data are available — Singapore, Thailand and the United States — services trade grew faster (both imports and exports) compared to pre-agreement rates. However, as noted in chapter 8 with respect to merchandise goods trade, such simple comparisons do not provide direct evidence of the agreement's success or otherwise due to a number of other confounding factors which have not been controlled for.

**Table 9.1 Services trade with BRTA partners — average annual growth rates, 2001-02 to 2008-09**

	<i>Credits</i>		<i>Debits</i>	
	<i>Pre agreement</i>	<i>Post agreement</i>	<i>Pre agreement</i>	<i>Post agreement</i>
	%	%	%	%
Chile	45	–	23	–
New Zealand	–	2	–	7
Singapore	0	9	4	13
Thailand	4	15	8	26
United States of America	-2	6	1	13
ASEAN	6	–	9	–
Total non-partner	6	–	6	–

*Source:* ABS (International Trade in Services by Country, by State and by Detailed Services Category, Financial Year, 2008-09, Cat. no. 5368.055.003).

Some participants also put forward examples where Australia's BRTAs had beneficially enhanced services trade. In the area of telecommunications, Telstra submitted that a number of agreements have secured 'WTO-plus' reforms in the telecommunications services area (sub. 31). The main driver of increased services flows, from Telstra's point of view, has been the ability of these agreements to improve regulatory certainty in overseas markets. The Business Council of Australia (sub. 41) also canvassed the possibility that many of Australia's BRTAs may have played some role in liberalising services trade, citing, for example, the provisions for Australian lawyers to practice foreign law on a fly-in-fly-out basis in Delaware following AUSFTA.

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Despite evidence of increased trade flows, as reported in chapter 7, the limited evidence from services businesses together with the views of their representative groups (such as the ASR 2008) suggest that Australian firms have made little use of the services provisions in the recently negotiated BRTAs. Rather, while many believed *ex ante* such agreements are likely to yield greater opportunities, as illustrated by changes in perceptions about the Australia-Thai agreement (AFG Venture Group, sub. DR69, Attachment 1, p. 9), actual experience significantly reduced positive perceptions of the benefits of BRTAs. This suggests that while potential exists for BRTAs to enhance services trade between partners, to date Australian agreements are likely to have had limited success in this direction.

In relation to the likelihood that expectations will be better met in the future, as discussed in chapter 7, processes established under Australia's agreements may yield benefits in specific areas of services. For example, while it is unclear that much use has been made of the provision allowing Australians to practice foreign law in Delaware, working group discussions with Delaware are provided for under the auspices of AUSFTA. This has potential to engender further cooperation towards outcomes with other jurisdictions and on other matters (such as the recognition of Australian law degrees for admission to practice in the United States), although this could be expected to take many years.

## 9.2 Investment

The impact of reforms to Australia's investment barriers under BRTAs is contentious and there are varying views concerning the restrictiveness of Australia's investment barriers, particularly those created by the operation of the Foreign Investment Review Board (FIRB). On one hand, some have argued that these barriers alter the risk premium of investing in Australia and therefore have a significant impact on FDI flows. On the other hand, the FIRB is thought by some just to add a small transaction cost and therefore have little to no impact. Investment provisions of trade agreements may also be considered to provide an additional element of certainty around access to the capital markets of partner economies and the regulatory environment in which businesses invest.

Modelling of provisions negotiated in the AUSFTA, conducted by the CIE, examined the issue of potential changes to Australia's investment barriers. Given the prospect for the AUSFTA to both reduce the transaction costs of investing in Australia (through increased notification thresholds on investments) and improve the certainty of investments (through an improved legal framework and altered notification thresholds), it was suggested that FDI into Australia was likely to increase (CIE 2004a).

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Under the CIE approach, a proportion of the long-run equity risk premium that exists between Australia and the United States (taken as 1.2 percentage points) was assessed as relating to investment barriers. The possible change from bilateral liberalisation in investment barriers was estimated to be 5 basis points. The 5 basis point fall in Australia's equity risk premium was then modelled allowing capital to be sourced from all countries (that is, no further restrictions were added to the source of capital inflows). The results showed a significant increase in investment, both domestically and internationally sourced, which at its peak leads to an increase in investment of nearly 1.4 per cent above levels that would otherwise apply (without the agreement) a decade out (CIE 2004a).

The CIE found that the reduction in investment barriers could increase real GDP — potentially by up to 0.4 per cent (CIE 2004a). The estimated impact on welfare measured by GNP is smaller, although significant, due to adjustment costs and time lags in capital investment flows. Putting these results in context, the gain to Australia from the investment reforms modelled was considerably larger than the gains from liberalisation in goods and services trade between Australia and the United States.

However, the approach taken by the CIE has not been without controversy. A number of commentators raised reservations about the scale of the premium reduction and the approach taken. For example, on the issue of scale, Quiggin stated:

Estimates based on the efficient market hypothesis suggest that the equity premium ought to be no more than 1 percentage point. Most of the premium is due to some combination of market failures, investor irrationality and distortions arising from taxes and regulations. (Quiggin 2004, p. 70)

Further, he stated that while the focus on the equity premium was right, the assumption it would be reduced and have no adverse impacts was not:

... the CIE is right to focus on the equity premium. The difficulty is in the assumption that capital market liberalisation will reduce the equity premium and will have no offsetting adverse effects. The proposed changes are tiny by comparison with the floating of the dollar, the associated removal of exchange controls over the 1970s and 1980s and the associated domestic liberalisation. Yet there is no convincing evidence that these changes had any effect on the risk premium for equity. (Quiggin 2004, p. 70)

Similar reservations were put forward in a study commissioned by the Senate *Select Committee on the Free Trade Agreement between Australia and the United States of America* (SCFTAAUSA 2004). It was argued by the author, Dee, that the link between FIRB and the equity premium was not valid:

The DFAT/CIE report treats FIRB screening as something that has added to investor uncertainty. They therefore claim that the relaxation of FIRB screening can be modelled as a reduction in the equity risk premium in Australia. It is by no means clear

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that this is the appropriate way to model FIRB screening. The equity risk premium is a concept that captures the effects of events that happen *ex post*, after an investment is made, that reduce or eliminate the expected returns on that investment, and hence affect the stock market valuation of the company making the investment. FIRB screening is an event that happens *ex ante*, before the investment is made. A negative ruling does not put at risk the entire amount that would have been invested. The potential investor still has their uninvested capital that they can put elsewhere. The only thing that is lost by FIRB screening is the cost of lodging a notification or application, and this is lost whether or not the application is successful. (Dee 2004, p. 29)

Dee (2004) also suggested that the only impact of FIRB relates to transaction costs, with the majority of such reductions accruing to United States investors:

So what effect does FIRB screening have? As noted in the DFAT/CIE report, it is a source of transactions costs. But most of the cost savings from relaxed screening will accrue to US investors overseas — Australia will still need to employ Treasury officials to continue screening of non-US investors and in sensitive sectors. And FIRB screening has an unknowable, but probably small, deterrent effect on a few particular investments, but nothing like the number of investments that would be affected by a generalised change in the risk premium. (p. 28)

Outside Australia, some international studies have also examined the link between investment flows (typically FDI) and BRTAs. For example, Waldrich (2003) examined the impact of NAFTA on FDI flows using regression analysis and found a positive effect for Mexico. It was estimated that United States and Canadian FDI into Mexico would have been 42 per cent lower in the absence of NAFTA. Despite this, as the CIE (2004a) caution, such evidence is biased as the level of foreign investment is also affected by domestic savings, investment balance, and changes in production activity due to reduced barriers, all of which could change following trade liberalisation.

Using regression analysis, the OECD has also suggested that investment provisions with BRTAs are positively related to both trade and investments flows (Leshner and Miroudot 2006). Those provisions had the greatest impact on FDI flows between member countries.

### **Impacts from other investment provisions in BRTAs**

Other benefits from BRTAs relate to improved investor certainty, particularly for Australian investors in countries where a lack of confidence in institutional arrangements may discourage investment. Typically if such concerns exist, Investor-State Dispute Settlement (ISDS) mechanisms are put in place (chapter 14). However, these arrangements are not unique to BRTAs and have been used extensively in bilateral investment treaties (BITs) — in Australia these are termed

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Investment Promotion and Protection Agreements (IPPAs). While little empirical work has been conducted on the impact of such arrangements in relation to BRTAs, a number of studies have examined BITs. Examining this literature, Bonnitcha and Aisbett suggest that few benefits have been created:

A basic survey of the BIT – FDI scholarship reveals eight studies that claim statistically significant findings to support the hypothesis that signing BITs increases FDI. This count includes studies that find only some types of BITs increase FDI and a study that makes a finding of a ‘minor and secondary’ relationship between BITs and FDI. A further five studies reject the hypothesis that BITs increase FDI. Not all these studies should be treated equally. Some studies draw on more comprehensive data sets and apply more appropriately specified statistical models to those data sets than others. The problem of controlling for policy shifts made concurrently with ratification of BITs and disentangling reverse-causality effects with data for such a small population is endemic to them all. However, it is clear that those studies whose empirical approach better accounts for endogeneity concerns generally do not find a link between BITs and FDI. Our appraisal of the current literature is that it does not provide any sound evidence that investor protections promote mutual direct investment. (sub. 45, pp. 5-6)

Further, during consultations over the course of this study, some participants suggested that not only were the benefits limited and questionable, but ISDS provisions also created some risk for governments when making domestic policy decisions. Further, it was also suggested to the Commission that, while Australia has included these provisions in BITs, they have not been used by Australian investors. Given the above factors, it is likely that the benefits from such provisions in BRTAs (and more broadly) are small.

### **Modelling reforms to investment barriers**

In order to gain an understanding of the potential impacts of preferential bilateral and non-preferential investment liberalisation, the Commission undertook some modelling using the GTAP model (see chapter 8 for a description of the model).

As discussed above, investment liberalisation could have different effects depending on assumptions about the effects of the barriers and of the liberalisation. Two possibilities include:

- quantitative restrictions to foreign investment, created through screening of certain investments, which may translate into a higher price for foreign capital, and thus increased returns to foreign owners and an economic rent for foreign capital owners; and
- the FIRB screening process which may increase the sovereign risk associated with foreign investment, resulting in a risk-premium (leading to a higher rate of return than otherwise).

The first type of barrier would require accounting for the economic rent in the database — something which is difficult. However, the sovereign risk approach assumes that the risk premium is in the data. While a number of commentators have questioned the ability of FIRB to alter the risk premium, others have suggested that it may have an impact, although the direction of change is questionable.

For illustrative purposes, and following the CIE (2004a) study (while noting its limitations), the assumption that FIRB barriers influence the sovereign risk of investments was modelled. As in CIE (2004a), it has been assumed that the change to arrangements reduces the level of sovereign risk. But unlike the CIE approach, investment flows from specific partner countries were identified, allowing for a preferential barrier reduction to be simulated. Results were also scaled according to the shares of FDI in total foreign owned capital.

The results of a reduction of 5 basis points in the required rate of return for foreign investment in Australia *and* the United States on a preferential and on a non-preferential basis are presented in table 9.2.

Reducing the cost of investment increases demand for, and the resulting supply of, capital in Australia and the United States.<sup>1</sup> Increasing the capital base of both economies, increases their production capacities, thus increasing GDP.

**Table 9.2 Effects on real GDP and GNP of reducing barriers to investment between Australia and the United States<sup>a</sup>**

5 basis points reduction in required rate of return; US\$ million

	<i>Australia</i>		<i>United States</i>	
	<i>GDP</i>	<i>GNP</i>	<i>GDP</i>	<i>GNP</i>
Preferential	58	-169	46	390
Non-preferential	392	321	5 976	5 008

<sup>a</sup> Simulations do not represent an analysis of existing agreements. GNP is a measure of the income received by residents from supplying labour and capital within the economy and abroad. It is calculated as the sum of the market value of all goods and services produced in one year within the economy (GDP) plus (net) income received from capital and labour employed abroad.

Source: Commission estimates.

Despite this, whether barrier reductions are preferential or non-preferential has a significant bearing on projected changes in national income, as measured by GNP. Because Australia is a net borrower of capital and the United States is a net lender to Australia, where reductions in barriers are undertaken preferentially, an increase

<sup>1</sup> A longer-run environment is adopted (chapter 8), in which increased demand is satisfied by allowing the supply of capital to adjust the point where the initial rate of return is obtained.

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in the output of both countries is projected to lead to Australia increasing its (net) borrowing to support the accumulation of additional capital, while the United States is projected to increase its (net) lending. After accounting for the respective changes in capital income flows, national income for Australia is projected to decline.

On the other hand, if barriers to investment in the Australia and the United States were reduced on a non-preferential basis, the consequential inflows of capital to the liberalising economies would be drawn from diverse sources. With more funds available to the liberalising economies, GDP is projected to increase more than in the preferential liberalisation case and Australian income is projected to rise.

### 9.3 Summing up

The inclusion of services and investment provisions within BRTAs, particularly where they extend commitments beyond those in the GATS, is likely to have led to at least some increase in services trade and investment flows. The limited evidence on, or assessments of, such provisions, and the relatively short lifespan of Australia's agreements, mean that definitive assessments of the extent of these effects are difficult to make.

Taking account of qualitative studies of BRTAs, the views of participants and the (limited) quantitative analysis available, the Commission's judgment is that the effects to date are generally likely to have been small. Although the processes established under Australia's BRTAs provide scope for greater benefits in the future, achieving meaningful reform is not straightforward. It is also important to note that reforms not directly initiated under BRTAs, but associated with their development, could also bring benefits.

#### FINDING 9.1

*The evidence available to the Commission indicates that the direct economic impacts from services and investment provisions in Australia's BRTAs to date have been modest. More significant gains may be achieved in the future through some of the processes established under Australia's agreements. However, their realisation will require concerted efforts from Australia and its BRTA partners over many years.*