



Australian Government
Productivity Commission

Rising protectionism:
challenges, threats and
opportunities for Australia

Productivity Commission
Research Paper

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

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Executive summary

Support for protectionist trade policies flares up periodically, usually during periods of slow economic and income growth. Now is one of those periods.

The trend towards use of tariffs and other protectionist measures has lifted in G20 countries since the Global Financial Crisis and there are clear signs that the protectionist trend could accelerate. US President Donald Trump was elected on the back of a protectionist trade policy stance and proponents of protectionism have been empowered in parts of Europe.

So far it is unclear how different countries' trade policies will change. However, developments to date suggest that maintenance of the status quo is unlikely. Some think change will be at the margin, others fear major backsliding on protection and a renunciation of the rules-based multilateral trading system.

How would Australia be affected by a new swing towards protectionism? Are there strategies for avoiding the risk of backsliding on protection? How can the costs of adjustment be minimised and the benefits of liberalisation made more inclusive?

The Commission was motivated to undertake this study by a desire to assist policy makers and the community with these broad questions. The analysis draws on stylised scenarios that the Commission has modelled to illustrate the possible effects on Australia of significant international increases in protection, and of different Australian policy responses.

From the analysis, we could comfort ourselves with a sense of isolation: the ultimate (longer term) effects on economic activity and living standards in Australia would be small if the rise in protectionism stopped at the United States imposing tariffs on China and Mexico, or adopting border adjustments. Yet in the interim, tariff increases would cause a significant disruption to, and reorganisation of, global trade in ways not captured by trade models. Uncertainty has a cost.

More seriously, if a scenario akin to the experience of the 1930s were to be repeated — with trade barriers significantly higher around the world — the economic dislocation unleashed would have the capacity to cause a global recession and put the rules-based global trading system under much strain.

Australia would not escape unscathed. Over one per cent of GDP every year and close to 100 000 jobs would be lost, and up to 5 per cent of our capital stock could be mothballed. Living standards would fall across the income distribution. A household with the median weekly income would be worse off by nearly \$1500 a year.

But not all Australian households would be affected equally. About 20 per cent of households — among them low income households dependent primarily on social services payments and consuming fewer traded goods — would be least affected. While this is cold comfort, the uneven distribution of impacts across households helps explain why the broad support of the community for open markets cannot be taken for granted.

Rising protectionist sentiment and actions in some countries may lead some to suggest that a rethink of Australia's commitment to free trade is needed. They would be wrong. Protectionist policies would harm the Australian economy and risk reversing the community-wide gains that the lowering of barriers to trade globally have helped to deliver to us and would not deal with the insecurity concerns about jobs and incomes that globalisation has come to encapsulate.

Yet it would also be a mistake to dismiss the signs of discontent that are testing the social compact that underpins open market policies.

Along with stronger social adjustment commitments, the best response to maintain and increase the wellbeing of Australians in the face of any widespread rise in protection would be to continue to work towards freer markets. Australia could proceed in this sense unilaterally, as most of the benefits, especially from lower non-tariff measures, do not depend on our trading partners taking similar actions.

One option we consider is to extend tariff and other concessions made in preferential trade agreements to other trading partners — that is, make them non-discriminatory or *most favoured nation*. This would remove costs associated with complex rules of origin. Another option would be to address Australia's non-tariff barriers that add to the cost of doing business across borders. The economic benefits from being a first mover would be predominantly and widely distributed across Australian households and businesses.

A further policy option is to help to form a coalition of countries that conspicuously and explicitly choose to act together to persist with using transparent processes to maintain liberalising processes in the flow of international trade and investment.

Trade policy alone cannot ensure that the potential benefits of liberalisation are fully realised or widely distributed. This report outlines a three pronged strategy that would help achieve better outcomes for all Australians and foster public confidence in open markets.

First, Australia should continue to work towards freer markets and to make the rules-based trade system function better, by:

- prioritising regional agreements that allow, or work directly towards, most favoured nation treatment
- promoting the greater use of plurilateral sector-specific agreements negotiated in the context of the World Trade Organization
- pursuing only those agreements where there is a strong case that a clear net benefit to Australia will result

-
- broadening participation in negotiations to parties capable of offering critical assessment, not just parties seeking an advantage or protecting a constituency
 - adopting better consultation processes in negotiating agreements, including widening stakeholder groups access to draft treaty text on a confidential basis during the negotiation and
 - strengthening Australia's reputation as an attractive destination for international investors through more consistent, transparent and predictable foreign investment approval processes while preserving our vital national security interests.

Second, governments should pursue broader policies that strengthen the economy's resilience and the workforce's adaptability to changes taking place in the global economy, many of which are driven by new technologies.

These companion policies can serve to lessen the disruptive impacts of change and create an environment that spreads the benefits of globalisation more widely. They include education and training policies that aim to build solid foundation skills and enable participation in further training and reskilling for displaced workers; work force policies that influence how readily firms can adjust the size and composition of their workforce; and macroeconomic stability.

There are also unfortunate policies and government decisions that act to prevent or delay change from occurring. These include localisation rules, regulatory measures that favour domestic companies and products and an increased proclivity to use trade remedies (anti-dumping duties, countervailing measures and safeguards) in response to perceived unfair competition by others. While they may provide respite to some, they do not encourage activity based on real comparative advantage, risk triggering reprisals and impose costs across the community. They should be avoided.

Third, governments should better engage with the community around the case for free trade and strengthen policies to respond to the human cost of technological change. Adjustment today is more driven by technology than liberalising markets. But debating the difference is not helpful. Sharing better the benefits from persisting with open markets would help to build community confidence in trade and foreign investment policies.

Resisting protectionism and continuing to work towards freer markets, while making trade work for all by minimising adjustment costs and ensuring the benefits are widely shared, is the best path for Australia. Higher living standards depend on it.

Conclusions

CONCLUSION 1.1

Protection has increased in G20 countries since the Global Financial Crisis and in the last few years world trade growth has been sluggish. There are clear risks and signs that the trend towards more protectionist policies could accelerate.

CONCLUSION 1.2

International trade and investment are vitally important to the Australian economy. Barriers to trade and investment pose a risk to economic growth and living standards.

CONCLUSION 2.1

A US trade war with China and Mexico would lower economic growth in all three countries, and particularly severely in Mexico, unleashing a significant reorganisation of world trade. In the longer term, economic activity in Australia would be little affected and the US trade deficit would not be narrowed by increasing protection on China and Mexico.

CONCLUSION 2.2

Uncertainty around what might eventuate from rising protectionist sentiment is likely to be already affecting global trade and investment. Further increases in uncertainty may well reduce investment (and economic growth), in ways not captured in standard trade models.

CONCLUSION 3.1

While in theory border adjustments would be offset by compensating moves in exchange rates, it is highly unlikely that these moves would be instantaneous.

- In the interim, the transitional costs for Australia (and other US trade partners) could be material, especially to established value chains involving US firms. These disruptions could damage trade relations.
- Once exchange rate adjustments had played out, US adoption of border adjustments as modelled would likely have little effect on Australia.

CONCLUSION 4.1

Significant worldwide increases in protection would cause a global recession. Australia would not escape unscathed. Modelling estimates show that for every \$1.00 increase in Australian tariff revenue, economic activity in Australia would fall by \$0.64. In total, GDP would be lower by over one per cent each year. This would equate to a loss of close to 100 000 jobs, and the average household would face an income cut of nearly \$1500 a year.

CONCLUSION 4.2

Significant worldwide increases in protection would cause lower living standards. Not all Australian households would be affected equally, but most would be worse off. The uneven distribution of impacts across households helps explain why the broad support of the community for open markets cannot be taken for granted, and it complicates the political economy of trade liberalisation.

CONCLUSION 5.1

In the event of a global rise in protection, Australia is likely to face intense political pressure to follow suit and lift its own barriers to trade and foreign investment. Working with a coalition of countries to keep their markets open is a strategy that would make it easier for Australia to resist protectionist pressures.

CONCLUSION 5.2

Even in a world of much higher protection globally, Australia would be better off to persist with lowering barriers to trade.

Co-operating with a coalition of like-minded countries could significantly amplify the positive economic effects for Australia of avoiding increases in protection.

CONCLUSION 6.1

Rising protectionist sentiment and actions in some countries may suggest to some that a rethink of Australia's commitment to free trade is needed. They would be wrong. However, there is a case to better understand and respond to the insecurity concerns of citizens about jobs and incomes that, for many, globalisation has come to encapsulate. The current environment presents a timely opportunity for Australia to evaluate its approach to international trade and investment and other relevant policy measures.

CONCLUSION 6.2

The best response to rising protection and other trade developments would be to continue to work towards freer markets.

Australia could proceed unilaterally to lower trade barriers, as most of the benefits do not depend on our trading partners taking similar actions. Scope exists to extend concessions made in preferential trade agreements to other trading partners, and to address the many non-tariff measures that add to the cost of doing business across borders.

The economic benefits from being a first mover would be predominantly and widely distributed across Australian households and businesses.

CONCLUSION 6.3

Australia's reputation as an attractive destination for international investors could be strengthened through more consistent, transparent and predictable foreign investment approval processes while preserving our vital national security interests.

CONCLUSION 6.4

A plurilateral approach to trade negotiation can bring many of the benefits of multilateral negotiation and may be a stepping stone to multilateral liberalisation. Australia should continue to invest effort in the development of plurilateral or sector-specific agreements, especially those that allow most favoured nation treatment and that can be incorporated into the World Trade Organization.

CONCLUSION 6.5

Preferential trade agreements are an option for reducing barriers to trade and investment in partner countries. They should only be pursued if a strong case can be made that there is a net benefit and in situations where broader agreements are unlikely to be reached. Agreements that adopt the principle of most favoured nation or cumulation (treatment of inputs from any partner country as local content) have been shown to generate higher benefits.

CONCLUSION 6.6

Trade policy making and processes for negotiating trade agreements need to become more open and consultative about the pros and cons of proposed agreements. Confidentiality agreements should be used to give a much broader range of stakeholders — including those capable of critical assessment — access to draft treaty text during the negotiation phase and draft agreements should be exposed to public interest assessment before being signed into law.

CONCLUSION 6.7

Trade policy alone cannot ensure that the potential benefits of liberalisation are fully realised or widely distributed. Companion policies are needed to manage the impact of reforms (and other disruptive developments), create an environment that spreads the benefits of globalisation, and assist those who lose their jobs to find new work.

CONCLUSION 6.8

Australia's targeted social safety net generally works well and strengthening it is the preferred approach for supporting those who are adversely affected by structural change. The suite of policies that foster macroeconomic stability and growth, workforce, education and training policies as well as taxation and investment policies that influence geographic mobility also have a vital role to play.

The most effective strategies to facilitate adjustment merit investigation and existing policies should be regularly evaluated to ensure they deliver their intended outcomes.

CONCLUSION 6.9

Better understanding of community concerns about free trade, improved engagement with the community around the case for open markets and clearer communication about the policies in place to manage the costs of adjustment are needed to build community acceptance of open markets.

1 A changing trade policy landscape

Key points

- Support for protectionist trade policies flares up periodically, usually during periods of slow economic and income growth. Now is one of those periods.
- International trade and investment are vitally important to the Australian economy. Lower barriers to trade and investment globally have helped bring growth and prosperity to Australia and elsewhere.
- This is at risk of reversing. Protection has increased in G20 countries since the Global Financial Crisis and in the last few years growth of world trade has been sluggish after many decades of rapid increases.
- There are clear signs that the trend towards more protectionist policies could accelerate.
 - US President Donald Trump was elected on the back of a protectionist trade policy stance, although so far it is unclear how US trade policy will change.
 - Likewise, in parts of Europe, protectionist protagonists have been empowered.
- There have been other developments in the global trade environment in recent years.
 - The number and scope of bilateral and regional trade agreements has expanded rapidly.
 - The importance of global supply chains has risen.
 - Progress in broad multilateral negotiations has effectively been at a standstill.
- The Commission has used economic models to assess plausible extreme scenarios. Estimates illustrate the possible effects on the Australian economy and its major trading partners of changes in international trade policies.

1.1 Why this study?

Debates between advocates of free trade and protectionism — discriminatory and restrictive trade policies — have flared periodically, usually during periods of slow economic and income growth. Now is one of those periods. Public scepticism about the benefits of trade has been rising and this has fuelled protectionist sentiment, especially in some advanced economies. For example, US President Trump in his inaugural address stated that ‘[p]rotection will lead to great prosperity and strength’ (Trump 2017d) and his campaign promised to turn the tide on globalisation (box 1.1).

So far it is unclear how US trade policy will change. However, developments to date suggest that maintenance of the status quo is unlikely. Some optimistic commentators argue there will be shifts in emphasis, such as favouring bilateral over plurilateral trade

agreements and a more forceful pursuit of alleged rule violations within the established international trade system. Others fear transformational changes that risk unwinding the significant reductions in trade barriers achieved over the past 50 years. They note that while applied tariffs have declined considerably; they could easily be raised.

Regardless of the degree of change in the US stance on trade, the risk of new restrictive trade and investment policies spreading more widely is real. In the years since the Global Financial Crisis (GFC), the number of trade-limiting measures implemented by G20 countries has more than quadrupled, and these new measures now cover about 5 per cent of world imports (WTO 2016). Recently, for the first time since the GFC, G20 countries backed away from a commitment to reject all forms of protectionism. And in the last few years, growth in the volume of world trade (which had quickly recovered from a GFC-induced dip), has remained sluggish, with the combined share of exports and imports in global GDP falling for several years running (figure 1.1).

Box 1.1 Trump on trade

Donald Trump's presidential campaign and his electoral victory in 2016 foreshadowed a fundamental shift in the United States' trade policy. His election on the back of a promise to 'put America first' and 'bring back manufacturing jobs' was coupled with promises of measures that would be a departure from US openness and leadership in the international trading system. For instance, in his inaugural address, Trump declared:

Every decision on trade ... will be made to benefit American workers and American families. We must protect our borders from the ravages of other countries making our products, stealing our companies, and destroying our jobs ... We will bring back our jobs. We will bring back our borders. We will bring back our wealth. And we will bring back our dreams. (Trump 2017d)

President Trump has stated that trade deficits cost American jobs, especially in the manufacturing sector, and are largely the result of the unfair trade practices of other countries (Trump 2017c).

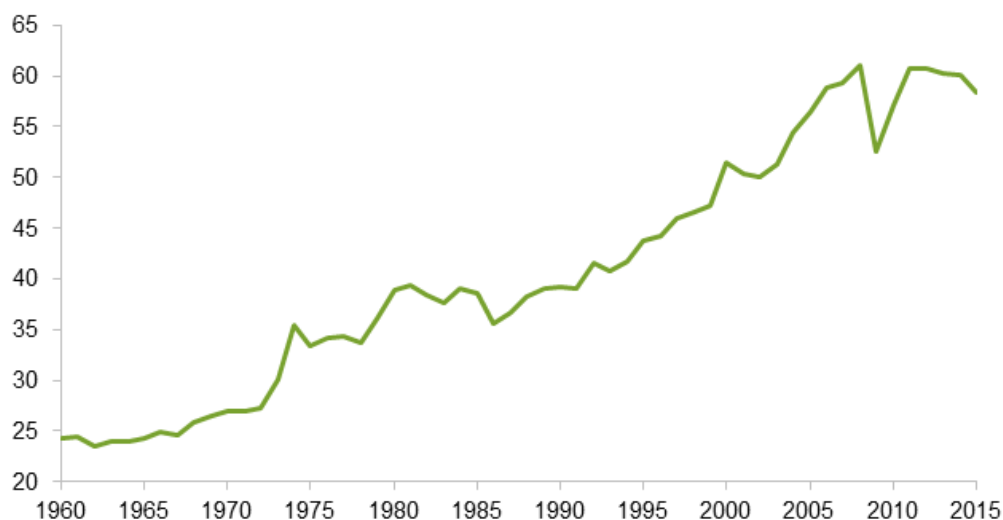
Chinese and Mexican trade practices drew much criticism during Donald Trump's presidential campaign, when he promised a 45 per cent tariff on Chinese imports and a 35 per cent tariff on at least some Mexican imports, as well as 'tearing up' or renegotiating the North American Free Trade Agreement.

He was also critical of the Trans-Pacific Partnership, an agreement involving Australia and other Pacific rim countries, and he withdrew the United States from the agreement three days after his inauguration.

The rise in support for protectionist policies reflects a distrust in globalisation. Although many people in developed countries believe that trade is beneficial, they are also well aware that it creates winners and losers. A view that trade has significant social costs and tends to increase inequality is widely shared in developed countries (Crozet and Orefice 2017). However, increases in inequality primarily reflect other disruptions, notably technological innovations; trade is invariably the scapegoat. And open markets have lowered prices — an outcome that is favourable to lower income households.

Figure 1.1 After increasing for decades global trade growth has slowed

Global trade in goods and services as a share of global GDP, per cent



^a Trade is defined as the sum of exports and imports of goods and services.

Data sources: World Bank national accounts data and OECD national accounts data files.

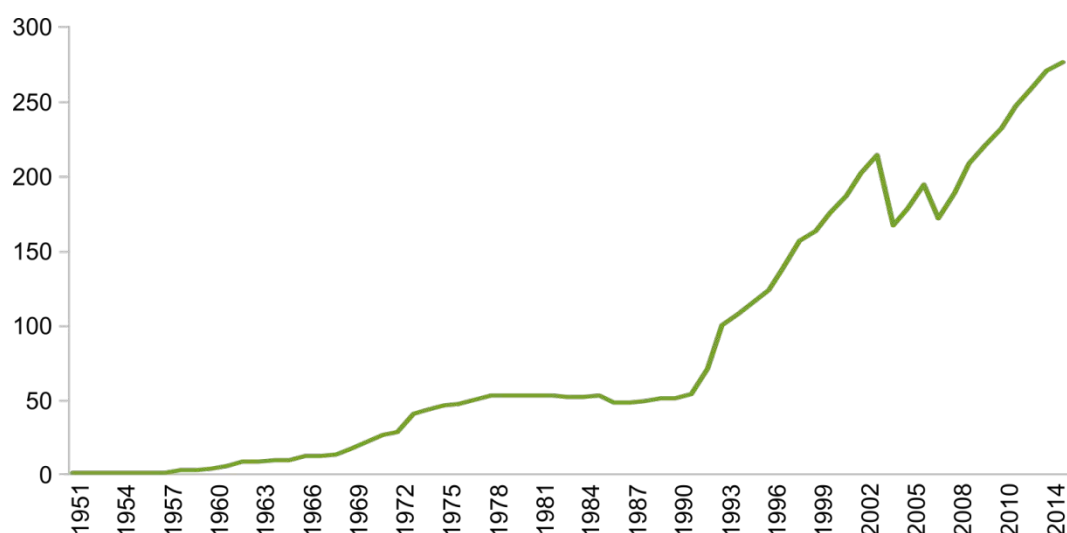
Trade does impose adjustment costs on an economy. Increased opportunities to export lead some firms to expand, while increased competition from imports drives other firms out of business or compels them to become more efficient. In the process, some new jobs are created and some existing jobs are destroyed. The smoother this adjustment process, the greater the benefits from trade and the smaller the social costs. Government policies play an important role in this process, and in the way that the benefits of trade are distributed.

There have been other changes in the global trade environment in recent years. First, the number of bilateral and regional trade agreements has expanded rapidly (figure 1.2) and so has their scope. They now cover a vast array of policy areas, including competition policy, intellectual property rights protection, customs regulations, electronic-commerce, standards and many more. Meanwhile, progress in broad multilateral negotiations (the Doha Round) is effectively at a standstill. On a more optimistic note, advances on sectoral agreements negotiated through the World Trade Organisation system have gained some momentum.

A second, and perhaps the most significant, development in international trade is the growing importance of global supply (or value) chains, where services, components and raw materials are traded across countries multiple times, assembled and then dispatched to their final customers. Lower barriers to trade and investment, together with reductions in transport and communication costs and logistical innovations have contributed to an increasingly integrated world economy. While the internationalisation and specialisation of production according to comparative advantage has been advancing steadily for many years, only recently have new statistics allowed us to measure its importance. Development

of these global supply chains has contributed to increased trade in services and foreign direct investment — notable for their relatively high propensity for employment.

Figure 1.2 The number of bilateral and regional trade agreements has increased rapidly



Data source: IMF, World Bank and WTO (2017).

The Commission was motivated to undertake this study by these developments in protectionist trade policies and a desire to assist policy makers and the community to understand what they may mean for Australia. This project assesses the potential impacts on Australia of shifts in international trade policy towards a more protectionist stance and the implications of these shifts for Australian policy settings. The key questions examined include:

- How might current trends in trade policy evolve? In what ways might the trade and investment environment facing Australia change?
- What impacts might this have on Australia? Would Australia's trade with China, the United States and other countries be adversely affected? Would there be opportunities from international shifts in trade policy?
- What are the likely impacts on foreign investment for a nation with a strong dependence on foreign capital such as Australia?
- What would these shifts mean for how Australia should respond, frame and conduct its trade and foreign investment policy? Would a strategic rethink be required for the trade agreements currently under negotiation and for the role Australia might play globally in promoting trade liberalisation?
- What would these shifts mean for Australian policy development more generally?

CONCLUSION 1.1

Protection has increased in G20 countries since the Global Financial Crisis and in the last few years world trade growth has been sluggish. There are clear risks and signs that the trend towards more protectionist policies could accelerate.

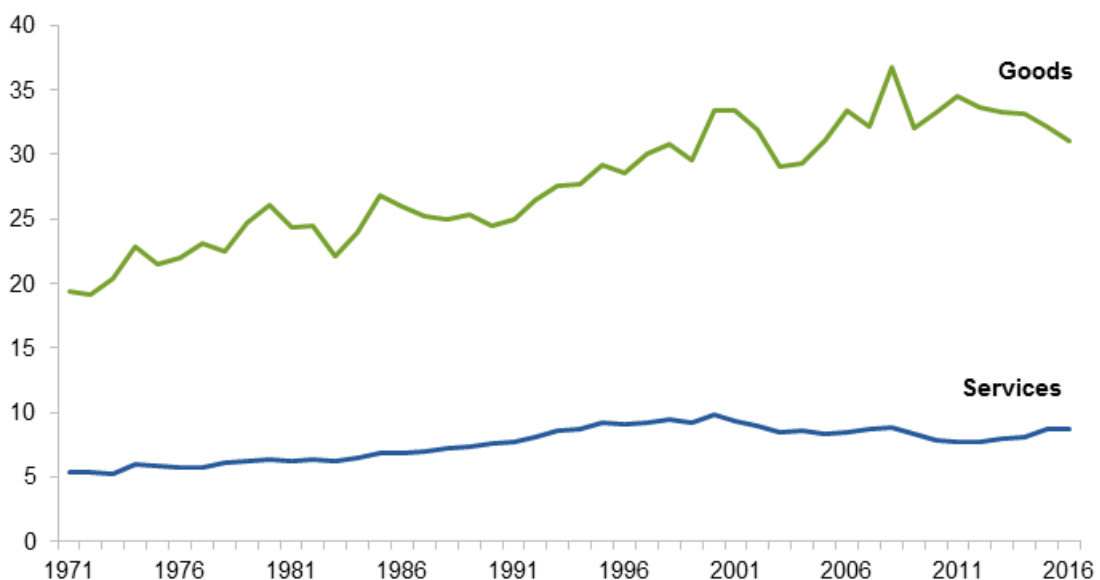
1.2 Australia's trade and investment at a glance

Trade

International trade is a key part of Australia's economy, and has made a substantial contribution to economic growth. Exports and imports of goods have risen considerably as a share of GDP since at least the early 1970s (figure 1.3), although the shares of both have fallen since the GFC. Trade in services in their own right is much smaller than trade in goods, but services trade is larger than the data in figure 1.3 suggest because of the services embodied in traded goods.

Figure 1.3 Trade's share of Australian GDP has risen considerably

Trade in goods and services, per cent of GDP



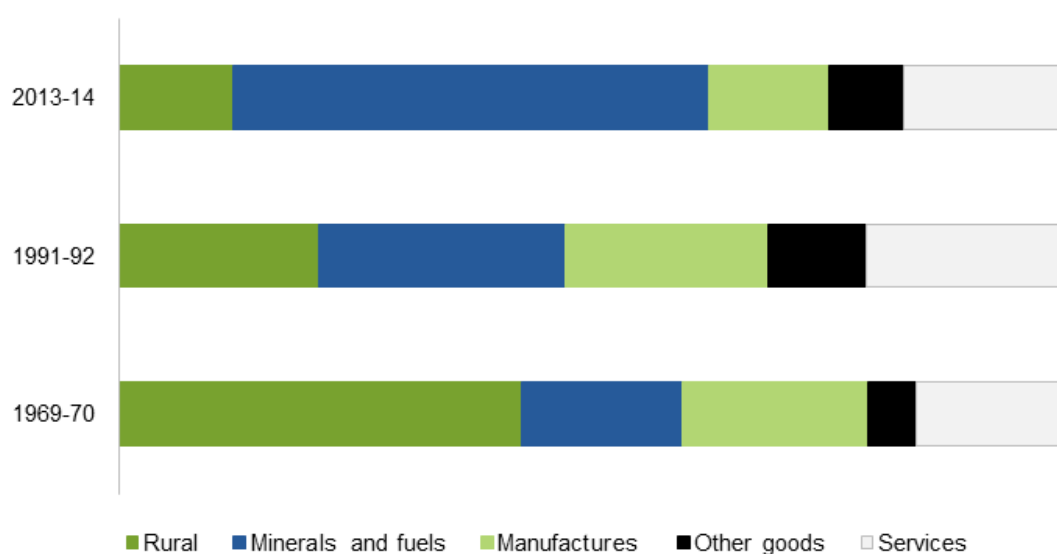
^a Trade is defined as the sum of exports and imports.

Data source: ABS (*Australian System of National Accounts, 2015–2016*, Cat. no. 5204.0).

What we export and import has also changed. On the goods side, exports are now dominated by minerals and fuels (particularly iron ore and coal) (figure 1.4). Manufactured goods, especially motor vehicles and petroleum products, represent the bulk of imports.

With respect to services, education to international students is Australia's largest service export — accounting for nearly 30 per cent of the total (DFAT 2016d). And overseas travel by Australians is the largest service import — accounting for 35 per cent of the total. As can be expected given Australia's location, transport also accounts for a large share of services trade.

Figure 1.4 Minerals and fuels have come to dominate exports
Share of total exports



Data source: DFAT (2014).

Our main trading partners have also evolved. From 2000 to 2016, China grew to become Australia's top trading partner, for merchandise and services exports and for merchandise imports (the top country we import services from is the United States) (table 1.1). Australia's historical trading partners such as New Zealand and the United Kingdom have been displaced by emerging-market economies such as India (for merchandise exports) and Thailand (for merchandise imports), with Japan remaining an important trading partner. In contrast, there has been relatively little change in the key sources of Australia's services imports.

Table 1.1 China has become Australia's top trading partner for all except service imports

	2000		2016
	%		%
Merchandise exports			
(Top five Australian merchandise export destinations ^{a,b})			
Japan	20.5	China	35.6
United states	11.5	Japan	14.7
Korea	6.6	Korea	6.7
New Zealand	5.5	India	5.2
Taiwan	5.2	US	3.6
Merchandise imports			
(Top five Australian merchandise import sources ^{c,d})			
United States	18.6	China	23.1
Japan	12.2	United States	11.8
China	7.6	Japan	7.8
United Kingdom	6.3	Germany	6.0
Germany	5.3	Thailand	5.3
Services exports			
(Top five Australian service export destinations ^e)			
United States	16.7	China	14.9
United Kingdom	11.2	United States	11.9
Japan	10.3	United Kingdom	7.6
New Zealand	7.8	New Zealand	6.3
Singapore	6.1	Singapore	6.2
Services imports			
(Top five Australian service export sources)			
United States	20.9	United States	19.7
United Kingdom	12.7	United Kingdom	9.5
Singapore	6.1	Singapore	7.0
Japan	5.2	New Zealand	4.9
New Zealand	4.7	Germany	3.9

^a December quarter data, free on board value. ^b China data exclude special administrative regions and Taiwan. ^c December quarter data, customs value. ^d China data exclude special administrative regions and Taiwan. ^e China data exclude special administrative regions and Taiwan.

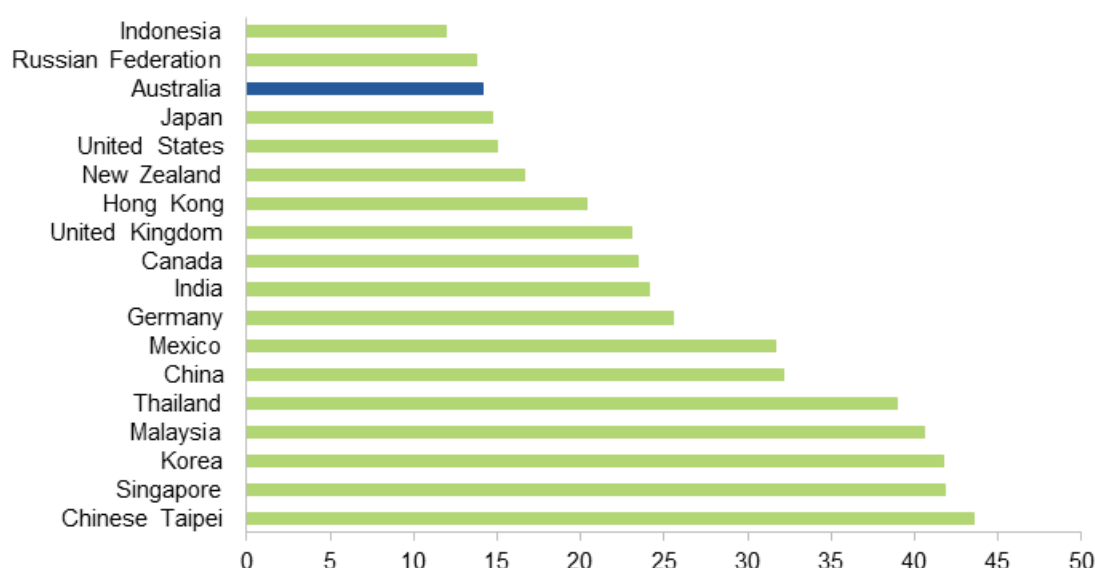
Sources: ABS (*International Trade in Goods and Services, Australia*, Cat. no. 5368.0); ABS (*International Trade: Supplementary Information*, Cat. No. 5368.0.55.004).

Australia's role in global supply chains

The global economy has become increasingly integrated, and much international trade is in product components that are on-sold to other countries for further processing. Because of its location and specialisation in the export of raw materials, Australia's participation in global supply chains is primarily oriented towards the overseas processing of its exports,¹ rather than the domestic processing of imported intermediate inputs for re-export. At around 15 per cent, Australia ranks relatively low internationally in terms of the foreign value added content of its exports (figure 1.5). The bulk of the foreign value added embodied in Australian exports lies in mining products shipped to China.

Figure 1.5 Australia participates in global supply chains, but less so than many other countries^a

Percentage of foreign value added in gross exports, 2011



^a This is one measure of global supply chain participation. More details are provided in OECD (2017a).

Data source: OECD (2017d).

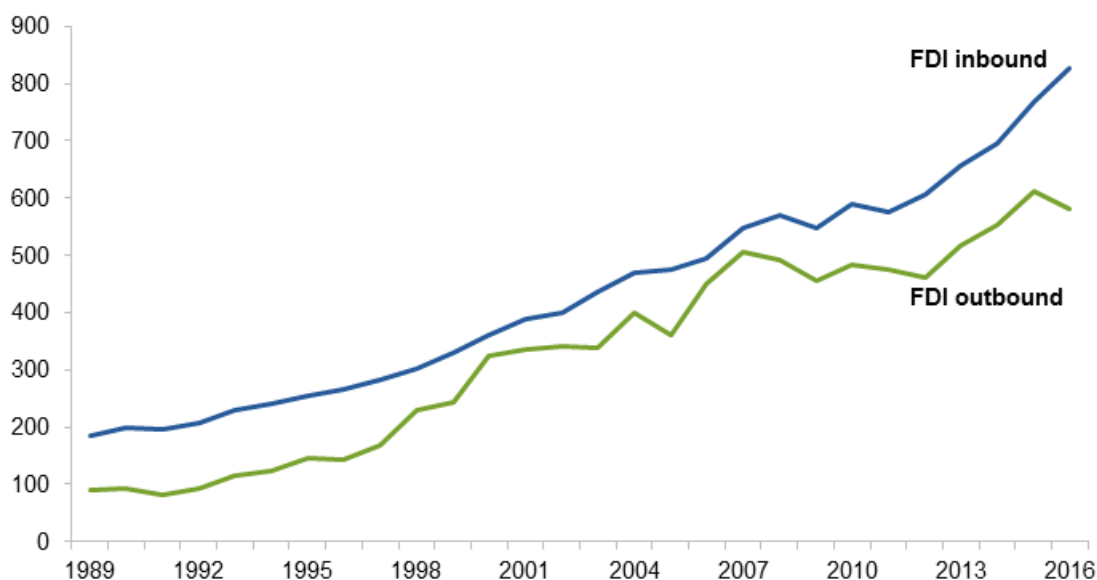
Foreign direct investment

Australia has always been a net importer of capital, as the demand for investment has long exceeded the supply of savings, especially during periods of natural resource development (figure 1.6). In the decade to 2011, inbound foreign direct investment growth was largely due to foreign funding of the construction phase of the mineral resources boom (PC 2013).

¹ For example, Australian iron ore is exported to China, to be on-sold as steel to the United States.

Figure 1.6 Foreign direct investment has grown steadily — both into and from Australia

Foreign investment in Australia and Australian investment abroad, 1989–2016^a, real values of assets and liabilities, \$ billion



^a Value in June of the specified year, deflated by the chain price index for GDP. The reference year is 2014.

Data sources: ABS (*Balance of Payments and International Investment Position, Australia*, Cat. no. 5302.0, *Australian System of National Accounts*, Cat. no. 5204.0).

In summary

International trade and investment are vitally important to the Australian economy (box 1.2). Trade generates new jobs, benefits consumers by making firms more competitive and increases the wellbeing of the community through greater economic activity and access to a wider range of products. Similarly, foreign direct investment lifts productive capacity, generates new jobs, brings new technology into Australia, upgrades skills and strengthens competition, supporting productivity improvements and through that, national income growth. Therefore, if the international trade and investment environment changes, the impacts for Australia, as well as nearly every other country in the world, are likely to be substantial. Barriers to trade and investment pose a risk to Australia's ongoing growth and wellbeing.

However, growth in trade has had costs, as well as benefits. Not all households benefit equally from the expansion of international trade. Some incur significant adjustment costs as markets adapt to greater competition from imports. Governments at times step in to lessen the disruptive effect that these adjustment pressures can have and that can impose both costs and benefits.

Box 1.2 **Why are trade and investment so important to the Australian economy?**

Trade is vitally important to the economy.

- Trade (exports and imports) is a big part of the Australian economy, equating to about 40 per cent of GDP (DFAT 2016a).
- Trade has been an important driver of economic growth. Over the past 25 years, Australia's economy has doubled in size; exports have accounted for over a quarter of this growth (Tuhin and Swanepoel 2017).
- Thanks to the trade liberalisation that occurred during the 1980s and 1990s, the average Australian working household was better off in 2009 by between \$100 and \$150 a fortnight (CIE 2009).
- Many Australian jobs rely on trade. About 1 in 7 workers are ultimately involved in the production of exports. Another 1 in 10 are involved in import related activity. All up, over 20 per cent of jobs are connected with trade (CIE 2009).
- Consumers are big beneficiaries of trade. Trade means access to a wider variety of goods and services at more competitive prices, boosting living standards. The price of audio, visual and computing equipment fell over 50 per cent in the five years to June 2014, for example, thanks, substantially, to imports from countries where it costs less to make those types of products (DFAT 2014).
- Exporting firms are typically more successful. They are larger, more productive, pay higher wages and are more likely to survive than non-exporters (Tuhin and Swanepoel 2017).
- Imports reduce Australian production costs and increase employment. Over half of all Australian imports are essential inputs that businesses use to produce goods locally (DFAT 2014). If firms had to buy higher cost domestic inputs, rather than import them, they would be less able to expand and hire more workers.
- Exposure to competition from overseas compels Australian firms to innovate and adopt more efficient production methods. More efficient resource use boosts economic growth.
- Foreign direct investment helps fund the growth and development of industry in Australia. Foreign investment brings new technologies and services and connections to foreign markets, boosting growth and exports.

CONCLUSION 1.2

International trade and investment are vitally important to the Australian economy. Barriers to trade and investment pose a risk to economic growth and living standards.

1.3 **The research approach**

Changes in protection affect trade in numerous and complex ways. Mapping these complex interactions is not possible without the aid of models that trace through the various

channels of effect. Computable general equilibrium models are used for this purpose. The Commission has developed two such models.

The first model, PC Global, traces trade and capital flows between countries (box 1.3) and is used to estimate the impacts on Australia and other countries of a number of possible scenarios for changes in international trade policies.

The second model, PC National, is used to look at potential changes in the distribution of income in Australia. This is an important departure from standard trade policy modelling, and it recognises the fact that, while many households benefit from trade, these benefits are not evenly distributed. For policy purposes, it is important to identify the types of households that bear the costs of trade — in the form of structural adjustment that leads to job losses, for example — so that governments can better design policies that lessen the disruptive effect of reform and spread the benefits more widely.

Box 1.3 Estimating the consequences of protectionism

To estimate the projected effects of changes to trade policy settings on different countries, the Commission has developed an economic model, PC Global, which captures the key features of the economies of all countries in the world (represented by 21 individual and 4 regional economies). The model has information about the structure of each of those economies and the nature of the trade and investment linkages between them.

This type of model enables analysis of the question ‘what would the world look like today if a different set of policies was in place’. It is not a dynamic model. That is, it does not permit analysis of the pathway taken by an economy following a shift in policy.

PC Global is a streamlined version of the widely used Global Trade Analysis Project (GTAP) model. In contrast with the GTAP model, however, PC Global takes account of inter-country capital flows, enabling insights into how policy changes affect national income (GNP) in addition to national output (GDP). Therefore, for each of the scenarios developed by the Commission, the model was used to estimate expected changes in:

- economic activity within borders, or real GDP
- income within borders, or real GNP
- purchasing power (or living standards), measured by real Gross National Absorption (GNA). This measure accounts for changes in the terms of trade by excluding the effect of the prices of exports (which residents do not consume) and including the effect of the prices of imports (which residents do consume).

These changes are reported both for Australia, and other relevant countries or regions around the world.

Key observations from the modelling work are presented in this report. The modelling approaches and detailed results are presented in an accompanying Technical Report. Key assumptions on which the results rest are also described in that report.

The model was used to estimate the results of several trade policy change scenarios (table 1.2). These are not the Commission’s view of the likely future, but a stylised device to

highlight the impacts and implications for Australia of the sorts of trade policies being countenanced. At this stage, the scale of any trade restrictions, and whether they will eventuate at all, are highly uncertain. With that caveat in mind, plausible extreme scenarios are considered to illustrate the possible effects on the Australian economy and its major trading partners.

Table 1.2 Scenarios modelled by the Commission

<i>Simulation</i>	<i>Specific policy changes modelled</i>
Trade restrictive measures in selected major trading partners	
US tariff on Chinese imports	US increases tariffs to 45 per cent on all imports from China
US tariff on Mexican imports	US increases tariffs to 35 per cent on all imports from Mexico
US tariffs on China and Mexico	US increases tariffs to 45 per cent on all imports from China and to 35 per cent on all imports from Mexico
Reciprocal US and China tariffs	US and China increase tariffs to 45 per cent on imports from each other
Reciprocal US and China and US and Mexico tariffs	US increases tariffs on imports from China and from Mexico as above and both retaliate in-kind
US border adjustments	
US border adjustment	Uniform 20 per cent increase in taxes on imports and uniform 20 per cent increase in export subsidies in the US
US trade-neutral border adjustment experiment	Uniform 20 per cent increase in taxes on imports and uniform 16.7 per cent increase in export subsidies in the US
Global contagion	
Global contagion	All countries increase tariffs by 15 percentage points
Strengthening the trading system among open economies	
Global contagion without Australia	All countries bar Australia increase tariffs by 15 percentage points
Global contagion without RCEP countries	All countries bar RCEP members increase tariffs by 15 percentage points
Global contagion with RCEP members liberalising NTBs and barriers to services	All countries bar RCEP members increase tariffs by 15 percentage points; RCEP members reduce non-tariff barriers and barriers to trade in services.
Global contagion with RCEP members abolishing tariffs, and liberalising NTBs and barriers to services	All countries bar RCEP members increase tariffs by 15 percentage points; RCEP members abolish tariffs (on a most favoured nation basis) and reduce non-tariff barriers and barriers to trade in services.

The scenarios fall into four categories.

1. Trade restrictive measures by the US on the global economy with a focus on implications for selected major US trading partners. Threats of higher tariffs made by President Trump during his campaign are assumed to be implemented. In the initial

variants of this scenario, China and Mexico retain their current levels of protection. In later variants, they retaliate in kind.

2. US border adjustments implemented as part of a new US corporate tax regime.
3. Global contagion, where all countries implement higher tariffs.
4. Strengthening the trading system among open economies. In the first scenario, Australia maintains an open trade stance in the face of global increases in protection. In later variants, Australia and other members of the Regional Cooperative Economic Partnership — including Australia, China, Japan, South Korea, India, New Zealand and the ASEAN countries — engage and adopt an open stance towards trade.

The Commission has also run a scenario to test the sensitivity of results to key assumptions. Results are summarised in chapter 2 and detailed in the Technical Report.

Not all of the questions of interest to this study can be addressed using PC Global or PC National. Where possible, conclusions from modelling work by others are drawn upon in considering these questions, and qualitative analysis is used to complement the modelling.

1.4 Structure of this report

The remainder of this report is organised as follows.

- Chapter 2 assesses the potential impacts on Australia and elsewhere of an increase in US tariffs on Chinese and Mexican imports.
- Chapter 3 focusses on the potential impacts if border adjustments were part of a new US corporate tax regime.
- Chapter 4 considers the implications for Australia and elsewhere of protectionism triggering tit-for-tat reprisals resulting in a global rise in protection.
- Chapter 5 examines a scenario where Australia resists reprisals and instead seeks to work with like-minded countries to pursue an agenda of further reductions in trade barriers and improved access to markets.
- Chapter 6 draws together the implications for Australian trade and investment policy as well as companion policies that facilitate structural adjustment and support a more inclusive sharing of the benefits from open markets for all Australians.

The Technical Report complementing this paper can be accessed from the Commission's website.

2 Higher US tariffs on imports from China and Mexico

Key points

- During his presidential campaign, Donald Trump foreshadowed substantial shifts in US trade policy, including withdrawing the United States from the Trans-Pacific Partnership, renegotiating or withdrawing from the North American Free Trade Agreement, labelling China a currency manipulator and stronger action against violations of trade agreements.
- He also threatened to substantially increase the tariffs imposed on Chinese and (at least some) Mexican products imported into the United States, to 45 and 35 per cent, respectively.
- Assessing the potential impacts of President Trump's trade policies is complicated by their lack of specificity. For analytical purposes, the Commission has taken the threats against China and Mexico at face value and used them in assessing the potential economic effects of a more protectionist United States, with a specific focus on Australia.
- It is unclear how China and Mexico would respond, if at all. If they respond, the Commission has assumed that they would retaliate in-kind.
- Such tariff increases would cause a significant reorganisation of global trade. Exports from other countries would replace Chinese and Mexican products in US markets, and Chinese and Mexican exports to countries other than the United States would rise. Overall, once the dust had settled, global trade, and world economic activity, would be slightly lower.
- Economic activity and living standards would fall in the United States, China and Mexico. In the United States and China, the Commission's modelling shows that, in the longer term, these falls would be equivalent to these countries permanently losing about five and four months of economic growth each year, respectively.
 - Mexico would be much more severely affected. Economic activity would be lower by about 10 per cent or the equivalent of four years of economic growth. This outcome is explained by the fact that 80 per cent of Mexico's exports go to the United States. Mexico would also incur significant costs in reorienting its trade to other markets.
- A more protectionist trade policy would not achieve the US administration's goal of narrowing the US trade deficit, mainly because such policies tend over time to result in lower levels of both imports and exports.
- Overall, and leaving aside transitional costs, there would be very little effect on economic activity in Australia. Falls in Chinese demand for Australia's main exports — minerals, energy and agricultural products — would be offset by increases in demand from other countries.
- In the short term, the effects of increasing tariffs would likely be more pronounced. New trade relationships would take time to form, and changes in the structure of economic activity would be associated with some unemployment of workers and underutilised capital.
- Uncertainty around future US policy is likely already impacting global trade and investment.

Trade was a particular focus of Donald Trump's election campaign, and has remained a priority since he became President. The breadth of Mr Trump's concerns are evident in comments during the campaign in a speech focused on trade policy (Trump 2016, various pages):

Our politicians have aggressively pursued a policy of globalization — moving our jobs, our wealth and our factories to Mexico and overseas ... When subsidized foreign steel is dumped into our markets, threatening our factories, the politicians do nothing ... We allowed foreign countries to subsidize their goods, devalue their currencies, violate their agreements, and cheat in every way imaginable ... NAFTA [the North American Free Trade Agreement] was the worst trade deal in history, and China's entrance into the World Trade Organization has enabled the greatest jobs theft in history ... as Secretary of State, Hillary Clinton stood by idly while China cheated on its currency, added another trillion dollars to our trade deficits, and stole hundreds of billions of dollars in our intellectual property ... The TPP [Trans-Pacific Partnership] would be the death blow for American manufacturing.

Mr Trump promised that he would take actions quickly after becoming President (Trump 2016) — many of which have been initiated. These included:

- withdrawing the United States from the Trans-Pacific Partnership (TPP). The President signed a memorandum to this effect shortly after taking office (Trump 2017b)
- appointing the 'toughest and smartest trade negotiators to fight on behalf of American workers' (Trump 2016, p. 17). Progress against this promise is difficult to evaluate. It is noteworthy, however that the new US Trade Representative (USTR), Robert Lighthizer, also held the role of deputy USTR under President Reagan who instituted voluntary export restraints with Japan and used safeguards vigorously
- directing the Secretary of Commerce to identify all violations of trade agreements that harm US workers and to use all tools available under US and international law to end those violations. The President signed an executive order initiating this work on 29 April 2017 (Trump 2017b) and authorised an investigation into the causes of trade deficits on 31 March 2017 (Trump 2017a)
- renegotiating or withdrawing from NAFTA. A letter notifying Congress of the President's intention to renegotiate the agreement went from the USTR to Congress on 18 May 2017 (USTR 2017c)
- instructing the Treasury Secretary to label China a currency manipulator. This has not yet happened
- instructing the USTR to bring trade cases against China. A number of investigations have been launched into the unfair or illegal subsidisation by China and other countries of US imports of aluminium, steel, chemicals and other products (Ross 2017)
- using every lawful Presidential power, including the application of tariffs, if China 'does not stop its illegal activities' (Trump 2016, p. 18). Tariffs have not been implemented. In April 2017 President Trump and Chinese President Xi Jinping announced a '100 day action plan ... to work towards rebalancing trade' (Cimino-Isaacs 2017, p. 1). Among initial results are China allowing beef and liquefied natural

gas imports from the United States and increasing market access for US credit rating and electronic payment services (US Department of Commerce 2017).

Many of these actions signal significant changes to future US trade policy, but the detail will not be clear for some time.

Although not mentioned during his major speech about trade policy since becoming president, Mr Trump also threatened big increases in tariffs against imports from China (to 45 per cent) and Mexico (to 35 per cent) during his campaign.

Making an assessment of the potential impacts of President Trump's trade policies is complicated by their lack of specificity. For analytical purposes, the Commission has taken the threats against China and Mexico at face value and used them to model the potential economic effects of a more protectionist United States, with a specific focus on Australia. The Commission does not envisage that these threats would be implemented to the letter — but they are illustrative of what higher protection might mean.

As background to the Commission's modelling work, Mr Trump's threats of higher tariffs, and the types of retaliatory action that China and Mexico might take in response, are discussed in the following section (section 2.1). Trading relationships between China, Mexico, the United States and Australia are then briefly described (section 2.2). Results from the Commission's assessment are then presented (section 2.3).

2.1 US threats of higher tariffs and potential retaliation

Much higher tariffs on Chinese imports

During the US presidential campaign, Donald Trump repeatedly blamed China for the loss of US jobs (The Economist 2015), and threatened to impose high tariffs on imports from China:

I would tax China on products coming in ... I would do a tariff ... the tax should be 45 per cent. (Donald Trump quoted in Haberman (2016, p. 1)

This would be an unprecedented action. The United States has imposed punitive and retaliatory tariffs on particular Chinese goods in the past, such as a 266 per cent anti-dumping duty on Chinese steel in March 2016, contributing to the lowest US imports of Chinese steel since 2010 (UN 2017). But a 45 per cent tariff on more than one sector — and possibly across all imports — against another member of World Trade Organisation, has not occurred in the 70-year history of the organisation.²

2 Punitive tariffs on specific products from other countries have been used before. The most prominent example is when US President Ronald Reagan imposed: quotas on imported steel; a 45 percentage point tariff increase on Japanese motorcycle imports in 1983 (Farnsworth 1983); and a 100 per cent tariff on medium-sized Japanese colour televisions, powerful laptop and desktop computers and certain hand power tools (Gerstenzang 1987) in 1987.

Currently, the US weighted average applied tariff rate for all imports is 1.6 per cent (The World Bank 2016a),³ and Chinese goods enjoy non-discriminatory market access to the United States. Moving to a 45 per cent tariff would be a big increase on current rates. To put it into historical perspective, it would be akin to more than double the highest average rate levied during the Great Depression in the 1930s.

A number of legal avenues through which he could raise tariffs are available to the President (box 2.1).

Box 2.1 Legal avenues for higher tariffs

Legal avenues exist for the President to levy tariffs. The President is empowered to unilaterally impose tariffs or quotas on imports from another country by invoking section 232b of the *Trade Expansion Act 1962* (United States) or section 122 or section 301 of the *Trade Act 1974* (United States) (Devereaux Lewis 2016). Noland et al. (2016) discussed these presidential powers in detail.

While there are some limits on the scope of these statutes (for example, section 122 of the Trade Act allows tariffs of up to 15 per cent for up to 150 days), there are more comprehensive measures available to the White House under the *Trading with the Enemy Act 1917* (United States) or the *International Emergency Economic Powers Act 1977* (United States). The latter Act allows for almost unlimited increases in trade restrictions, while the *Trading with the Enemy Act* would enable the levying of tariffs against any country, but section 2c of the Act requires that the United States would have to be engaged in a war declared by Congress.

If the US targeted imports from China with higher tariffs, there are plausible scenarios involving retaliation by China in which protection escalates. Initial measures might only be temporary, with little if any long term effect on trade flows. But Chinese retaliation could lead the US Congress to extend protectionist measures and have the tariff measures endure, shifting trade flows permanently.

While a 45 per cent tariff on all US imports from China is an extreme case in a range of possible unilateral tariff measures, it forms an indicative upper bound to model.⁴ Other studies have estimated the potential effects of the United States levying tariffs of this magnitude. Dixon (2017), Kawasaki (2017) and Noland et. al. (2016) modelled a 45 per cent US tariff on Chinese imports, while McKibbin (2017) modelled a US tariff of 40 per cent on Chinese imports and McKibbin (2016) assessed the potential impacts of the United States levying a 40 per cent tariff on imports from all countries. Findings from this research are discussed later in this chapter, in chapter 4 and in the Technical Report.

³ The simple average most favoured nation applied tariff rate is 3.5 per cent (WTO nd).

⁴ The head of the new National Trade Council in the White House, Peter Navarro, has advocated that 'about 43 per cent of the Chinese advantage was unfair trade practices' (Lee 2016).

Much higher tariffs on Mexican imports

Trade with Mexico was also a target for Donald Trump during his election campaign:

When do we beat Mexico at the border? They're laughing at us, at our stupidity. And now they are beating us economically. They are not our friend, believe me ... they're killing us economically. (Trump 2015, p. 1)

The trade relationship between the United States and Mexico is governed by the North American Free Trade Agreement (NAFTA), of which Canada is also a signatory. Donald Trump has repeatedly said that he will 'rip up' NAFTA, renegotiate it or withdraw from it altogether (Needham 2016). However, as noted, he recently notified Congress that he will renegotiate the agreement.

There are aspects of NAFTA that are outdated and not relevant to contemporary commerce between the NAFTA signatories (the United States, Canada and Mexico) and their other trading partners. For example, areas such as digital commerce and data protection were not issues when the pact was negotiated; today they are significant sectors. The TPP agreement with 12 Asia Pacific economies that included all three NAFTA members would have significantly upgraded rules from NAFTA but, as noted, President Trump withdrew the United States from the TPP early in 2017. Mexico has suggested that NAFTA renegotiations could be based on agreements reached during development of the TPP in areas including biotechnology, labour regulation, e-commerce and intellectual property (Wheatley and Webber 2017).

There are also particular issues related to trade with Mexico and Canada that the Trump administration is targeting as unfair trade practices. One focus of these practices identified by President Trump's trade policy team, including US Commerce Department Secretary Wilbur Ross, is the competition from Mexican producers that use imported inputs from non-NAFTA countries and gain preferential access to the US market. To tackle this, Secretary Ross has initiated renegotiation of the automobile parts provisions in NAFTA, making it harder for producers in Mexico to source cheaper inputs from outside the NAFTA grouping. Stricter rules of origin may result from a renegotiation of NAFTA.

During his presidential campaign Donald Trump threatened a 35 per cent tariff on at least some imports from Mexico. At his campaign launch, for example, Mr Trump stated that if Ford moved vehicle production to Mexico, its exports back to the United States would face a 35 per cent tax (Trump 2015). Other car makers have been similarly threatened (Taylor and Rinke 2017). More broadly, in a series of tweets in December 2016, President Trump stated that any company that left the United States for another country would face a 35 per cent tax on their exports to the United States (Tucker 2016).

Mr Trump's campaign comments on tariffs on products from Mexico have been interpreted by many as implying he would levy a 35 per cent tariff on all imports from Mexico, for example, BBC News (2016) and Noland et al. (2016).

In summary, there is great uncertainty around the scope of any renegotiation of NAFTA, and about the extent of any tariffs that might be levied on US imports from Mexico. For the analytical purposes of this study we use a tariff of 35 per cent on all US imports from Mexico to illustrate the types of effects that could emerge were the United States to significantly raise protection against imports from Mexico.

Retaliatory increases in protection by China?

The likely response of Chinese policy makers if the United States did levy punitive tariffs is very difficult to predict. There is little precedent for any significant trade war involving China since it embarked on opening up its economy in 1978. China undertook unilateral liberalisation aimed at, and culminating in, World Trade Organization (WTO) accession in 2001. At accession, China committed to rules and practices above and beyond those that apply to other WTO members as the price for entry.

China's accession to the WTO transformed the global trading system, lifted trade as a share of China's GDP (figure 2.1) and helped to make China the largest international trader. The Chinese economy continues its transition from a centrally planned economy to a market economy and economic openness has been critical to China's economic development and modernisation. China has followed the commitments it made in its accession to the WTO (USTR 2015) and has abided by rulings against it in WTO dispute settlement cases.

There are three plausible Chinese responses to US increases in protection against its imports. One is for China to do nothing in retaliation and to keep its outward economic orientation. A second response could be to make business difficult for US firms operating in or exporting to China. A third response would be to respond in-kind with like-for-like measures. Each of these is considered in turn.

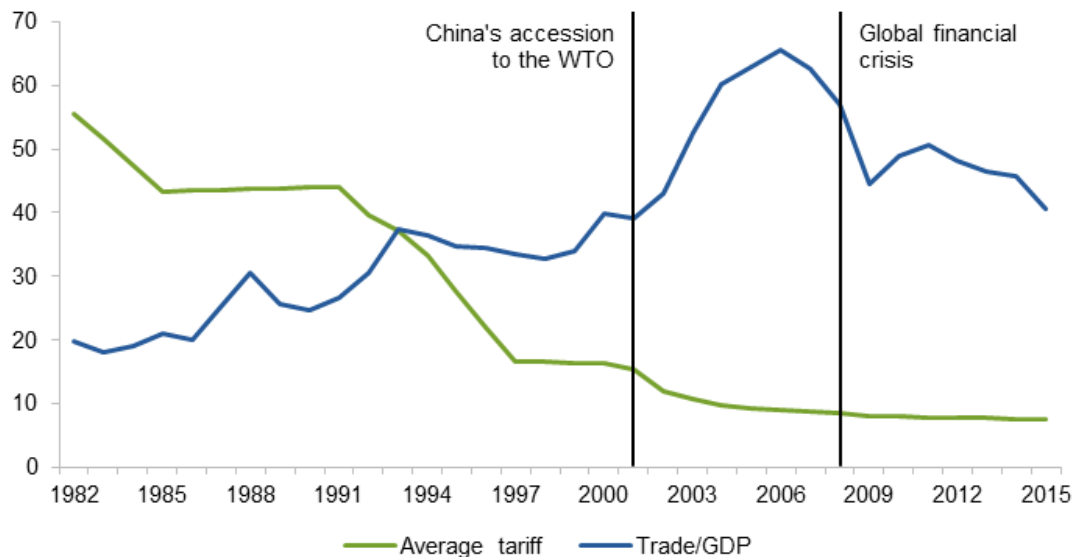
Comments made on possible reasons for adopting each scenario are not intended to characterise any scenario as more (or less) likely than any other. Commentators may choose their own assessment of likelihood.

China continues liberalising ...

China could work to avoid a trade war for at least two reasons.

First, the Chinese government puts a premium on social, economic and political stability (Prasad 2017). An economically damaging US tariff on Chinese goods would be disruptive and bring uncertainty and instability to the Chinese economy. The Chinese leadership could recognise the even larger costs that retaliation would impose on the Chinese economy. Not retaliating would still be disruptive for the Chinese economy, but less so than a trade war.

Figure 2.1 **China's accession to the WTO significantly expanded the contribution of trade to China's economy^a**



^a The average tariff is a simple, not weighted, average. Missing tariff values are imputed through averaging data for neighbouring years.

Data sources: Blancher and Rumbaugh (2004); World Bank (The World Bank 2016b).

Second, the nature of global supply chains and Asian production networks mean that Chinese exports to the United States include goods that embody intermediate inputs from other Asian countries. As a result, a US tariff on Chinese goods would hurt Asian firms that are part of the global supply chain with the final product exported from China (the example of the iPhone is discussed in chapter 6). Some of these firms and others may benefit as the United States would source imports from suppliers other than China. The effect at the country level would depend on their mix of firms (and industries) and the nature of their involvement in global supply chains.

Given these links, the United States would likely be put under significant pressure from other Asian countries and the global economic community over punitive tariffs on China. This could contribute to the Chinese leadership choosing to demonstrate global economic leadership for geopolitical reasons, as well as economic self-interest, by not retaliating. Comments from President Xi in a speech to the World Economic Forum Annual Meeting in Davos (Xi 2017) might be considered by some to be consistent with this response.

... or it could place restrictions on US businesses ...

The Chinese state-run Global Times news agency has warned that in the event of large US tariffs aimed at Chinese goods, major US firms that operate in, or export to, China might be targeted (Bloomberg 2016). There is some evidence China might have used these types

of actions in the past (box 2.2). The US Chamber of Commerce has also pointed to US firms being hit with large fines for antitrust violations, increased regulatory scrutiny and restrictions from Chinese industrial policy when tensions between the two countries have risen (Miller and Martina 2014).

Adding to the uncertainty of doing business in China are the complex and opaque approvals process for foreign investments (US Chamber of Commerce 2012) and an obscure regulatory environment that is susceptible to political interference and to delay. While these processes have been streamlined and become more transparent over time, they are still a sticking point in negotiations for a US–China Bilateral Investment Treaty. US firm entry to the Chinese market and operations could easily be impeded by Chinese authorities without openly and obviously flaunting international trade rules and norms.

Box 2.2 China has adopted trade restrictions in the past

There is a range of examples of China adopting trade restrictive measures in pursuit of different aims.

In retaliation for South Korea hosting the US Terminal High Altitude Area Defense anti-missile system, since July 2016 China has banned some Korean television programs, stopped Chinese tourist groups from visiting South Korea, and there have been protests against prominent South Korean brands and firms (Lim and Ferguson 2017), especially Lotte on whose land the facility is to be located. It is unclear how much of the Chinese retaliation is state-led or whether South Korea is able to challenge China in the World Trade Organization for breaching international trade rules over these interventions.

China has also been known to use behind-the-border measures to impede commerce with other countries when there have been tensions. In 2010 China banned Norwegian salmon due to quality and safety concerns (WTO 2013). This ban was widely thought to be in response to Norway's Nobel Laureate Committee awarding the Nobel Peace Prize to imprisoned democracy advocate Liu Xiaobo (Chan 2016).

Health and quality standards (under sanitary and phytosanitary measures) were cited as the reason for the Chinese ban on Philippine bananas in 2012 (Asia Sentinel 2012), which was widely believed to have been in response to territorial disputes between the two countries in the South China Sea.

In response to a territorial dispute with Japan and the arrest of a Chinese fishing captain, China allegedly banned exports of rare earth metals to Japan (Bradsher 2010). This case was resolved after Japan, the United States and Europe took action against China in the World Trade Organization and China accepted the ruling against it.

The Chinese Government made no direct link between these political disputes and the import bans, and the dispute over the bananas appears to have predated the particular escalation in the territorial dispute by a month. Similarly, the rare earths export bans do not appear to have been synchronised with the escalation of the territorial dispute with Japan. There is also a question as to how effective these measures have been in punishing or changing policies in another country if indeed that was their intention. But these behind the border restrictions have coincided sufficiently with political tensions to have been linked by the international press and in international perceptions.

Behind the border restrictions in China and/or restrictions on US firms entering China could empower President Trump, whose comments suggest he would prefer US firms to boost their domestic operations and repatriate capital to be invested domestically in the United States. Chinese retaliation that helped increase domestic US manufacturing would be counted as a win for Trump. But it would come at a significant loss to the Chinese economy and to US companies invested in or exporting to China.

Another possibility is Chinese restrictions on investing in the United States. There are already significant restrictions on outward investment and further restrictions could be easily implemented. Firms in China that wish to invest abroad are required to seek approval from multiple government ministries, including additional approvals for central state-owned enterprises, through a cumbersome process (Sauvant and Chen 2014). The approvals are subject to restrictions around priority sectors and can be restrictive when the government fears capital flight (Wildau, Weinland and Mitchell 2016).

... or it might retaliate in-kind

In the face of a large US tariff there would be significant domestic pressure on the Chinese leadership to appear strong and this could take the form of retaliating in-kind. In late 2017, the 19th Party Congress will see the largest turnover in China's political leadership in five years. While stability is a priority, no leader can afford to appear weak in the face of significant provocative action from a foreign country. In standing up to the United States, China might respond in-kind.

As there are no precedents to confidently predict retaliatory actions, the scenario of a like-for-like response to US protectionist action aimed at China is adopted to illustrate the potential effects of retaliation.⁵ A 45 per cent US tariff on Chinese goods would be met with a 45 per cent tariff in China on US imports.

Retaliatory increases in protection by Mexico?

Possible Mexican retaliation to US protectionist measures would include similar scenarios to the Chinese case for similar reasons. Mexico could hold the line and not respond, could respond in a like-for-like manner or resort to other measures. Mexico and the United States are parties to NAFTA, aspects of which are likely to be renegotiated or updated, and protectionist rhetoric — from both sides — could be seen as an attempt to gain negotiating leverage.

The scenario of a like-for-like response to US protectionist action aimed at Mexico is adopted in this study to illustrate the effects of retaliation. A 35 per cent US tariff on Mexican goods would be met with a 35 per cent tariff in Mexico on US imports.⁶

⁵ Results from a scenario in which China does not retaliate are presented in the Technical Report.

⁶ Results from a scenario in which Mexico does not retaliate are presented in the Technical Report.

2.2 Trade relationships between China, Mexico, the United States and Australia

Trade relationships between the United States and China and Mexico, and between Australia and the US and China, are material. Increases in tariffs could be highly disruptive.

China and Mexico are key trading partners for the United States. Between them, they account for over 30 per cent of US imports and nearly one quarter of US exports (figure 2.2), and rank among the United States' top three import sources and export destinations. The United States is also a major trading partner for China, and completely dominates Mexican trade. The United States relies on Mexico for the final assembly of a significant share of its consumption goods. Inputs to manufacturing typically flow across the border to Mexico and final manufactured goods flow back.

Figure 2.2 **China and Mexico are major US trading partners^{a,b}**



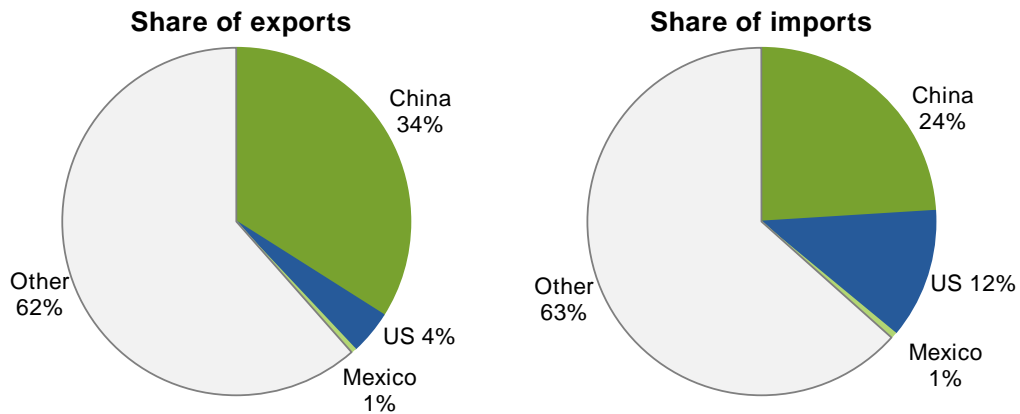
^a The trade deficit with China accounted for over 60 per cent of the overall US trade deficit in 2016, which reached about US\$500 billion; the deficit with Mexico represented another 10 per cent. ^b All figures represent 2016 goods trade except for Chinese trade which uses 2015 data.

Data sources: Comtrade database, total 2016 and 2015 HS commodity trade (UN 2017).

If the United States did levy high tariffs against imports from China and Mexico, these measures may well affect the Australian economy. China is Australia's most important trading partner, accounting for over one third of Australia's export earnings and nearly one quarter of imports (figure 2.3). A decline in economic activity in China due to decreased US demand for Chinese exports could be bad news for Australian exporters. On the other hand, Australian consumers might be better off if decreased US demand for Chinese products led to lower traded good prices, and Australian producers might be better off if

US consumers switched to Australian suppliers.⁷ (The modelling results presented below shed light on these possibilities.)

Figure 2.3 China is Australia's largest trading partner, with the US in second place on imports



Data source: UN (2017).

Mexico accounts for a very small share of both Australia's exports and imports, suggesting that the direct impacts on Australia of any increase in US protection against imports from Mexico would likely be small.

Changes in the US economy as a result of any large increase in tariffs might also be expected to affect Australia. The United States is the second most important source of Australia's imports, but it is a relatively insignificant destination for Australia's exports. Higher US tariffs on imports from China might lead to higher prices on imports from the United States for Australian consumers, as US producers redirected output to the domestic market and raised the prices of their exports. And any decline in economic activity in the United States might reduce demand for Australia's exports, although this could be offset by US consumers substituting Australian exports for the now higher priced goods from China.

⁷ Consumers include firms as users of intermediate goods and investment goods as well as consumers of final private and public goods.

2.3 How might Australia be affected if the United States raises tariffs on imports from China and Mexico?

Insights from the literature

As noted, a number of authors have assessed the potential impacts of significantly higher US tariffs on imports from China, and a couple — Kawasaki (2017) and Noland et al. (2016) — have also looked at the potential impacts of higher tariffs on imports from Mexico.

Only Dixon (2017) considered how Australia might be affected by an increase in US tariffs on imports from China, and found that the impact would be small (2017, p. 1):

On the upside, cheaper imports from China will be good for Australia's terms of trade. Also on the upside, there will be scope for Australian goods to replace Chinese goods on the American market. Modelling shows that there will also be scope for Australian goods to replace American exports on the world market as American exports are diverted to home use. On the downside, declining incomes in both China and the US will put downward pressure on demand for Australian exports. We find that the overall macroeconomic impact on the Australian economy is small. Disturbances at the sectoral level are also small relative to normal economic growth.

These conclusions are similar to those obtained from the Commission's analysis.⁸

Insights from the Commission's modelling

The Commission has assessed the potential effects of the United States raising tariffs on China and Mexico individually and simultaneously and, for each of these scenarios, of each country retaliating in-kind. Detailed results from all of these assessments are reported in the Technical Report. Rather than discuss results from each scenario (which overlap quite a lot in terms of their main conclusions), the following discussion focuses on what might happen if the United States levied tariffs of 45 per cent and 35 per cent on imports from China and Mexico, respectively, and they retaliated in-kind.

As discussed in chapter 1, the Commission's modelling approach does not trace what happens in economies during the period of adaptation to a new trade policy regime. The results abstract from that process, estimating the longer-term outcomes once affected economies have fully adjusted to the new regime. But some general conclusions about the transition paths can be drawn and are presented following discussion of the model results. Some comments are also made about the potential effects on trade of uncertainty about US trade policy settings.

⁸ The conclusions arrived at by different authors for other countries are highly dependent on the type of model used and the assumptions made about key variables in those models (Technical Report).

Projected impacts of higher US tariffs in the longer term

Dramatic changes to US trade policy would have marked effects on world markets. However, much higher US tariffs on Chinese and/or Mexican products would ultimately likely only have a limited effect on Australia, and on global economic activity.

On the United States

The primary outcome of higher US tariffs would be higher prices for imports from China and Mexico in the United States. In the face of those price hikes, US consumers would turn to locally produced goods, and — to a much larger extent — to imports from other countries.

As US demand for Chinese and Mexican exports declined, given the size of the US market, world prices for those exports would fall, leading to an increase in demand for them in non-US markets, including Australia.⁹ Cheaper world prices for Chinese and Mexican exports would see them replace exports from other countries in markets around the world. Consumers in those markets would benefit, while producers may suffer.

Higher US import prices for Chinese and Mexican inputs would mean higher costs for US producers, which would flow through to higher prices for US exports and lower export volumes. (The Commission's modelling results estimate the fall at nearly 6 per cent.) Although US domestic demand would increase for products made in the US (as a result of the higher prices of competing imports), this increase would not be enough to offset the fall in US exports — overall demand for the output produced by US exporting firms would fall.

Expansion of US firms that compete with Chinese and Mexican imports would draw labour and other resources from other companies. This artificial shift in demand between US sectors means that those resources would not be as productive in their new employment. The related fall in the efficiency of resource use would contribute to a fall in overall economic activity. That said, this effect would be relatively small because US consumers would have the ability to draw more on imports from other countries than on local products to replace imports from China and Mexico.

The decline in economic activity would make the United States a less attractive destination for foreign investment and investors would in some instances look for better returns elsewhere. Capital inflows to the United States would fall.

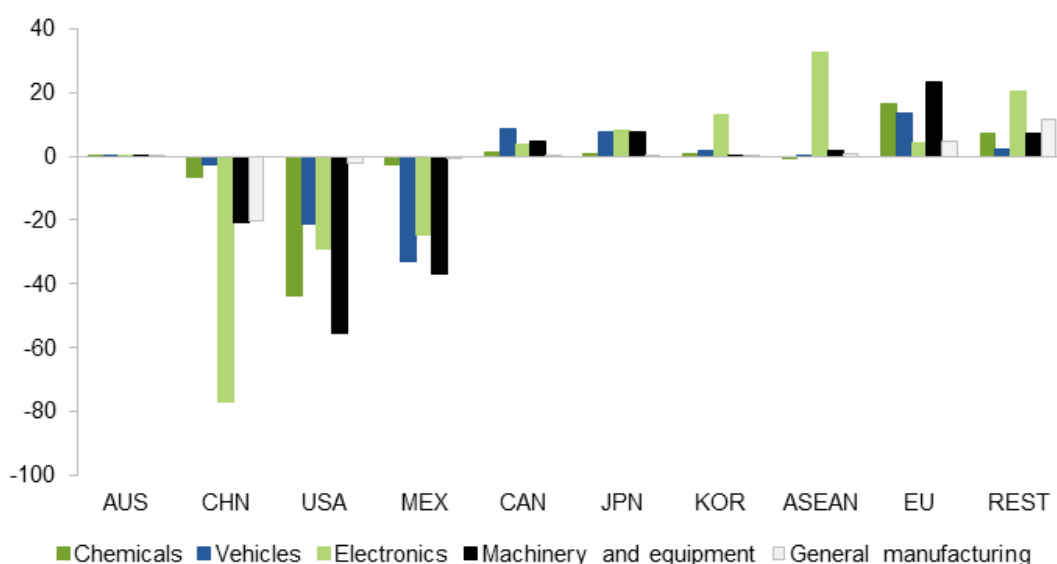
Overall, if the United States were to levy high tariffs on both China and Mexico, and those countries retaliated in-kind, the Commission's modelling shows that economic activity (real GDP) and living standards in the United States would be lower by about 1 per cent in each year that the higher tariffs were in force. This would be akin to the United States permanently foregoing about five months of economic growth per year.

⁹ This would happen because the United States is such a large market that changes in its demand for products move prices on world markets.

On China and Mexico

There would be a significant reorganisation of global trade as the United States sourced imports, particularly of manufactured goods, from countries other than China and Mexico (figure 2.4). Overall, the Commission's results show that world trade would fall by only about 1 per cent, but China's exports would be lower by nearly 3 per cent, and Mexico's by about 26 per cent. Exports from a range of other countries would expand to replace Chinese and Mexican products in US markets.

Figure 2.4 Higher US tariffs on imports from China and Mexico would cause a significant reorganisation of global trade^a
US\$b change in export volumes by sector and exporting nation



^a Results from a simulation in which the United States raises tariffs on imports from China and Mexico by 45 per cent and 35 per cent respectively, and both countries retaliate in-kind.

Data source: Commission estimates generated using the PC Global model.

Because the US is such a large market, the price declines needed on world markets in order for other countries to absorb the products that China and Mexico would have sold in the United States would make current production levels uneconomic. Many Chinese and Mexican exporters would have to reduce production. Manufactured goods sectors in both countries — the main sources of their exports to the United States — would be particularly affected. Resources would be reallocated, particularly to the primary sector. In addition, the declines in income experienced in both countries would translate into declines in activity in the services sector. As exporting industries shrank, real wages would fall and both countries would become less attractive destinations for local and foreign investment. Economic activity and living standards would fall.

Reflecting the importance of the United States as a trading partner, Mexico would be much more severely affected. With such a large share of its exports going to the United States (in contrast with China's relatively low share), Mexico would find it much more difficult than China to find new markets for its exports. The Commission's modelling results show that economic activity and living standards would be over 10 per cent below current levels — the equivalent of the Mexican economy not growing for four years. In contrast, economic activity in China would be lower by about 1.4 per cent, and living standards by about 2 per cent. Given China's relatively high growth rates, China would permanently lose four months of economic growth for each year that higher tariffs were in force.

On Australia

Demand for Australia's exports would be little changed by the reorganisation of global trade. Australia's exports are dominated by minerals, energy and agricultural products — not the types of products that China and Mexico export to the United States.¹⁰ As other countries stepped in to replace China and Mexico as suppliers in US markets, those countries would become more important destinations for Australia's exports. Potential impacts on iron ore and steel markets illustrate this effect (box 2.3).

Box 2.3 Effects of higher US tariffs on iron ore and steel markets

The main players in the markets for iron ore and steel include Australia, Brazil, China, South Korea, Japan and the United States. Australian iron ore is exported primarily to China, Japan and South Korea, where it is turned into steel. Some of this steel is eventually exported to the United States.

Higher US tariffs would cause the cost of Chinese steel in the United States to increase. US users would substitute toward the other main sources: South Korea and Japan (and to some extent, toward US-made steel).

Meanwhile, the world price of Chinese steel would decrease, making it more competitive in markets other than the United States. China would divert its exports towards those markets, crowding out other exporters (South Korea and Japan).

Australian exports of iron ore to traditional exporters of steel would decline, this would be compensated by an increase in Australian steel exports to countries that produce steel mainly for domestic purposes. The overall effect would be a small decrease in Australian exports of iron ore and a marginal increase in Australian exports of steel.

Source: Technical Report.

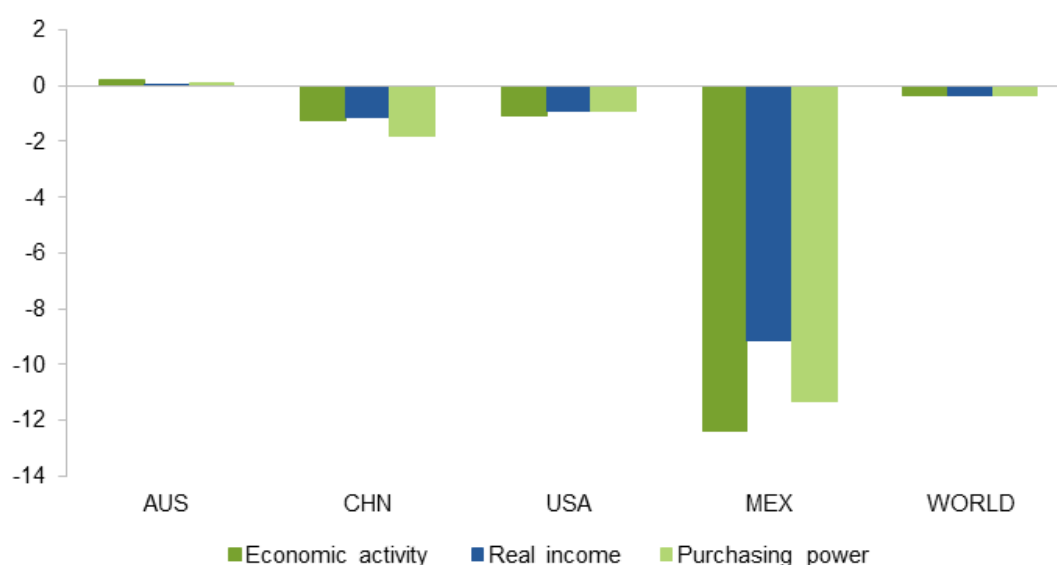
Australian consumers would benefit from the price falls in global markets for the products that China and Mexico export to the United States because they are the types of goods that dominate Australian imports.¹¹

¹⁰ In 2016, about 80 per cent of Australia's merchandise export earnings came from these sources.

¹¹ About 70 per cent of Australian imports are either machinery and transport equipment or manufactured goods, and many of them are made in China.

Overall, there would be very little effect on economic activity or living standards in Australia (figure 2.5). Detailed results for Australia, including estimates for changes in activity in different sectors, wages, capital flows and trade are presented in the Technical Report.

Figure 2.5 Higher US protection against imports from China and Mexico would have little effect on Australia^a
Percentage changes, selected regions



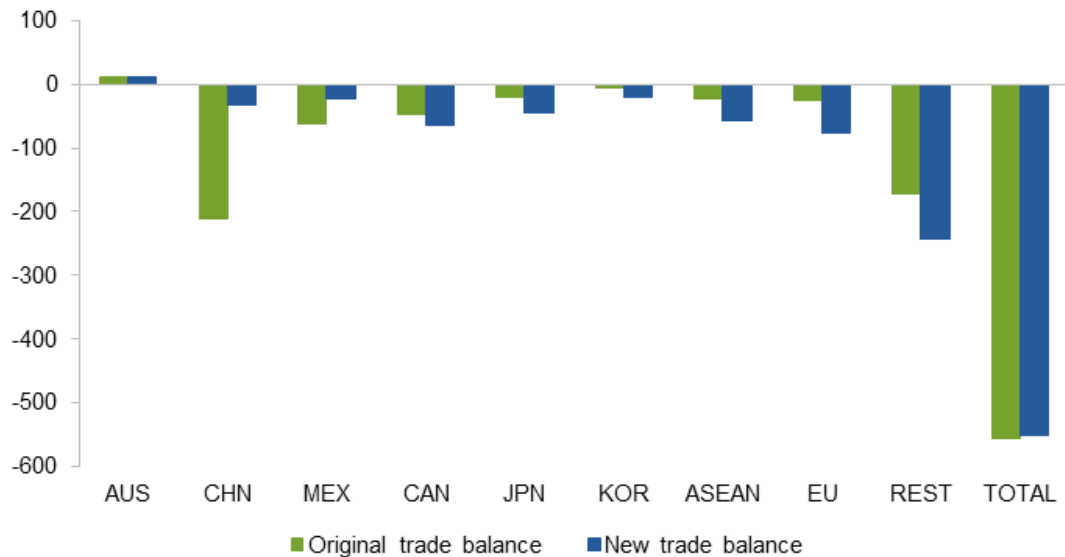
^a Results from a simulation in which the United States raises tariffs on imports from China and Mexico by 45 per cent and 35 per cent respectively, and both countries retaliate in-kind.

Data source: Commission estimates generated using the PC Global model.

One other noteworthy conclusion

While the US bilateral trade deficits with both China and Mexico would fall, the overall US trade deficit would be little changed (figure 2.6). Although imports from China and Mexico would fall markedly, so too would US exports, and imports from other countries would rise. Protectionist trade policy would not achieve the US administration's goal of narrowing the overall US trade deficit. Restoring a more balanced trade position depends on securing changes in saving and investment behaviour and protectionist policies cannot directly influence these at an aggregate level.

Figure 2.6 The overall US trade deficit would be unaffected by higher tariffs on Chinese and Mexican imports
US\$b deficit by trading partner



a Results from a simulation in which the United States raises tariffs on imports from China and Mexico by 45 per cent and 35 per cent respectively, and both countries retaliate in-kind.

Data source: Commission estimates generated using the PC Global model.

CONCLUSION 2.1

A US trade war with China and Mexico would lower economic growth in all three countries, and particularly severely in Mexico, unleashing a significant reorganisation of world trade. In the longer term, economic activity in Australia would be little affected and the US trade deficit would not be narrowed by increasing protection on China and Mexico.

Sensitivity of the results to model assumptions

The extent to which there would be a reorganisation of global trade in the event of reciprocal tariff increases between the United States and each of China and Mexico would depend on how readily countries substituted between imports from different countries as the prices of those imports changed (this is reflected in the trade elasticities of substitution). The more similar the products from different sources, the greater the extent of substitution (and reorganisation of global trade flows). The model underlying the results presented above includes assumed trade elasticities that were estimated about 20 years ago based on empirical work from the preceding 20 years (Technical Report).

There are at least two reasons to wonder how fit-for-purpose those elasticities are today. On the one hand, global supply chains, with the associated contribution of inputs from many companies in many countries to the production of a final good, mean more complicated cross-border supply relationships. Adjustment to an economic shock might be messier, and more prolonged, implying that the current trade elasticities might be lower than when they were estimated. On the other hand, technological changes mean that the costs of trading are much lower than in the past. Switching from a supplier in one country to a supplier in another is probably much easier than. Adjustment to an economic shock might be smoother than the elasticities imply, indicating that the current trade elasticities might be higher than when they were estimated.

The Commission tested the sensitivity of its modelling results to halving the elasticities for a scenario in which the United States raises tariffs on China only, and China does not retaliate.¹² In other words, it was assumed that imports from different countries are less substitutable or products from different countries are more differentiated. The key outcome is a smaller decrease in Chinese exports to the United States and a smaller increase in Chinese exports to other markets. There are also smaller increases in exports from other countries to the United States and in those countries imports from China. In short, there is less reorganisation of global trade. But there is little change in world trade overall or in global economic activity. For Australia, economic activity and living standards are effectively unchanged.

Potential impacts of higher US tariffs in the shorter term

The impacts of higher US tariffs on imports from China and Mexico described above would create adjustment pressures in each economy. Modelling results indicate that resources would move from exporting into import competing firms in the United States, and out of manufacturing and services into agriculture in China. These shifts would take time. During the transition phase, resources (including labour) that were no longer used by exporting firms would need to be reemployed in other parts of the economy. This is likely to lead to increases in unemployment as the economies adjust, which would add to downward pressure on output.

McKibbin (2017) presented estimates of the transition paths for real GDP in the United States and China following an increase in US tariffs on Chinese imports to 40 per cent. Initial impacts were more pronounced than the longer-term effects, which were estimated to take eight to ten years to emerge. This suggests that the effects on Australia in the shorter term could be more pronounced than the preceding analysis suggests.

However, just as China and Mexico would be adjusting to a fall in demand for their exports, other countries would be adjusting to an increase in demand for theirs. Demand for Australia's key export — primary products — might not be particularly affected even

¹² Detailed results for this scenario are presented in the Technical Report.

in the shorter term. Demand for Australian education and tourism exports from the United States and China (in particular), would fall by more in the shorter term than the longer term, as people in these countries spent less on overseas travel and education. But those falls could be offset, to some degree, by increases from other countries whose economies expanded as a consequence of lower world prices for Chinese and Mexican exports and stronger demand for exports from other countries.

Overall, while substantial uncertainty remains over changes to trade policy that the United States may impose on some of its trading partners, Australia's economy is likely to remain resilient and the effect of such changes would likely be limited. However, if there was contagion of higher protection from the United States to other countries, Australia would be considerably more adversely affected. This scenario is discussed in chapter 4.

Chilling effects of uncertainty?

The actions that President Trump has initiated against promises made during his election campaign are creating uncertainty about what US trade policy might look like in the future. This in turn bears on confidence, and investors may be delaying decisions until there is greater certainty about the shape of that policy. The current situation is likely to be having a chilling effect on global trade and investment. The longer uncertainty continues, and the more investment decisions are delayed, the further into the future it will be before the potential economic gains from that investment are realised. This is not a scenario that can be tested with the model used by the Commission.

CONCLUSION 2.2

Uncertainty around what might eventuate from rising protectionist sentiment is likely to be already affecting global trade and investment. Further increases in uncertainty may well reduce investment (and economic growth), in ways not captured in standard trade models.

3 Trade effects of border adjustments

Key points

- The Trump Administration intends to introduce large scale tax reform, including a substantial cut to corporate taxes. Several reform packages have been proposed and further proposals are likely as negotiations progress. The specific details of the reform package ultimately to be adopted, if any, remain uncertain.
- For this report, the Commission's sole focus is the vexatious — from a trade policy perspective — issue of border adjustments, which are an element of some of the corporate taxation reform proposals.
- Under border adjustments (BAs) to the corporate income tax base, revenue from sales overseas would be untaxed and the cost of imported goods would no longer be deductible in calculating taxable income. These adjustments would be equivalent to a subsidy for exports and a tax on imports.
- The potential for BAs to alter trade flows is vehemently debated. The key factors determining whether they would be trade neutral or distortionary are the size and speed of movements in exchange rates, along with the extent to which those movements pass through to prices. Ultimately these are empirical issues.
- The costs for Australia and other US trade partners during the adjustment phase would likely be material. This could prompt some form of retaliation and put the rules-based global trading system under significant strain.
- While in theory the effect on trade of BAs would be offset by a compensating move in the exchange rate, it is highly unlikely that this move would be instantaneous. Moreover, other proposed elements of the new tax system would make the United States a much more attractive destination for global capital. There are multiple conflicting effects on exchange rates, and the overall effect is consequently unclear.
- The Commission's analysis finds that BAs could have impacts on global trade even after compensating adjustments in the exchange rate. They would:
 - lead to a small increase in US net exports
 - change the composition of economic activity in the United States, favouring exporters and firms that compete with imports, but their overall effect on real US GDP would be small
 - have little effect on economic activity in Australia and in most other US trade partners.

US President Trump and the Republican congressional leadership are committed to broad-based tax reform. Although the US Administration has not released final details of a tax reform plan, and there is uncertainty around what may eventually result, public discussion has focused on a blueprint released by the White House in April 2017 (Kapur and Pettypiece 2017), and a proposal from Republican leaders in the House of Representatives in June 2016 (Ways and Means Republicans 2016).

The House Republicans' 2016 proposal sets out a Destination-Based Cash Flow Tax (DBCFT) system. An element of this plan is the use of border adjustment measures. These adjustments are equivalent to a subsidy for US exports and a tax on US imports. Whether border adjustments are trade neutral or distort international trade and capital flows is contested.

Although border adjustment measures were not mentioned in the Trump Administration's tax blueprint released in April 2017, they were not ruled out. Because they are a significant source of revenue, without which the scope for feasible tax cuts is limited, they could well re-enter the mix as negotiation of a new US tax system progresses. The following discussion, therefore, draws on the tax plan proposed by House Republicans in June 2016 to illustrate the potential effects of border adjustments on global trade flows and economic activity more broadly.

This chapter assesses the potential effect on Australia of the United States adopting border adjustments to the tax base as part of a broader set of reforms implementing a DBCFT system. Details of the House Republicans' proposal are described (section 3.1) and potential impacts discussed (section 3.2). Although border adjustment measures are the primary focus of the chapter, it also presents a brief commentary about other elements of the DBCFT that may influence trade and investment.

3.1 The DBCFT system

The House Republican tax reform plan would involve a change in the corporate income tax system from one where firms in the United States are taxed based on the country where goods and services are produced (origin-based) to one where firms are taxed based on the country where the sale of goods and services takes place (destination-based). The application of border adjustments delivers this shift.

Key features of the House Republicans' proposed corporate tax reforms include:

- a reduction in the corporate tax rate from 35 per cent to 20 per cent for incorporated businesses and from up to about 40 per cent to 25 per cent for unincorporated businesses
- full write off of capital investments in the year in which they are made (with interest expenses no longer deductible as a business expense)
- border adjustments (BAs) — revenue from sales overseas would be untaxed and the cost of imported inputs would no longer be deductible in calculating taxable income (this element would implement the 'destination' principle)
- exempting the financial sector from BAs.

Possible effects of border adjustments on trade

The potential for BAs to alter trade flows has been widely and vehemently debated (Gleckman 2017). Opinions differ as to whether BAs would be trade neutral or create distortions amounting to protectionism. The key factor determining which view would prevail is the size, speed and pass-through to prices of movements in exchange rates. Ultimately, how the exchange rate would adjust is an empirical issue.

The tax economists who designed the scheme appeal to theory to argue that BAs would be offset by a compensating movement in the exchange rate (Auerbach et al. 2017). They reason that BAs would increase the demand for US dollars as other countries bought more (of the now cheaper) US exports, and fewer US dollars would be available as US consumers bought less (of the now more expensive) imports. This increase in demand for US dollars, and simultaneous fall in supply, would push up the price of the US dollar — an appreciation in the nominal exchange rate.¹³

If the nominal exchange rate did not fully adjust to offset the BAs, BA proponents argue that the real exchange rate would start to appreciate (Auerbach et al. 2017). Exporting firms would expand to meet increased world demand for relatively cheaper US exports. And import-competing firms would expand to meet higher demand for locally produced goods. This expansion in US activity would place upward pressure on US wages and prices (assuming little slack in the economy) relative to wages and prices in the rest of the world. Over time, these pressures would lift the price of US exports and import-competing goods relative to the prices of goods made in other countries, offsetting the price advantage for US firms created by the BAs.

In either case, with an offsetting adjustment in the nominal or real exchange rate, switching from an origin-based to a destination-based tax would not put the US at a trade advantage or disadvantage (Pomerleau 2016). However, there are several possible reasons why neither the nominal nor the real exchange rate might adjust to fully offset the effect of the BAs:

- A key concern is that the exchange rate is influenced by many factors in addition to trade. Trade is responsible for only a fraction of the demand for (and supply of) US dollars. It is not clear, therefore, that the nominal exchange rate would appreciate sufficiently to compensate for the BAs — at least not without exchange rate movements caused by other factors, for example, an increase in capital flows prompted by other potential tax changes (discussed below) or interest rate rises (Pomerleau 2016).
- The nominal exchange rate offset scenario assumes that firms fully pass on the changes in their costs (due to the BAs first, and to exchange rate movements second) to consumers. There is evidence that such complete pass-through does not occur in practice (Campa and Goldberg 2005; Menon 2006).

¹³ A large appreciation of the exchange rate would be required to return export and import prices to their original levels. At a 20 per cent corporate tax rate, the BAs would be equivalent to a 20 per cent export subsidy and a 20 per cent tax on imports. In order for the BAs under the Republican Leaders' plan to be trade neutral, the exchange rate would have to appreciate by 25 per cent.

-
- In terms of non-trade drivers of the demand for, and supply of, US dollars:
 - A fall in the company tax rate is likely to encourage increased investment in the United States, and the DBCFT as a package is likely to encourage the repatriation of capital. Associated adjustments in capital markets might cause the exchange rate to overshoot (or appreciate by more than necessary to return trade flows to pre-tax reform levels).
 - US dollar-denominated assets and debts held globally will be affected by changes in the exchange rate and there will be large transfers of value and wealth to the owners of these assets and debts. Portfolio capital flows are likely to adjust in anticipation of the exchange rate changes that would probably flow from the introduction of border adjustments to the tax base.
 - The US dollar is a global reserve currency, meaning it is held in large quantities by other countries and used instead of their domestic currencies for international payments. This adds to the demand for dollars independently of the demand that might be associated with US demand for trade or capital movement purposes.

A best case scenario for trade neutrality would be the real exchange rate appreciating fully and relatively quickly through an adjustment in the nominal rate. But the shift in the real exchange rate is unlikely to be instantaneous. And, given the United States is a large economy, changes in trade flows are likely to affect world prices — a point revisited below.

In summary, although the BAs are not designed as an instrument of trade policy, they would likely have significant implications for the size and composition of global trade and capital flows.

Possible institutional issues

Several commentators have argued that the proposed BAs are likely to infringe US commitments under international treaties. Lincicome and Eglin (2017), for example, note that World Trade Organisation (WTO) rules permit BAs for indirect taxes, but not for direct taxes. Therefore, while the value-added taxes applied by all OECD countries except the United States are allowed under international trade law, the proposed BAs could be disallowed because they would be applied as part of a direct tax system. Avi-Yonah and Clausing (2017) comment that BAs would also override elements of international tax treaties.

Both WTO rules and tax treaties also require equal treatment of imports and domestic production — and the tax plan proposed by the Republicans advantages US producers. Under the plan, US producers would be able to deduct labour costs — reducing their tax base. Labour costs are not deductible in the value-added tax regimes of countries that supply US imports, meaning their firms' tax bases would be larger. Other things equal, firms that import into the United States would pay higher taxes than equivalent US producers.

Border adjustments that breached WTO rules would most likely be contested, creating a period of uncertainty — including in foreign exchange markets — and could even prompt retaliatory action by US trade partners. Specialist trade media commentary suggests that US trading partners would take action against BAs, should they be part of a new US tax regime. For example, the European Union is reported to have trade lawyers preparing to challenge BAs in the WTO (Donnan, Jopson and McClean 2017). And Germany has reportedly considered potential responses to a BA, including higher tariffs on US imports (Speciale 2017).

In terms of tax treaties, Avi-Yonah and Clausing (Avi-Yonah and Clausing 2017, p. 15) conclude that:

The possible end result could be a collapse of the treaty-based international tax regime, to the disadvantage of US taxpayers who will face increased withholding taxes overseas as well as increased transfer pricing enforcement.

3.2 Possible impacts of border adjustments

The Commission's modelling of the application of border adjustments to US trade flows, by necessity, abstracts from other elements of the proposed DBCFT package. The Commission's model does not have a detailed representation of the US tax system — being absent, for example, differential tax rates for the incorporated and unincorporated sectors and allowable deductions. Nor is the model capable of tracing through the likely effects of a move from the current system of depreciation to full write off of capital investments in the year in which they are made.

Furthermore, as noted in chapter 1, the results abstract from the shorter-term adjustments that would occur in world markets following the adoption of border adjustments. In other words, the modelling results answer the question *'What would the world look like today if the United States had adopted border adjustments (but no other tax reforms) and world markets had fully adapted to the new tax regime?'*

These limitations of the Commission's modelling of border adjustments imply highly stylised scenarios. Nonetheless, the mechanisms underlying the adjustment phase can be explained. Some general comments about the potential impacts on world markets of the adjustment process, and of other elements of the proposed DBCFT package, follow discussion of the Commission's modelling results.

Insights from the literature

To our knowledge, only one other study (Ciuriak and Xiao 2017) has modelled the potential impacts of US adoption of BAs as part of a DBCFT system.

Ciruriak and Xiao (2017) conclude that BAs would not be trade neutral. They estimate that the US trade balance would improve, but real US GDP would fall by about 1.3 per cent due to higher consumer prices and a loss of competitiveness in the United States. They also conclude that the Australian economy would be unaffected, with real GDP in Australia falling by 0.005 per cent — effectively, there would be no change.

Ciruriak and Xiao's (2017) estimate for the potential effect of BAs on US GDP is quite different from the Commission's — an outcome explained by differences in the way the two studies model BAs. Ciruriak and Xiao (2017) applied a 20 per cent import tax only on US producers' intermediate imports (rather than all imports) and a 20 per cent export subsidy only to exporters' profits (rather than revenues).¹⁴ Relative to the Commission's analysis, Ciuriak and Xiao's approach results in a smaller import tax and an even smaller export subsidy. Negative effects of higher import prices on the US economy overwhelm the positive effects of the (lower) export subsidy. (Further discussion of Ciruriak and Xiao's (2017) analysis is presented in the Technical Report.)

Insights from the Commission's modelling

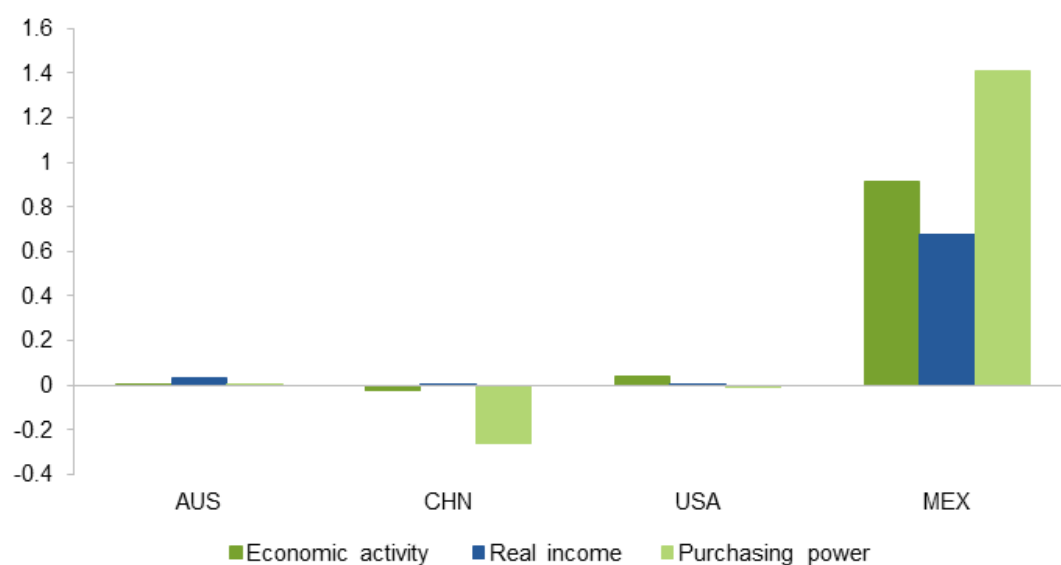
A key insight from the Commission's modelling is that border adjustments would not be trade neutral, even with full exchange rate adjustment. The United States is a very large economy. An effective tax of 20 per cent on US imports would raise prices in the United States, decrease demand for these goods and lower their world prices. Because of lower world prices, the rise in the price of US imports (and import-competing US production) would be less than 20 per cent. A 20 per cent effective subsidy on exports would, therefore, be higher than the rate needed to avoid a net export subsidy and a related net decrease in the world price of US exports, which would lead to an expansion in US exports. The Commission's modelling (Technical Report) suggests that a subsidy of 16.7 per cent on exports would leave trade flows unchanged given a 20 per cent tax on imports. But different values for the effective subsidy on exports and effective tax on imports are not compatible with a single corporate tax rate. Net exports from the United States would therefore rise.

But this does not mean that the US would be better off with a border adjustment regime. Change in the structure of economic activity would lead to a less productive use of resources, offsetting any potential boost to GDP from the BA alone. Once exchange rates and the economy had adapted to the BAs, the net effect on US economic activity would be minimal. The Commission's modelling suggests a change in real GDP of 0.04 per cent — effectively zero (figure 3.1). The impacts on US national income and living standards would similarly be small. That said, there would be some changes in the composition of economic activity in the United States. Exporters and import-competing firms would gain, at the expense of firms

¹⁴ It is not clear why Ciuriak and Xiao (2017) adopted this approach. Following the approach used by the architects of the DBCFT, Professor Alan Auerbach and colleagues (see, for example, Auerbach and Holtz-Eakin 2016) the Commission has applied an effective tax on all imports and an effective subsidy on revenues from exports, not just profits.

that produce goods and (particularly) services for the US market but do not compete with imports. The adjustment processes associated with this outcome are described below.

Figure 3.1 Border adjustments in a US tax regime would have little effect on output in Australia once the exchange rate (nominal and/or real) had adjusted
Percentage change



Source: Commission estimates generated using the PC Global model.

Longer-term, Australia and most other countries would also be only slightly (if at all) affected. The Commission's modelling shows that global GDP would be unchanged. The largest effects would be felt by Mexico (and, to a lesser extent, Canada) where increased demand by US exporters for inputs imported from those countries would lead to an increase in real GDP and living standards — estimated in the Commission's modelling to be in the order of 1 per cent.

However, these insights reflect a world in which exchange rates and prices had fully adjusted. What might happen in the interim?

Beyond the modelling

There are a number of reasons to be concerned about the potential shorter-term impacts of BAs, and about some other elements of current US tax proposals.

BAs with slow offsetting exchange rate appreciation would have marked effects ...

... on the US economy ...

Border adjustments would have a range of both positive and negative effects on the US economy as it adjusted following implementation of a new tax regime (figure 3.2). These effects would be more pronounced the slower the exchange rate appreciation.¹⁵

On the one hand, the export subsidy implicit in the BAs would mean higher output from US firms that produce exports or products that compete with imports. This would prompt an increase in demand for capital — raising returns and foreign capital inflows. With increased returns to capital, US savings would also rise, and private and government consumption would fall as a result. The effect of these changes would be to increase US GDP. On the other hand, the increase in production by exporting and import-competing firms would draw resources from other, more productive, uses. The effect of the efficiency cost created by this reallocation of resources would be to decrease US GDP. The net effect on economic activity and living standards in the United States as these forces played out is very difficult to assess.

... and on US trading partners

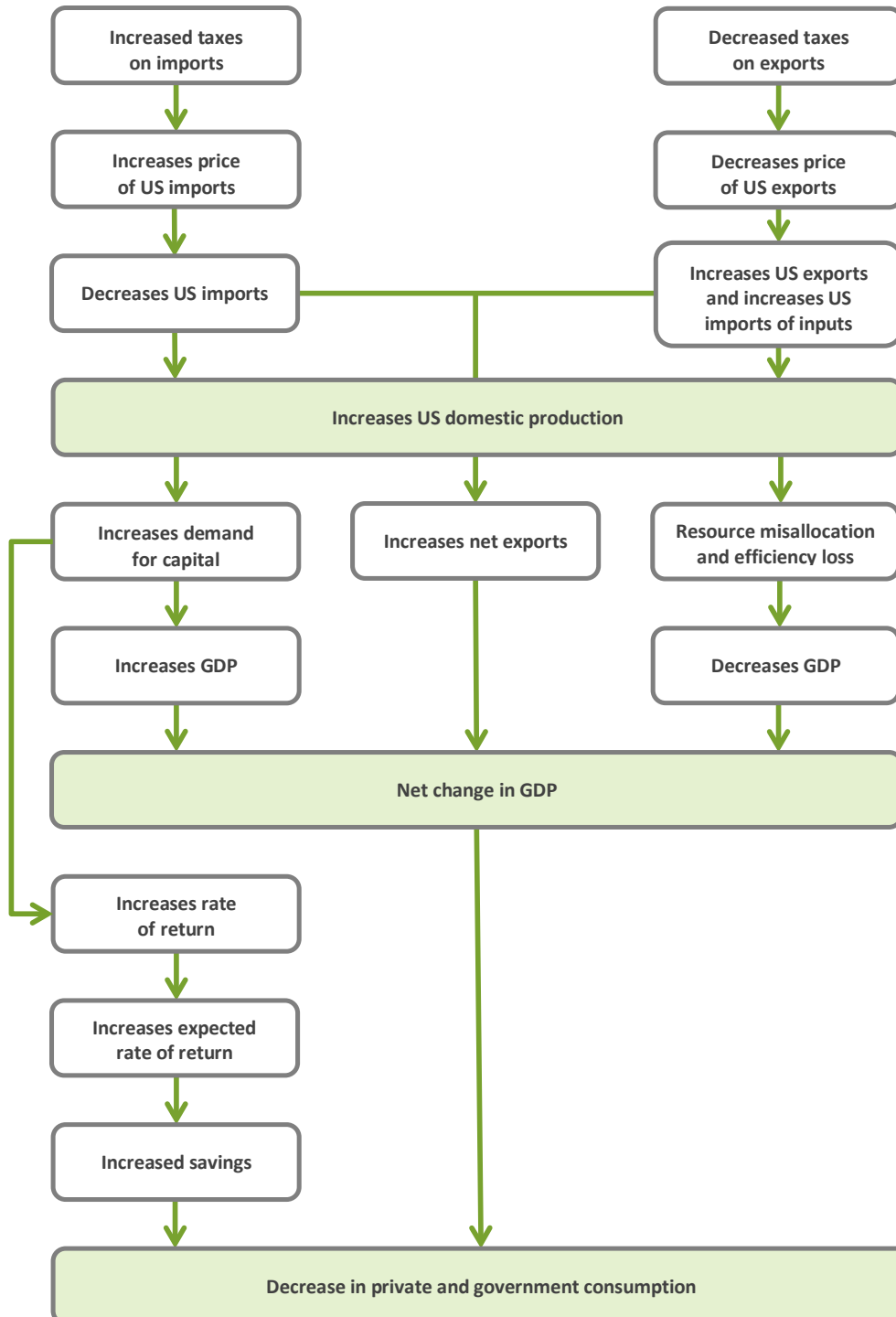
If exchange rates did not fully appreciate, or did so only slowly, and US exports were therefore markedly more competitive on world markets, the transitional costs of BAs for Australia (and other US trade partners) could be material for at least two reasons.

First, the slower the appreciation of the US exchange rate, the greater the disruption of global markets, economic activity and trading relationships. If adjustment was slow, those economies with an export profile more like the United States' (which is dominated by manufactures) would be especially badly affected, as would those providing inputs into products manufactured in the United States, since US producers would look to source locally. Global supply chains would be disrupted, and capital would flow into the United States.

The relatively low share of manufactures in Australia's exports, and Australian firms' small role in global supply chains, would likely mean that Australia would be less severely impacted. However, the ructions in world markets would cause falls in global economic activity and income, reducing demand for Australia's exports (for example, food, tourism and education) and thereby Australian GDP.

¹⁵ If exchange rate appreciation was instantaneous, these effects would be very muted. Changes would only occur because, as noted above, the effective subsidy would be larger than that required to maintain trade patterns.

Figure 3.2 **Effects of border adjustments on the US economy as it adjusts to a new corporate tax regime**



Second, as border adjustments modify a direct tax, they would very likely be challenged at, and found to be in breach of US commitments to, the WTO. This could encourage other countries to adopt retaliatory measures, before or after any WTO decision. Reprisals would be more likely if US exchange rate adjustment was slow, putting the rule-based global trading system under significant strain. (The potential effects of global increases in protection are considered in chapter 4.)

CONCLUSION 3.1

While in theory border adjustments would be offset by compensating moves in exchange rates, it is highly unlikely that these moves would be instantaneous.

- In the interim, the transitional costs for Australia (and other US trade partners) could be material, especially to established value chains involving US firms. These disruptions could damage trade relations.
- Once exchange rate adjustments had played out, US adoption of border adjustments as modelled would likely have little effect on Australia.

Other tax changes might also markedly affect world markets

More broadly, if a new US corporate tax regime included lower corporate tax rates and the immediate and full write off of investment costs (which are other elements of the DBCFT), the United States would become a much more attractive destination for global capital — impacting global patterns of economic activity.¹⁶ Proponents of the proposed DBCFT anticipate that the ‘reforms will make the United States the most attractive place to invest in the world’ (Ways and Means Republicans 2016, p. 14).

The share of global capital located in the United States would rise as US owners brought capital home and foreign owners increased their US investments. US GDP would rise; GDP in other countries would fall. But changes in US national income would be smaller because the payment of capital returns from the US to foreigners would rise, and payments from abroad to the US would fall. (Changes in the location of global capital could prompt changes in the corporate tax regimes of other countries, designed to counteract these effects — a scenario beyond the capability of the Commission’s model and the scope of this project.)

The effects of such massive global capital movements on exchange rates and world trade are very difficult to predict, but they are likely to have a material effect on Australia given the important role foreign capital plays in funding investment.

¹⁶ Arguably, immediate write off would have similar effects on incentives to invest as depreciation over time does. However, current US taxation rules mean that that is not the case (Ways and Means Republicans 2016, p. 25).

Finally, tax changes along the lines proposed in the DBCFT would also encourage US firms to repatriate profits to the United States (Pomerleau 2016, p. 11). Under the current tax regime, US firms have an incentive to structure their activity so that profits are earned in countries with lower tax rates. By setting the tax on profits earned overseas to zero, the DBCFT would reduce that incentive.¹⁷ To the extent that economic activity moved back to the United States alongside profits, there would be a positive economic effect on the United States and a decline in activity in the countries from which activity was moved.

¹⁷ The House Republicans' proposal (Ways and Means Republicans 2016, p. 27) argues that the DBCFT would bring tax inversions to a halt — that is, that it would remove the incentive for US companies to locate their headquarters in a low tax country. Avi-Yonah and Clausing (2017) suggest that it would not completely achieve that goal. They point to challenges associated with the collection of tax on services and intangibles, and to suggestions by tax practitioners of ways in which the proposed tax system could be gamed.

4 The risks of global contagion

Key points

- Trade protectionism has increased in advanced economies since the Global Financial Crisis and, amidst an uneven and slow recovery, there are clear signs that the protectionist trend could accelerate.
- The likely extent of any global increase in protection is very unclear. Some argue change will be at the margin, others fear major backsliding on protection. The Commission has considered a scenario in which all countries raise tariffs by 15 percentage points. This is not a forecast. It serves to illustrate the costs of bad public policy via an outbreak of protectionism.
- Significant worldwide increases in protection would cause a global recession. Higher tariffs would raise the costs of imports, harming consumers and producers. The effects of global contagion would be magnified by global supply chains where parts and components of goods cross borders multiple times.
- Australia would not escape unscathed. Modelling estimates show that for every \$1.00 increase in Australian tariff revenue, economic activity in Australia would fall by \$0.64. In total, every year that higher tariffs prevailed GDP would be lower by over one per cent. This would equate to a loss of close to 100 000 jobs, and about 5 per cent of Australia's capital stock would be mothballed — equivalent to nearly half of the investment in the mining sector over the past ten years.
- Australian living standards would fall across the income distribution. A household with the median weekly income would face an income cut of nearly \$1500 a year.
- Not all households would be affected equally. For the nearly 80 per cent of households whose living standards fall, the magnitude would depend on how their wages, returns on savings and investment and the prices for the things they consume changed.
 - For some of these households, the modelling estimates suggest the fall would be relatively small. But, for nearly 30 per cent of the population, living standards would fall by at least 4 per cent. To put this into context, a household that spends \$2500 a fortnight on goods and services would be worse off by \$100 a fortnight.
 - For the remaining 20 per cent of households, the effect on living standards could be positive. Households at the lower end of the income distribution would tend to be among this group, in part because the transfer system would help some welfare dependent households maintain the real value of their income, and in part because the consumption bundles of many of these households contain a higher proportion of non-traded goods whose prices would not rise by as much as those of imports and import-competing goods. Some higher income households with members employed in less-traded service sectors, such as education and health, would benefit from higher wages as demand for their services increased.
- The uneven distribution of impacts across households helps explain why the broad support of the community for open markets cannot be taken for granted, and it complicates the political economy of trade liberalisation.

While protectionist rhetoric is most strident in the United States, the risk of new restrictive trade and investment policies spreading more widely and deeply is real. In parts of Europe, protectionist protagonists have been empowered, with agendas that seek to reverse globalisation gaining more support. Already, since the Global Financial Crisis the World Trade Organization (WTO) has documented a rise in the number of trade restrictive measures implemented by G20 countries, covering about 5 per cent of world imports (WTO 2016). If these trends were to escalate and translate into widespread increases in protection, the effects would be far reaching.

This chapter assesses the economic implications of an extreme scenario — global contagion of increases in protection. The chapter has three parts. Evidence of rising protectionist sentiment and trade restrictions is overviewed in section 4.1, and the potential economic impacts of a global increase in tariffs of 15 percentage points are assessed in section 4.2. Increases in protection of this magnitude would have a pronounced effect on the Australian economy, but not all households would be affected equally. Section 4.3 assesses the extent to which different types of Australian households would be impacted.

4.1 Evidence of recent rises in protectionism

Global efforts reduced protection during the second half of the 20th Century

Through to the turn of the decade, the previous 70 years of trade liberalisation and economic engagement based on agreed principles and even-handed rules had their origin in the lessons learnt from the 1930s. As the Great Depression unfolded in the early 1930s, average tariff levels more than doubled in a number of large economies (Eichengreen and Irwin 2010), and world trade fell nearly 30 per cent (Eichengreen and Irwin 1995). This deepened the decline in economic activity and delayed the recovery.

In the post war period, the United States and the United Kingdom recognised that lower barriers to trade would foster global economic growth, and that barriers would be unlikely to fall without coordinated effort. Under their leadership, work began on an international trade agreement (Irwin 1995) and, in 1947, 23 countries, including Australia, agreed to the *General Agreement on Tariffs and Trade* (GATT). The Agreement established a set of principles and rules to govern the global trading system (box 4.1), and the associated organisation, also known as the GATT, was one of the post-war institutions alongside the International Monetary Fund and World Bank that has underpinned the global economic system since.

Over time, barriers to trade fell, and the range of trade-related restrictions covered by international agreements expanded. The Uruguay Round (1986 to 1994) of negotiations, for example, reached major new agreements on services, intellectual property rights and investment. Over the same period the number of signatories to these agreements grew, and

the GATT was replaced by the WTO as a permanent organisation in 1994 and put in place a consistent dispute settlement process across different agreements (VanGrasstek 2013).

The present multilateral trading system is defined by the rules set out in the multilateral agreements (that is, agreements signed by all WTO members) reached through the Uruguay Round. Each agreement has similar basic elements, including: countries' obligations to reduce barriers to trade; permitted exceptions to those obligations (to protect consumers, the environment or national security); dispute settlement mechanisms; special treatment for developing countries; and requirements for transparency around trade policy.

Box 4.1 Principles underpinning the global trading system

The following fundamental principles underpin the global trading system. The trading system should:

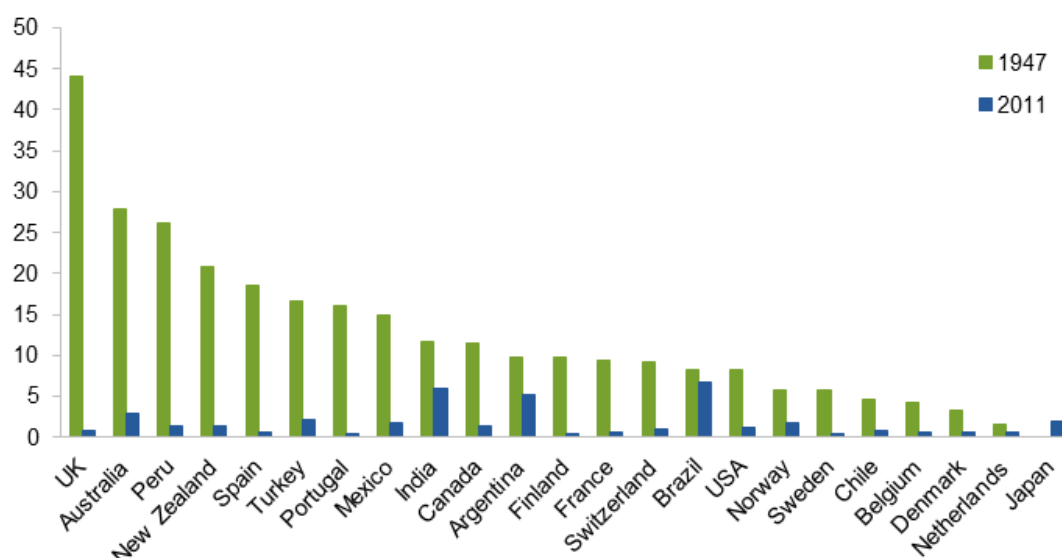
- *be without discrimination.* World Trade Organization (WTO) member countries should:
 - treat their trading partners equally; an advantage offered to one must be offered to all. This is known as the principle of most favoured nation treatment
 - treat local and foreign goods, services and intellectual property equally once they have entered a country. This is known as the principle of national treatment
- *support freer trade.* Barriers to trade should be lowered gradually through negotiation
- *be predictable.* When WTO member countries open up their markets, they 'bind' their commitments to their trading partners. In other words, they give an undertaking not to raise trade barriers beyond a certain level. Countries are also required to publish their trade policies and practices, and the WTO regularly reviews countries' trade policies. These measures are aimed at ensuring a stable and predictable environment for traders and investors, encouraging them to enter overseas markets
- *promote fair competition.* In addition to most favoured nation and national treatment, additional WTO rules address, for example, export subsidies and dumping (pricing exports below cost to gain share of a foreign market), with the aim of supporting fair competition
- *be more beneficial for less developed countries.* In recognition of the challenges that less developed countries can face, they are given more time, greater flexibility and special privileges in implementing multilateral agreements reached through the WTO.

Source: WTO (2015, pp. 10–13, 23).

For many decades, the GATT and WTO have helped prevent countries from backsliding from open markets, contributing to lower barriers to trade and investment (figure 4.1). Trade disputes between members large and small, and rich and poor, have largely been settled in the WTO and as a result have not escalated as they might have in the pre-war or inter-war period. These efforts in reducing protection have generally delivered broad economic gains.

Figure 4.1 **Tariffs have fallen markedly since the middle of the 20th Century^a**

Selected countries, per cent



^a Tariffs are estimated by dividing duty revenue by import value.

Data sources: Bown and Irwin (2015); Aguiar, Narayanan and McDougall (2016).

But protectionist pressures are rising ...

Recently, however, there have been signs of significant shifts in both the rhetoric and reality of protectionism.

... in the United States

As previously discussed (chapters 1 and 2), President Trump has undertaken to fundamentally change the direction of US trade policy. Renegotiation of the North American Free Trade Agreement, threats of higher tariffs against China and Mexico and border adjustments that would advantage US exports and discriminate against imports have been touted. There is also a risk that the Trump administration might take unilateral action against imports from a broader range of countries. President Trump's series of tweets threatening taxes against exports to the United States from any company that relocated to another country (chapter 2) highlights this risk, as do new US tariffs on Canadian lumber, President Trump's threats to impose measures against Canadian dairy (Sevastopulo and Manson 2017) and his comments that German trade policy is 'very bad' for the United States and 'will change' (Jacoby 2017).

Any broadly based increase in US tariffs beyond a few percentage points would be in violation of WTO commitments. It is plausible that the US Congress (supported by the business community) could (with some effort) limit protectionist measures to those that are legal under the WTO. That said, the United States Trade Representative's Trade Policy Agenda for 2017 made the case for defending US sovereignty over trade policy and stated that 'Americans are not directly subject to WTO decisions' (USTR 2017a, p. 3).

If the United States took unilateral action that violated WTO rules it could face large fines or retaliatory action. But dispute settlement panels can take years to conclude cases in the WTO and many countries might not wait for a ruling to retaliate, leading, conceivably, to contagion of higher protection.

... and more broadly

Likewise, in parts of Europe protagonists of protectionist trade policies have also been empowered. Support for politicians with nationalist agendas favouring protectionism and averse to foreign ownership of assets, land and property has been increasing.

- In France, 2017 Presidential candidate Marine Le Pen's policy platform included higher barriers against trade and foreign investment (Sandford 2017). While Emmanuel Macron, winner of the election, is pro-globalisation, he is looking to strengthen EU anti-dumping measures and discriminatory foreign direct investment controls in strategic sectors (Chassany 2017).
- Politicians in Germany, Belgium and Austria have been particularly opposed to the planned Europe-US free trade agreement, the Trans-Atlantic Trade and Investment Partnership, in some cases for populist reasons (The Local 2016; van der Wolf 2016).
- The largest opposition party in Italy, the Five Star Movement, has nominated resistance to free-trade deals as its foreign policy priority (Politi 2017).

As noted in the *Economist* (Charlemagne 2016, p. 1), even though populists have not won elections in Europe, they are influencing the European Union's agenda:

From trade to migration to budgets, Europe's populists are already shaping policy to a degree that belies their limited success at the ballot box. Few may have yet penetrated the fortress keep. But they are hurling infected missiles over the walls, and the liberals inside are already succumbing to the virus.

Reflecting this, for the first time in a decade, there are signs that the G20 might be backing away from a commitment to reject all forms of protectionism. Leaders have made this commitment each time they have met since the Global Financial Crisis, but Finance Ministers (G20 2017) meeting in March did not — an outcome interpreted as a sign of an accommodation of the United States' more protectionist stance, and an opening of the door to protectionism in other countries.

... and are evident in data on trade restrictive measures

Rising protectionist sentiment has already been matched by action in some countries. Since 2009, the number of new protectionist measures recorded by both the WTO and Global Trade Alert (box 4.2) has exceeded the number of liberalising measures. By mid-October 2016, the WTO had recorded a total of 1671 new measures (figure 4.2).¹⁸ About 60 per cent of these have been trade remedies (particularly anti-dumping measures), and about 30 per cent have been import-limiting measures including increases in tariffs. Over time, only a quarter of these new measures have been removed. As the WTO (WTO 2016, pp. 5–7) concluded:

The number of new trade-restrictive measures being introduced still remains worryingly high ... Overall, the stockpile of restrictive measures introduced by G20 economies continues to grow ... It is imperative that G20 economies – collectively and individually – re-double their efforts to deliver on their commitment to refrain from taking new protectionist measures and roll back existing ones.

The picture for investment is more positive (although barriers to investment are much less common than barriers to trade (Evenett and Fritz 2016). According to the most recent report from the OECD and the United Nations (2016, p. 3):

The overall direction of investment policy measures — both specific to FDI and not specific to FDI — taken by G20 Members remains solidly oriented towards further liberalisation and easing of conditions for international capital flows.

Box 4.2 Initiative measuring trade restrictions post the Global Financial Crisis

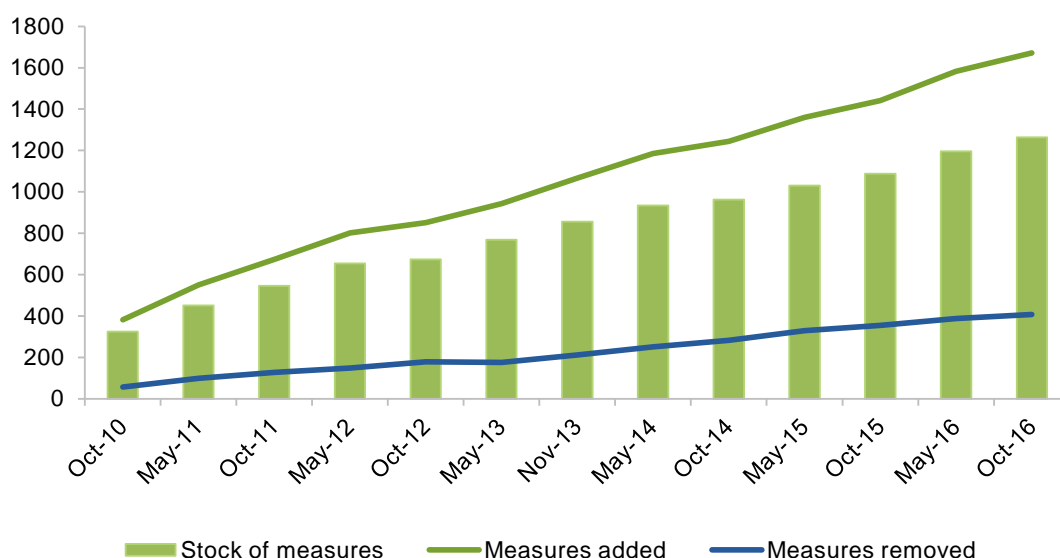
Since the Global Financial Crisis, at the request of G20 leaders, the World Trade Organization (WTO), along with the OECD and the United Nations Conference on Trade and Development, has been monitoring and reporting on trade restrictive measures in G20 countries. An independent organisation, Global Trade Alert, coordinated by the London-based Centre for Economic Policy Research, has undertaken a similar exercise (Evenett 2009).

WTO reporting focuses on trade restrictive initiatives, including trade remedies (anti-dumping, countervailing and safeguards measures), and measures that limit imports or promote exports, enforce local content requirements or increase the complexity of customs procedures. Global Trade Alert reporting also includes 'policy measures that possibly abuse policy space granted under WTO rules, or that are beyond the latter's reach, in order to discriminate against foreign producers' (ECB 2013, p. 90). Among the latter are state aid, non-tariff barriers and investment measures.

Neither source attempts to differentiate between measures on the basis of how trade restrictive they are because many are difficult to quantify. They simply report counts of measures. But both series demonstrate clear trends of an increase in trade protection.

¹⁸ WTO data covering the period from mid-October 2016 to mid-May 2017 were released on 30 June 2017 (WTO 2017b). Adoption of a new reporting approach by the WTO means figure 4.2 is not easily updated.

Figure 4.2 G20 countries have been adopting new trade restrictive measures more quickly than they have been removing old ones since October 2008



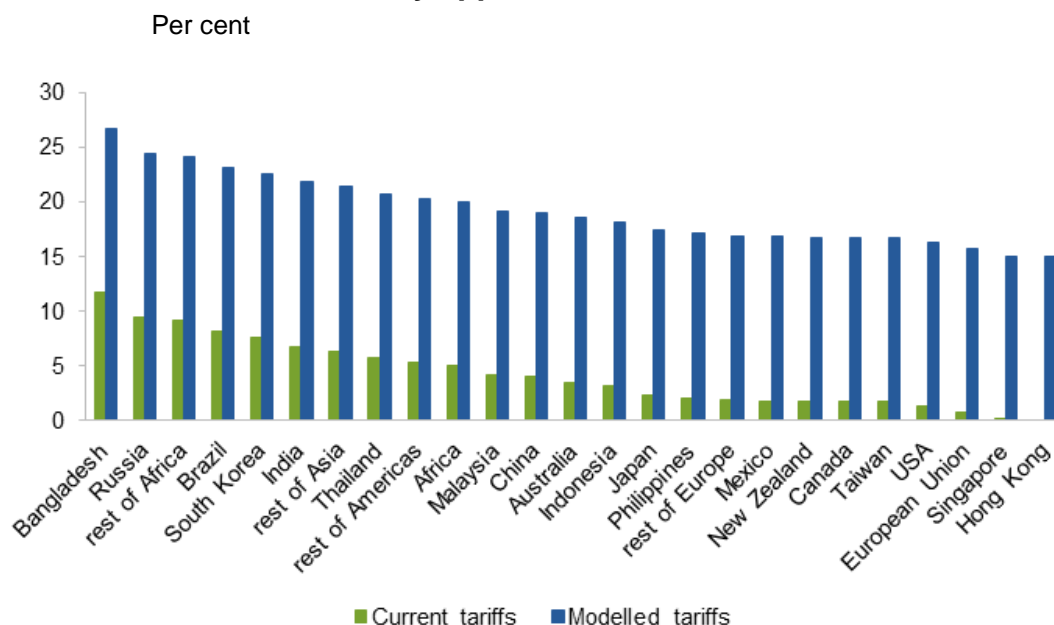
Data source: WTO (2016).

4.2 How might Australia be affected by global increases in protection?

Many governments would have public support for retaliatory action in the event of large increases in protection by their trading partners. But predicting the scale and scope of reprisal measures that countries might take is very difficult. They might, for example, respond by increasing tariffs to their bound rates to avoid being challenged in the WTO. But bound rates in many developed countries are low (figure 4.3). And if a country was in violation of WTO rules, there would be little incentive for other countries to comply with those rules when retaliating — tariff increases could go well above bound rates. Other measures, such as increases in non-tariff barriers, are equally likely.

To illustrate the potential impacts on Australia and elsewhere of a global rise in protection which repeats the policy mistakes made during the 1930s, and which G20 leaders have sought to avoid, the Commission has modelled a 15 percentage point increase in tariffs by all countries — a significant increase on rates currently applied in most parts of the world. It implies tariffs not too different from the average levels that applied in a number of developed economies during the Great Depression (Eichengreen and Irwin 2010).

Figure 4.3 A 15 percentage point rise in tariffs would be a big increase on the rates currently applied in most countries^a



^a Some countries with high tariffs rates (such as Mexico) show low applied rates due to trade through preferential agreements. Most favoured nation rates will be higher than applied.

Data source: Aguiar, Narayanan and McDougall (2016).

Protection contagion would cause a global recession

Worldwide increases in tariffs of 15 percentage points would cause a global recession (figure 4.4). According to the Commission's modelling, once the dust had settled global trade would be lower by 22 per cent, global output would be nearly 3 per cent lower — or the equivalent of more than a year of global growth at current rates — and the global stock of capital would shrink by 5 per cent. To put the costs of these tariff increases into perspective, each US\$1 increase in tariff revenue would cost US\$1.18 of world income.

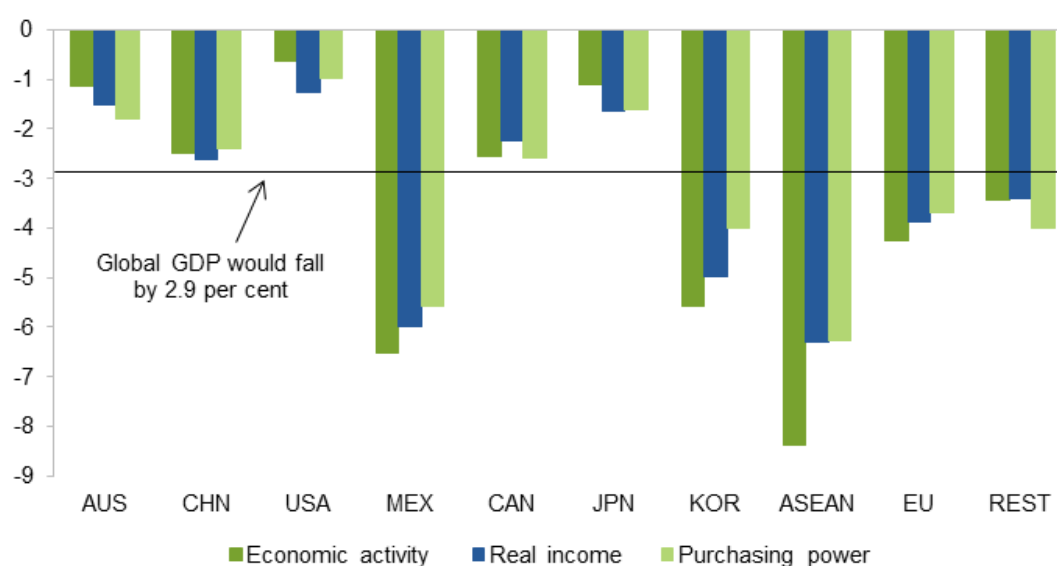
Australia's economy and living standards would contract

Australia would not escape unscathed. The Commission's modelling estimates that, in total, economic activity (GDP) would be more than one per cent lower in each year that the higher tariffs were in force — equivalent to removing about half a year of growth from the economy or, in employment terms, close to 100 000 jobs (ABS 2017). For every \$1.00 increase in Australian tariff revenue, economic activity in Australia would fall by \$0.64. National income would be about 1.5 per cent lower, and the purchasing power of that income (or Australians' living standards) would drop by 1.8 per cent. For the median household this would amount to an income cut of nearly \$1500 a year.

Australia's export sectors would be hardest hit, with exports falling by close to 15 per cent. Reflecting the high proportion of mining and energy in Australian exports, activity in the primary sector would be hit particularly hard — output would fall by over 5 per cent. And exporters that use imports as an input to production would see a fall in competitiveness as import prices rose with higher tariffs.

Figure 4.4 A global increase in protection would cause a global recession^{a,b,c}

Percentage changes for select regions



^a All countries are assumed to raise tariffs by 15 percentage points. ^b Real income is measured as real GNP adjusted for changes in the terms of trade. ^c ASEAN includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

Data source: Commission estimates generated using the PC Global model.

While some sectors would lose, others would expand. Rising import prices would improve the competitiveness of import-competing firms — most of which are in manufacturing. According to the Commission's modelling, manufacturing output would be higher by nearly 3 per cent. But the expansion of manufacturing activity would attract resources from services, and falls in income would translate into lower demand in this sector. Services output would fall by about 1 per cent.

Overall, both workers and capital owners would be worse off. For workers, wages are estimated to fall by 2.5 per cent on average due to less efficient production and, in line with the shifts in the structure of economic output, people employed in the primary and services sectors, especially lower skilled workers, would face a higher risk of redundancy. In the Commission's modelling, at least 1 per cent of lower skilled workers (or an estimated 50 000) and 0.7 per cent of higher skilled workers (or an estimated 46 000) would have to find a new job. These figures are lower bounds, as the modelling only picks

up moves between sectors and misses moves within sectors which would add considerably to these estimates.

For capital owners, the rate of return earned on their assets would fall. And close to 5 per cent of Australia's capital stock would be mothballed — equivalent to nearly half of the investment in the mining sector over the past ten years.

The Commission's finding that global tariff increases would depress economic activity in Australia is in line with other research. McKibbin and Stoeckel (2009) predicted that a 10 percentage point rise in tariffs globally would cause Australia's GDP to fall by at least 1.4 per cent. Dixon (2017) predicted that larger tariff increases (a flat rate of 20 per cent on all trade, except for 45 per cent tariffs on US and Chinese imports from each other), would see Australia's GDP fall by about 4 per cent. (Details about differences and similarities between these analyses and the Commission's work are presented in the Technical Report.)

More protected economies would be harder hit

Looking beyond Australia, countries including the Association of South East Asian Nations (ASEAN)¹⁹, South Korea and Mexico would be much more seriously affected (figure 4.4). This is because the efficiency (and economic activity) losses in an economy are magnified when a new tariff is imposed on top of already relatively high tariff levels.

Trade in price sensitive products would fall more heavily

Not all global trade would be affected equally. Falls across product categories would depend on how responsive demand was to price rises. The Commission's modelling shows the largest relative declines for trade in dairy, wool and meat (with global exports falling by up to 38 per cent in those three sectors), but machinery and equipment, chemicals and electronics falling more steeply in absolute terms (figure 4.5).

Global supply chains would accentuate losses in global economic activity

The increased prevalence of global and integrated supply chains would make a 'tit-for-tat' response more costly. Because parts and components cross borders multiple times as value is added in different locations, border protection on intermediate inputs is cumulative and can lead to higher average tariffs in some sectors. As a result, higher tariffs would affect a larger share of economic activity and translate into larger cost increases, notably for manufacturers. Price increases in world markets, and falls in demand and global income, would be larger.

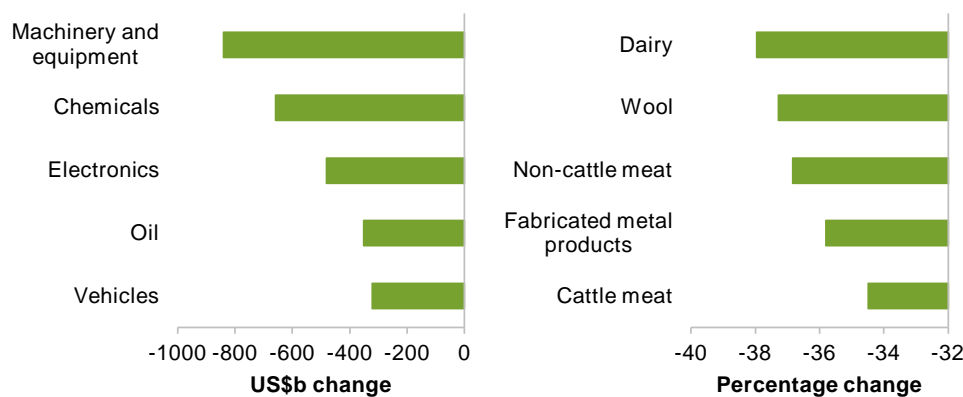
¹⁹ Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

CONCLUSION 4.1

Significant worldwide increases in protection would cause a global recession. Australia would not escape unscathed. Modelling estimates show that for every \$1.00 increase in Australian tariff revenue, economic activity in Australia would fall by \$0.64. In total, GDP would be lower by over one per cent each year. This would equate to a loss of close to 100 000 jobs, and the average household would face an income cut of nearly \$1500 a year.

Figure 4.5 Global trade in some product categories would be hit harder than others

2016 US\$ billion and percentage change, by product category



Data source: Commission estimates generated using the PC Global model.

Short-term effects would be even more pronounced

As discussed in chapter 2, the initial impacts of increases in protection would likely be more pronounced than the above analysis suggests. Price rises and income losses would be higher during the reshaping of global supply chains than would be the case at the end of that process. And labour and capital resource movements within economies would take time. During this period, both unemployment and stranded assets would be higher than in the longer term, as economic activity adjusted to increased tariffs.

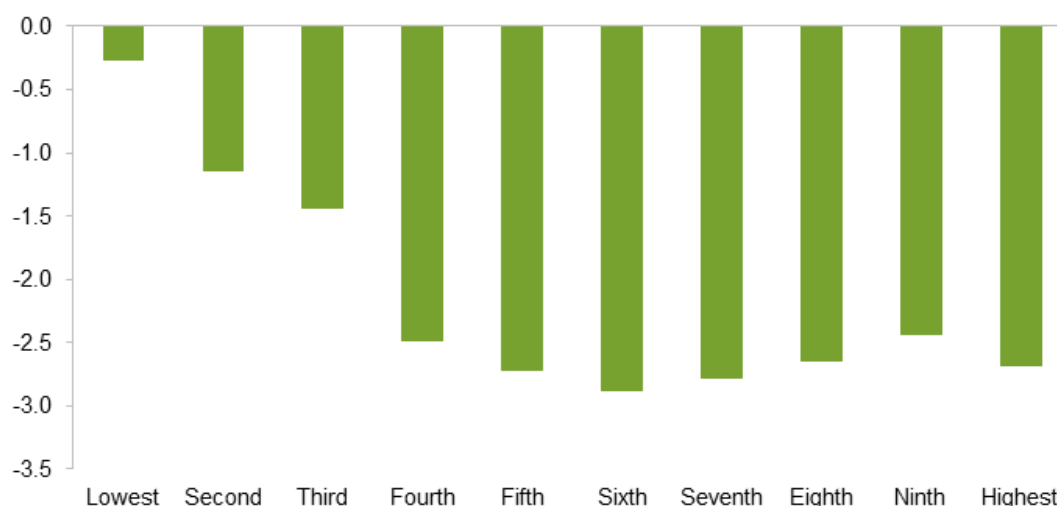
4.3 How would Australian households be affected?

Most, but not all, households would be worse off

Global tariff increases would cause lower living standards, on average, in every decile of the distribution (figure 4.6). But not all households would be affected equally. Those at the

lower end of the distribution would be less severely affected — in part because the transfer system (if it remains intact) would help welfare dependent households maintain the real value of their income, and in part because the goods and services consumed by many of these households contain a relatively high proportion of non-traded goods whose prices would not rise by as much as those of imports and import-competing goods.²⁰ Households reliant on benefits indexed to the consumer price index, rather than wages, would likely be better off because wages would fall in general, whereas the consumer price index would be little changed. That said, workers in less-traded service sectors, such as education and health, would likely benefit from higher wages as demand for their services increased.

Figure 4.6 Global tariff increases would see Australian average living standards fall in all deciles
Percentage changes in purchasing power



Data source: Commission estimates generated using the PC Global and PC National models.

The average falls mask considerable variation in outcomes within deciles (figure 4.7).

Nearly 80 per cent of households would face lower living standards, notwithstanding the assumption that the social support system remains intact. For some of these households the fall would be relatively small but, for nearly 30 per cent, the purchasing power of their income would be at least 4 per cent lower. To put this into context, a household that spends \$2500 a fortnight on goods and services would be worse off by \$100 a fortnight. The magnitude of the fall would depend on how a household's wages, returns on savings and investments and the prices for the things they consume changed. Households that were

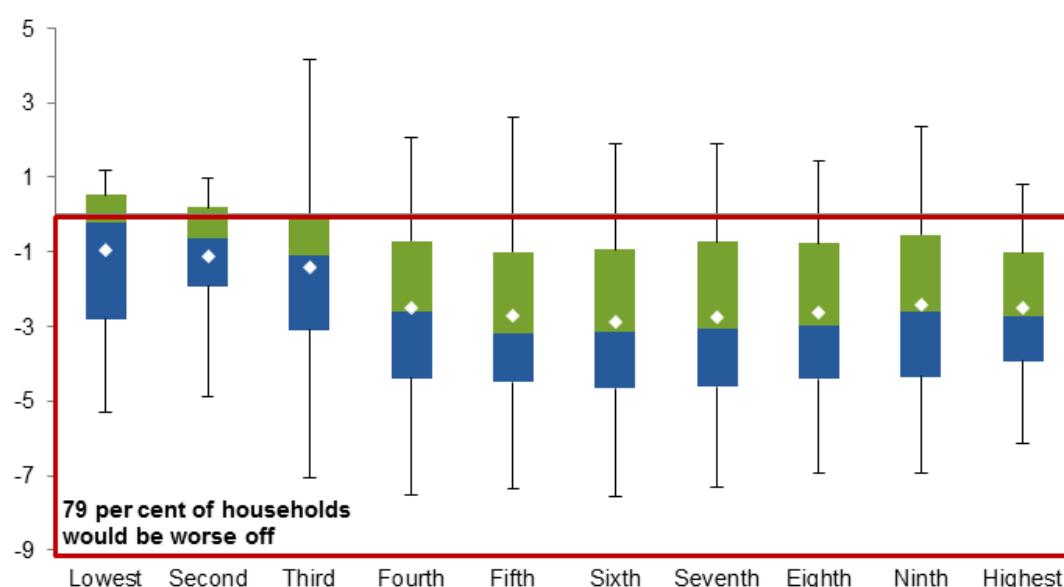
²⁰ This analysis assumes that budgetary pressures created by the fall in national income do not lead to reductions in transfer payments.

larger consumers of imports and import-competing goods and those with a greater reliance on income from capital would be more severely affected.

For a minority of households (just over 20 per cent) the effect on living standards could be positive. Households at the lower end of the income distribution would be more likely to be in this group, for the reasons outlined above in explaining why the average fall in living standards is smaller for lower income deciles.²¹ In higher deciles, the main driver for households that would be better off is income from employment in a sector where wages rise.

The uneven distribution of impacts across households helps explain why the broad support of the community for open markets cannot be taken for granted, and it complicates the political economy of trade liberalisation (chapter 6).

Figure 4.7 In each decile there would be some households that were better off, and others that would be much worse off^a
Percentage changes



^a For each decile, the diamond represents the change in mean income, as reported in figure 4.6. The end of the bottom whisker reports the income change for households at the bottom 5th percentile of the distribution of income changes; the top of the upper whisker reports changes for the 95th percentile of the distribution. The bottom of the blue box represents changes for households at the 25th percentile of the distribution of income changes, the top of the blue box reports changes for the median household (50th percentile) and the top of the green box reports the change in income households at the 75th percentile of the distribution.

Data source: Commission estimates generated using the PC Global and PC National models.

²¹ About 44 per cent of households in the lowest decile, about 30 per cent of those in the second decile and between 15 and 25 per cent of household in other deciles would be in this position.

Finally, there are no marked differences in the distributions of income changes for households across different states and territories, nor between capital cities and other parts of the country (Technical Report).

CONCLUSION 4.2

Significant worldwide increases in protection would cause lower living standards. Not all Australian households would be affected equally, but most would be worse off. The uneven distribution of impacts across households helps explain why the broad support of the community for open markets cannot be taken for granted, and it complicates the political economy of trade liberalisation.

5 The benefits of further liberalisation

Key points

- In the event of a global rise in protection, Australia would face intense political pressure to follow suit and lift its own barriers to trade and foreign investment.
- Notwithstanding the pressure, there would be no economic justification for Australia to join a trade war. Raising Australia's barriers would shrink economic activity and harm employment and wages.
- However, resisting these pressures would be easier if Australia was part of a coalition that acted together using open and transparent processes to maintain the flow of international trade. Consequent gains would offset the losses from higher protection elsewhere.
- This coalition of 'like-minded' countries could agree to maintain protection at current levels or to go further, liberalising by reducing tariffs, non-tariff barriers and barriers to services trade.
- Participants in the Regional Comprehensive Economic Partnership (RCEP) — including Australia, China, Japan, South Korea, India, New Zealand and the ASEAN countries — could possibly form the basis of such a grouping.
 - RCEP members have benefited significantly from open international trade, providing an incentive to hold the line on protection to maintain economic growth and living standards.
- Relative to a scenario in which other countries raised tariffs by 15 percentage points, engaging with a group like RCEP would significantly amplify the positive economic effects for Australia of avoiding increases in protection once the global economy had adjusted to the new trade policy settings.
 - If RCEP members maintained tariffs at current levels, the Commission's modelling shows that the negative effect of higher protection elsewhere on Australia's income would be largely offset and the drop in living standards smaller by a factor of five.
 - With liberalisation of tariffs by RCEP members, economic activity in Australia would be about 2.5 per cent higher (or more than a year of growth at current levels).
 - And benefits would be larger again if RCEP countries extended liberalisation efforts to non-tariff barriers and barriers to services trade. A household with the median weekly gross income of about \$1600 a week would be better off by about \$44 a week.
- In focusing on avoiding the risk of backsliding on protection, it is easy to forget that substantial scope exists to lower existing trade barriers.
 - Estimates of non-tariff barriers and barriers to services trade, while hard to quantify, are typically large.
 - There is no reason why Australia could not proceed unilaterally. Lowering these barriers would not depend on our trading partners taking similar actions and the benefits would be widely distributed across Australian households and businesses.

As demonstrated in previous chapters, the ultimate effect on economic activity and living standards in Australia would be small if the rise in protectionism stopped at the United States imposing tariffs on China and Mexico, or adopting border adjustments. But if the largest global economies were to raise trade barriers simultaneously, the economic dislocation unleashed would be material. In these circumstances, a middle-sized open economy like Australia would be subject to intense political pressure to follow suit and lift its own barriers to trade.

Australia could resist the pressure to raise barriers to trade and investment. But this would be easier if other countries were also holding the line against protectionism. Joining a coalition of countries that share a strong interest in maintaining open markets would help to shore up the case for resisting a knee-jerk protectionist response. Moreover, tariffs, non-tariff barriers and barriers to services trade remain prevalent. The coalition could embark on further trade liberalisation.

Which pathway might deliver the best outcomes for Australia? This chapter answers this question by assessing scenarios in which, in the face of 15 percentage point tariff increases elsewhere, Australia:

- unilaterally maintains current levels of protection
- co-operates with a group of countries to maintain policies that support international trade
- joins with that group in further reducing barriers to trade.

Section 5.1 discusses possible institutions and organisations through which Australia could co-operate on free trade, and the types of policies that could be adopted to further liberalise trade; and section 5.2 presents results from the Commission's modelling of the possible effects on Australia from being part of a regional coalition that not only reduced tariffs but also lowered non-tariff barriers to trade and barriers to services trade.

5.1 What might a regional coalition look like?

A coalition of countries committed to resisting widespread increases in protection would be most likely to emerge from a group already cooperating on trade and investment. And it would be easier for Australia to join a group with which it already has strong connections.

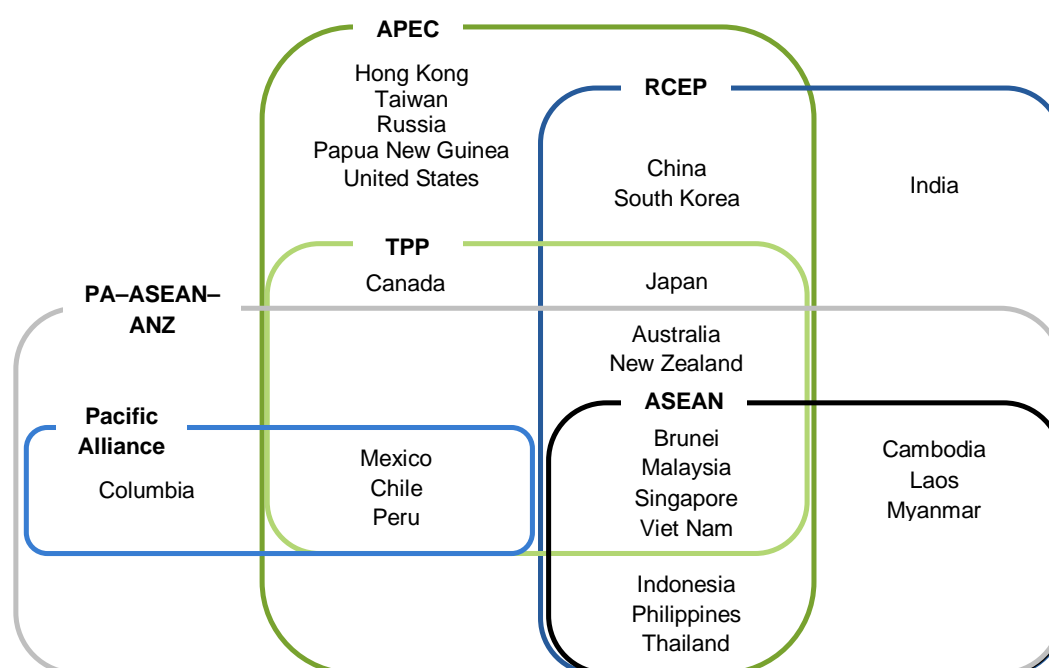
Australia is working with groups of World Trade Organization (WTO) members on agreements in environmental goods and trade in services, and is a member of the G20. But the United States and other major economies are involved in each of these groups. Mobilising these groups into action would require major political commitment and leadership, and that might prove very difficult if major economies were prompted to retaliate against higher US protection (chapter 4).

Beyond the WTO, Australia's focus in cooperating on trade and investment has been in the Asia-Pacific region. The natural grouping to form a coalition of open economies is likely to

be found in East Asia, a region that accounts for two-thirds of Australia's trade in goods. Economies in this region have developed rapidly through embracing open markets and, for most, that is a process still underway. For decades, Japan, South Korea, Taiwan, Hong Kong, Singapore and, more recently, China, have followed export-oriented growth strategies that have brought development and greater prosperity. Developing countries in Southeast Asia have embraced openness, and the 10 country members of the Association of South East Asian Nations (ASEAN) are engaged in promoting regional co-operation through multiple processes, such as the ASEAN Economic Community and broader regional groupings.

There are a number of fora, including East Asian economies within the Asia-Pacific that might provide the foundations for a coalition (figure 5.1).

Figure 5.1 **Potential candidates for a regional coalition^a**



^a APEC — Asia-Pacific Economic Cooperation; RCEP — Regional Comprehensive Economic Partnership; TPP — Trans-Pacific Partnership; PA — Pacific Alliance; ASEAN — Association of South East Asian Nations; ANZ — Australia and New Zealand.

The Asia Pacific Economic Cooperation (APEC) grouping is one option, but it includes the United States. And, given APEC is a non-binding cooperation arrangement, it is difficult to see how it could succeed in taking a stand against protectionism without the leadership of its largest economy. Even non-binding statements that promote openness and resist protectionism need consensus among the members and that has proved difficult in the G20, for example, under Trump's leadership of the United States.

The Trans-Pacific Partnership is another option. Initial reactions to the withdrawal of the United States suggested the agreement was dead (The Economist 2017). Remaining

members are now assessing avenues for bringing it into force (DFAT 2017b), but its future is uncertain given likely division on the best way to move it forward without the United States.

A further option could integrate the Pacific Alliance with ASEAN, Australia and New Zealand (Emerson 2017). ASEAN and the Pacific Alliance have an agreed framework for cooperation; ASEAN, Australia and New Zealand are signatories to a regional trade agreement; and Australia is exploring opportunities for trade agreements with Pacific Alliance members. But this grouping does not yet exist, making it a less ready candidate for a coalition.

The remaining option is the Regional Comprehensive Economic Partnership (RCEP) — a proposed regional free trade area. The Commission has used the RCEP grouping to illustrate the potential economic effects of Australia participating in a coalition that resisted increasing protection in the face of rises elsewhere.

Major East Asian economies have been discussing the establishment of RCEP, together with Australia, New Zealand and India, since 2012. With the US withdrawal from the TPP, and the negotiations on the Transatlantic Trade and Investment Pact (TTIP) between the United States and Europe stalling (Mansfield 2017; USTR 2017b), RCEP is the only major regional economic co-operation agreement that is under negotiation (box 5.1). Furthermore, Australia has a history of negotiating with many RCEP members. Australia already has bilateral trade agreements with China, South Korea, Japan, New Zealand, Malaysia, Singapore and Thailand and, as noted above, a regional trade agreement with ASEAN and New Zealand. It is negotiating deals with India and Indonesia.

Box 5.1 The Regional Comprehensive Economic Partnership

Australia has been involved in discussions to establish the Regional Comprehensive Economic Partnership (RCEP) since 2012. The talks were initiated by the Association of South East Asian Nations (ASEAN), which is comprised of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

The RCEP forum aims to establish a regional free trade area, which would encompass the ASEAN countries and those countries that have free trade agreements with ASEAN: Australia, China, India, Japan, South Korea and New Zealand. The proposed free trade area would account for almost half the global population and a third of global GDP. From an Australian perspective, RCEP countries account for 70 per cent of goods and services exported, and 50 per cent of imports.

To date, 18 rounds of negotiations have been completed, looking at various aspects of trade in goods and services, investment, intellectual property, e-commerce, and others. In the latest meetings, which took place in late 2016 and early 2017, participating countries have stated their commitment to continue progressing the RCEP agenda, specifically in light of rising protectionism.

Source: DFAT nd.

RCEP also has the advantage of including China — Australia's largest trade partner. President Xi Jinping has publicly expressed a leadership role for China in trade

liberalisation. And RCEP member countries account for much of the economic dynamism in the global economy.

RCEP provides a platform for members to promote their shared interests in freer trade. Not all members would necessarily make a strong stand against global protectionism (for example, India has objected to aspects of free trade agreements). But even if a core group of China, Japan, South Korea, Australia and key Southeast Asian nations made significant commitments to avoid higher protection and press on with liberalisation it would have a large effect on the global trade policy environment.

How could a regional coalition respond to increased global protection?

In reaction to rising protection elsewhere, a coalition of open economies could maintain existing tariff levels, or the group could pursue a more active agenda, and reduce barriers to trade and investment. Cutting tariffs would be one option, but several members already have very low tariffs and greater gains would accrue if the subset of non-tariff measures that constitute non-tariff barriers to trade (NTBs), along with barriers to trade in services (BTSs), (box 5.2) were also reduced.

Box 5.2 Barriers to trade beyond tariffs

Non-tariff measures are domestic or trade measures other than customs tariffs that can affect international trade in goods, changing quantities traded, prices, or both (UNCTAD 2012). An example is technical requirements that prove costlier for foreign producers than for domestic producers to meet. Foreign producers may need to have their products undergo safety inspections twice, once in the country of origin and once in the country of destination.

However, not all such measures impede trade. For example, regulatory requirements that protect consumer health and safety (such as food safety checks) are not identified as a barrier, as they are considered legitimate means of addressing risks, and also applied equally to imported and domestically produced goods. Accordingly, non-tariff barriers are the subset of non-tariff measures that discriminate against foreign products by raising prices of imported goods, and/or otherwise restricting trade.

Similarly, barriers to trade in services are a result of domestic laws, regulations and practices that restrict market access for foreign providers relative to domestic providers. For example, licensing requirements can increase the administrative burdens on companies that export their services overseas. In industries such as architectural and engineering services, providers may need to be licensed both in their country of origin and in the country they are exporting to, which imposes additional costs and may restrict trade.

NTBs and BTSs arise from domestic policies that breach the principle of national treatment — one of the fundamental principles of the WTO trading system. Under this principle, local and foreign goods and services should be treated equally once they enter a country (chapter 4). There are many regulations and practices where the principle of

national treatment does not occur. Some of them that give rise to NTBs and BTSs affect only foreign firms, while others apply to both foreign and domestic firms.

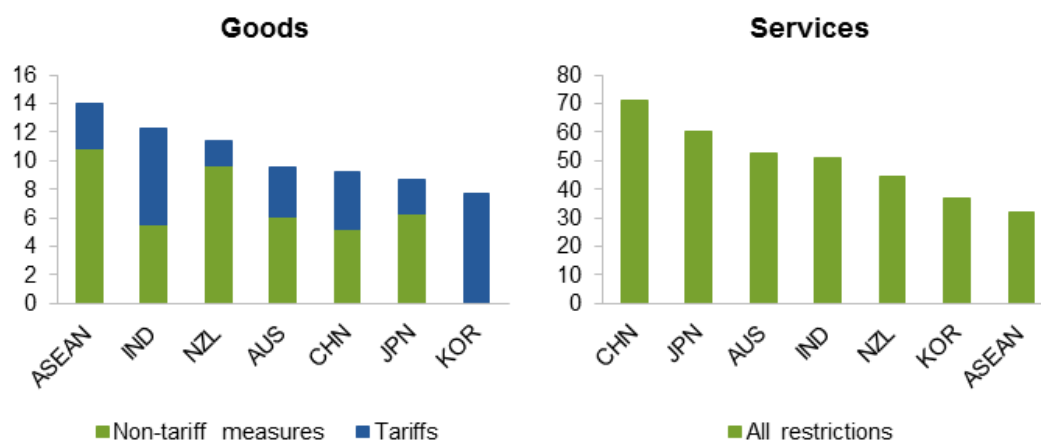
Examples of regulations and practices that specifically affect foreign firms include rules of origin, anti-dumping and countervailing measures, restrictions on foreigners in management roles, and limits on foreign investment. Like tariffs, these measures raise costs to consumers and reduce competitive pressures, leading to less efficient resource use in the country levying the protection. Regulations covering product characteristics, measures that limit competition in a sector and occupational licensing requirements are other examples of market interventions that affect both local and foreign firms. While these policies impose costs on both foreign and domestic providers, they may, in some instances, be more costly for foreign firms (box 5.2).

As tariffs have been declining globally over the past few decades, non-tariff measures and policies affecting trade in services have become relatively more significant (ECORYS 2009). Estimates of these restrictions on trade illustrate the prospect for action against barriers in addition to tariffs to improve trade flows. In particular, estimates for services are particularly high (figure 5.2), and measures for agriculture are larger than those for manufacturing (figure 5.3). While in some instances these measures will be legitimate instruments to manage risks (for example, quarantine measures required to mitigate biosecurity risks that affect agricultural products), others (including the price support programs and direct payments to farmers used in many countries), could be classed as industry protection that has high economic costs. Moreover, where those barriers affect local as well as foreign businesses, there would be gains from bringing barriers down beyond those stemming from freer trade. Changes to regulatory settings that enhanced competition between local firms, as well as from foreigners, would provide widespread benefits.

CONCLUSION 5.1

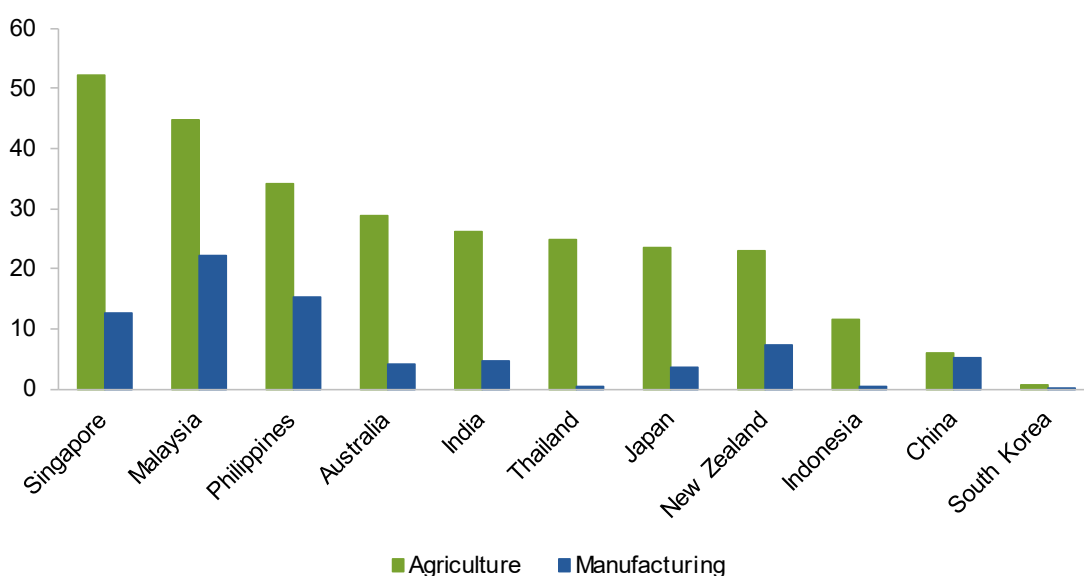
In the event of a global rise in protection, Australia is likely to face intense political pressure to follow suit and lift its own barriers to trade and foreign investment. Working with a coalition of countries to keep their markets open is a strategy that would make it easier for Australia to resist protectionist pressures.

Figure 5.2 Many opportunities to reduce barriers to trade lie in non-tariff measures and restrictions on services trade^{a,b,c,d}
Per cent tax equivalent, RCEP members



^a Non-tariff barriers are a subset of the non-tariff measure (NTM) estimates included in the figure for goods. ^b Service barriers are much higher due to differences in statistical estimation; the service values likely include other trade frictions not related to restrictive trade policy as noted in Fontagné, Mitaritonna and Signoret (2016). ^c Due to differing input data sources, goods data is aggregated with 2009 Comtrade data whereas services uses 2011 GTAP data. ^d Small revisions were made to this figure on 27 July 2017.
Data sources: Fontagné, Mitaritonna and Signoret (2016); Kee, Nicita and Olarreaga (2009); PC Global/GTAP 9 bilateral trade values; UN (2017).

Figure 5.3 Opportunities to reduce barriers may be greater in agriculture
Non-tariff measures, per cent tax equivalent, RCEP members



Data source: Kee, Nicita and Olarreaga (2009).

5.2 How might Australia be affected by regional co-operation?

Insights from the literature and past Commission work

The impacts of regional co-operation, in the form of bilateral and regional trade agreements, have been examined by the Commission in the past. This work concluded that ‘insofar as they focus trade towards a partner country, preferential agreements can detract from broader regional integration, while agreements based on open regionalism ... appear to foster economic and regional integration’ (PC 2010, p. 183).

More specifically, with respect to tariffs, the work concluded that the net benefit of preferential tariffs was likely to be small, due to trade diversion effects, the costs stemming from a less efficient allocation of resources and administrative and compliance costs associated, for example, with rules of origin. Greater benefits would come from countries reducing or eliminating tariffs on a non-discriminatory, most-favoured nation basis.

The Commission also found that while the agreements (mostly bilateral) signed by Australia have affected non-tariff barriers to trade, the costs and benefits of many provisions was unclear (PC 2010). This is because some elements raised rather than lowered the barriers. For example, rules of origin, which are an intrinsic part of a preferential trade agreement, can add to the cost of trade and raise complexity (Crook and Gordon 2017). Further, looking at intellectual property arrangements, the Commission found that poor consultation and transparency have led Australia to sign international agreements that have sometimes worked against its own interests (PC 2016a). This points to the necessity for careful cost–benefit analysis before an agreement is implemented.

With respect to services trade, earlier work by the Commission concluded that the benefits of provisions included in agreements had been modest. More recently, the Commission found that while trade agreements can be useful in reducing barriers to services exports, their ability to address behind-the-border barriers was limited (PC 2015a). In fact, there is no reason why Australia could not proceed unilaterally to lower barriers to trade in services, as they do not depend on our trading partners taking similar actions and the economic benefits would be widely distributed across Australian households and businesses. All who use a service would gain.

Trade agreements have evolved considerably in recent years. Their scope has expanded to include a broad range of economic issues that go beyond commitments made in the WTO. The majority of new agreements coming into force in the past decade have provisions covering 10 or more policy areas, such as environmental laws, data protection and government procurement (figure 5.4).

The increasing depth and breadth of issues covered by trade agreements has amplified the importance of good consultation processes (chapter 6). As long as participants account for a large share of world trade and remain open to additional participation by countries

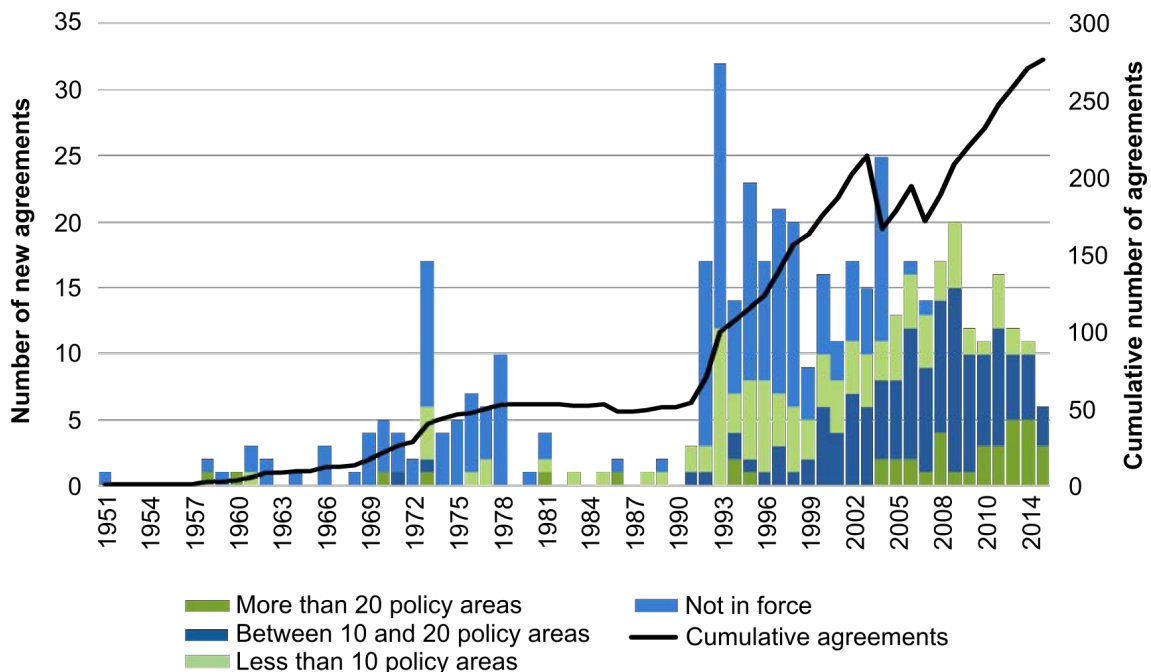
committed to meeting these standards, a regional approach to cooperation can complement and bring many of the benefits of multilateral agreements.

Recent regional initiatives are on an entirely new scale. The TTIP and RCEP negotiations are examples (while not yet in force) of modern, large regional initiatives that offer a vehicle for like-minded countries to maintain and pursue freer trade. TTIP members account for about 45 per cent of global GDP and world trade; RCEP members about 30 per cent; and both partnerships go beyond providing preferential access to member countries' markets.

To date, only Kawasaki (2017) has analysed how effective such regional groupings of countries would be as a response to increased protectionism. He estimated the effects of scenarios involving RCEP, including RCEP countries removing all tariffs as well as reducing non-tariff measures. Depending on the specific scenario, his estimates suggest that the removal of trade barriers could increase real GDP in the RCEP countries. For Australia, his estimates of increases in real GDP range from 0.12 per cent to nearly 3 per cent.

Figure 5.4 Trade agreements cover an increasing range of policy areas

Number of agreements, 1951–2015



Data source: IMF, World Bank and WTO (2017).

Insights from the Commission's modelling

Chapter 4 presented results from the Commission's modelling of a contagion scenario, where tariffs rise globally by 15 percentage points. This chapter extends that analysis,

considering the impacts on Australia of scenarios where, in the face of much higher protection elsewhere, Australia:

- stands alone in maintaining current trade barriers and levels of openness
- cooperates with a coalition of like-minded countries, represented by RCEP members, that either:
 - maintains their existing levels of protection
 - eliminates tariffs on goods from all countries (that is, on a most favoured nation basis), or²²
 - eliminates all tariffs and reduces NTBs and BTSs.

Measuring and, therefore, modelling NTBs and BTSs is challenging and the results should be viewed as indicative (box 5.3). Furthermore, the modelling only estimates the effect of lower barriers on trade. As noted above, reductions in barriers that restrict local as well as foreign businesses would bring gains beyond those stemming from freer trade. These broader benefits are not modelled.

Box 5.3 Challenges in assessing the economic impacts of non-tariff barriers and barriers to services trade

Modelling the impacts of non-tariff barriers and barriers to services trade is complicated by the challenges inherent in measuring barriers.

Researchers typically use a model (specifically, a gravity model) to generate estimates of the effects of regulations on trade flows. The model estimates the association between trade costs and trade flows.

- This type of model is successful in explaining the influence of trade costs on the pattern of goods trade. That said, it is difficult to disentangle the effects of barriers to trade that have potential industry assistance effects from the effects of measures that are considered legitimate regulations, and that have benefits not captured in the estimates.
- In the context of cross-border services trade, the estimates are likely to account for a large number of possible trade frictions beyond the effects of any barriers to trade in services.

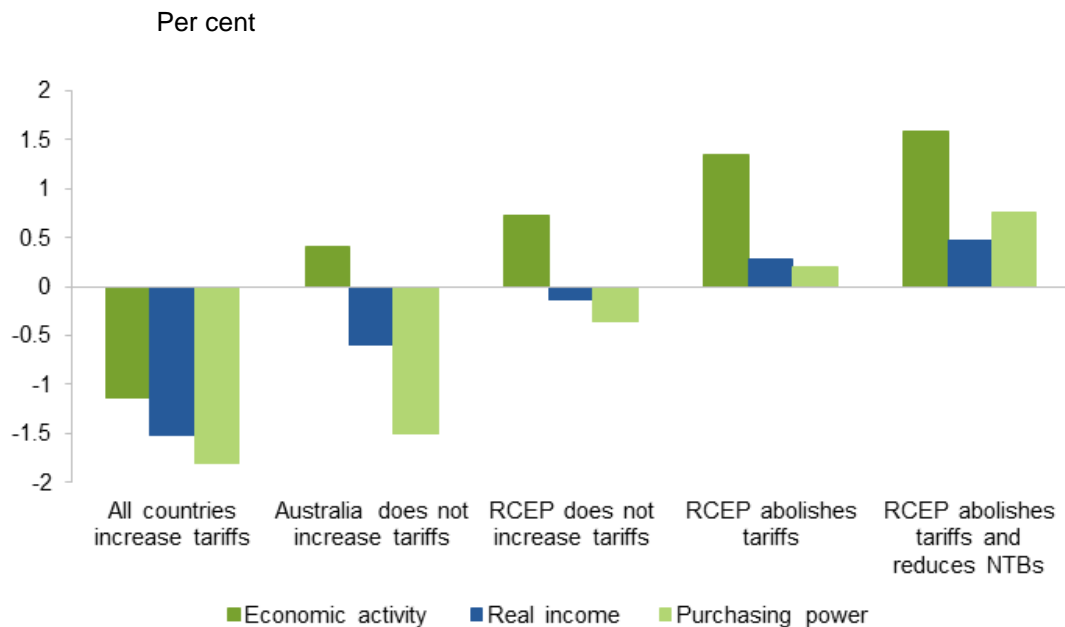
Given these issues, estimates from the literature were assumed to include effects other than barriers, so were heavily discounted when applied in the Commission's modelling. Twenty per cent of the original estimates were assumed to be actionable barriers. The results are dependent on this discounting, which is based on judgements that others have used in similar situations. For further details, see the modelling Technical Report.

²² This is different to a preferential trade agreement where tariffs are lowered only for those countries that are party to the agreement.

Benefits would be higher with lower barriers

Even in a world of much higher protection globally, Australia would be better off maintaining current levels of protection, than following suit and increasing protection (figure 5.5). Trade patterns would be much less disrupted because import prices would not be lifted by higher tariffs. Patterns of economic activity would be less distorted, meaning fewer people would be forced to find new employment. Capital inflows would rise because Australia would be a more attractive investment destination relative to other countries, contributing to stronger economic activity. Overall, living standards would still be lower than they are today, but not by as much as they would be if Australia also raised tariffs.

Figure 5.5 Removing tariffs and other barriers to trade would increase living standards in Australia^{a,b}



^a This chart compares five scenarios — from left to right, in the first scenario, Australia, along with the rest of the world, raises tariffs by 15 percentage points. This scenario is discussed in detail in chapter 4. In the second scenario, Australia maintains existing tariff levels, while tariffs rise by 15 percentage points overseas. In the third scenario, RCEP countries are assumed to maintain existing levels of protectionism, while all other countries raise tariffs by 15 percentage points. In the fourth scenario, RCEP countries are assumed to remove all tariffs applied to all countries. The fifth scenario extends the fourth to include decreases in non-tariff barriers and regulatory barriers to service trade. ^b Economic activity is defined as real GDP, real income is defined as real GNP and purchasing power is defined as gross national absorption adjusted for terms of trade effects.

Data source: Commission estimates generated using the PC Global model.

Co-operating with RCEP countries to maintain existing tariff levels would amplify the benefits to Australia. The Commission's modelling shows that the negative effect of higher protection elsewhere on Australia's income would be largely offset and the drop in living standards smaller by a factor of five. Further, agreements by RCEP countries to eliminate tariffs would ensure that Australia not only avoided a global recession but would improve

key indicators of welfare. Economic activity, for example, would be higher by 2.5 per cent (or more than a year of growth on current levels). Benefits to Australia would be higher again if RCEP countries also reduced NTBs and BTSs. Relative to a world of tariff hikes in which Australia participated, living standards would be 2.7 per cent higher; a household with the median weekly gross income of about \$1600 a week would be better off by \$44 a week.

These are lower bound estimates. Gains would be higher again if reductions in NTBs and BTSs improved competition between domestic providers, as well as competition from foreign sources. It is unclear how much larger these additional benefits would be — this is an empirical question meriting further research. Nonetheless, they could be material. And the greater efficiency of resource use and lower prices that would flow from greater competition would have widespread benefits for Australian households and businesses. As mentioned above, these benefits could be achieved through unilateral action on Australia's part. They do not depend on trading partners taking similar action, although it might be easier to implement such changes as part of a concerted regional effort.

In short, unilateral liberalisation and regional co-operation could mean more economic activity (GDP), higher national income, and improved living standards for Australia.

CONCLUSION 5.2

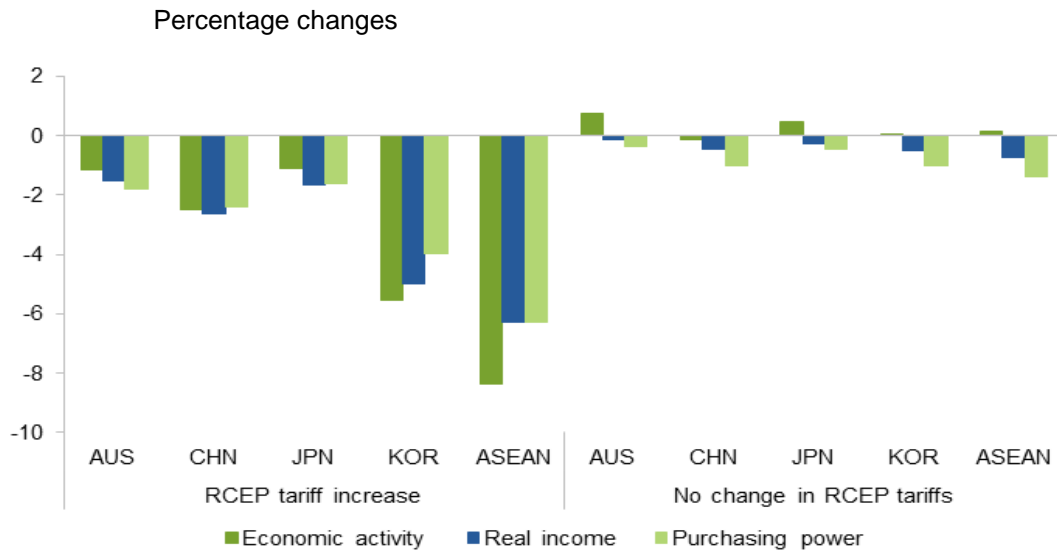
Even in a world of much higher protection globally, Australia would be better off to persist with lowering barriers to trade.

Co-operating with a coalition of like-minded countries could significantly amplify the positive economic effects for Australia of avoiding increases in protection.

Importantly, the Commission's modelling results hold for the other RCEP countries too — they all do better by not adopting tariff retaliation, and better still by eliminating their tariffs and reducing other barriers to trade. The RCEP countries, in particular the ASEAN members and South Korea, do much better in the face of global contagion if they, along with the other RCEP countries, did not follow suit and maintained tariffs at current levels (figure 5.6).

Even larger gains would be available to RCEP countries if they liberalised tariffs and other barriers to trade (figure 5.7).

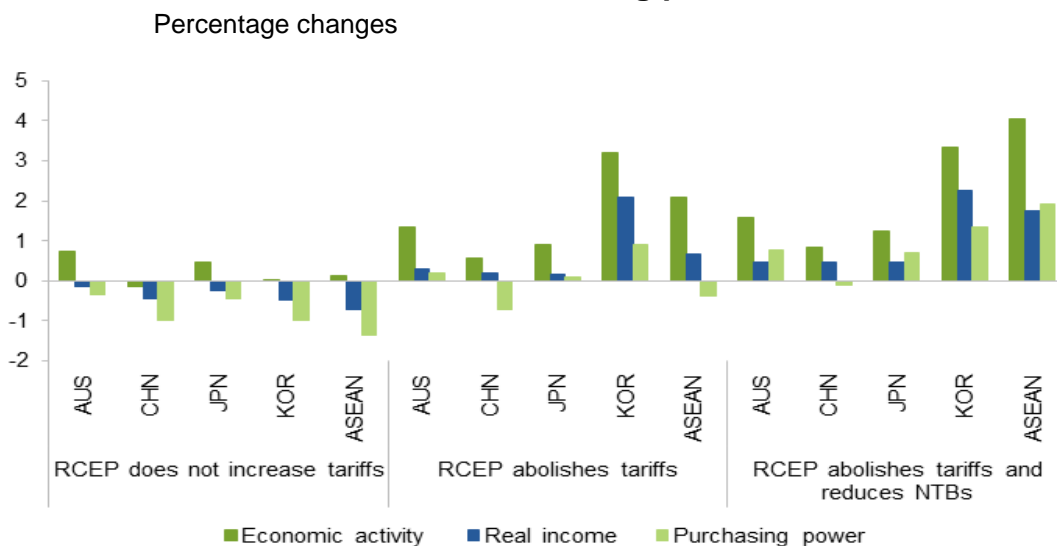
Figure 5.6 RCEP countries would benefit by cooperating to resist rising protection elsewhere^{a,b}



^a RCEP countries are assumed to maintain exiting levels of protectionism, while all other countries raise tariffs by 15 percentage points. ^b Economic activity is defined as real GDP, real income is defined as real GNP and purchasing power is defined as gross domestic absorption adjusted for terms of trade effects.

Data source: Commission estimates generated using the PC Global model.

Figure 5.7 RCEP countries would benefit even more from further trade liberalisation in the face of rising protection elsewhere^{a,b}



^a RCEP countries are assumed to completely remove all tariffs and either maintain non-tariff barriers and barriers to services or decrease them, while all other countries raise tariffs by 15 percentage points. ^b Economic activity is defined as real GDP, real income is defined as real GNP and purchasing power is defined as gross domestic absorption adjusted for terms of trade effects.

Data source: Commission estimates generated using the PC Global model.

6 Where to for Australia

Key points

- A retreat from openness to trade in some countries may suggest to some that a rethink of Australia's commitment to free trade is needed. They would be wrong.
- Protectionism is not a magic wand. Protectionist trade policies would harm the Australian economy rather than dealing with the insecurity concerns of citizens that, for many, globalisation has come to encapsulate. But it would also be a mistake to dismiss the signs of discontent.
- The best response would be to continue to work towards freer markets. Australia can proceed unilaterally, as most of the benefits, especially from lower non-tariff measures, do not depend on our trading partners taking similar actions.
- But in practice, support for open markets is more likely to be forthcoming if pursued through even-handed, rules-based, trade agreements that enable more countries to participate and benefit from the expanded economic opportunities offered by improved market access.
- There is considerable scope to achieve better outcomes and foster public confidence in open markets through Australia's approach to trade agreements. In particular by:
 - prioritising new regional agreements, especially those that allow benefits to a broader group of countries and do not exclude others, and expanding the use of World Trade Organization sector-specific agreements which have proven to promote multilateral liberalisation
 - pursuing only those agreements where there is a strong case that a net benefit will result
 - improving consultation processes, including providing key stakeholders access to draft treaty text on a confidential basis during the negotiation and broadening participation in negotiations to parties capable of offering critical assessment.
- Australia's reputation as an attractive destination for international investors could be strengthened through more consistent, transparent and predictable approval processes while preserving our vital national security interests.
- Limited policy attention given to the distribution of the benefits and to the uneven costs of adjustment associated with reducing protection is testing the social compact that underpins open market policies.
 - While Australia (like other countries) is a winner overall from open markets (and technological change), some displaced workers struggle to find a new job.
 - Continued support for open markets relies on the community seeing that the gains are shared, and that there is effective support for those who are negatively affected by trade.
- More effective policies to facilitate adjustment, for example retraining, merit investigation and existing policies should be regularly evaluated to ensure they deliver their intended outcomes.
- Better understanding of community concerns about free trade, improved engagement with the community around the case for open markets and clearer communication about the benefits of trade and the policies in place to support adjustment would also help to build community acceptance and reduce pressures for higher protection.

6.1 Is there a case for a policy rethink?

The global trade landscape has evolved substantially in recent years. Most significantly, following decades of support of a liberal trading order, the discourse has changed in key advanced economies. A growing number of people in our communities are expressing scepticism about the benefits of trade and concerns about the ‘offshoring’ of jobs. This is once again fuelling protectionist sentiment. This is most evident in the United States, although so far it is unclear how their trade policy will change. Likewise, in parts of Europe protectionist protagonists have also been empowered.

Another significant development in international trade is the growing importance of global supply chains (GSCs). These have been facilitated by technological innovations, notably in transport, communications and logistics, and by recent trade agreements. Specialisation by firms within GSCs contributes to productivity growth, but the displacement of jobs as production is relocated across borders contributes to community concerns about trade.

Furthermore, the majority of new trade agreements in force, or under negotiation, cover a vast array of policy areas. They serve to facilitate trade,²³ but can also constrain national sovereignty. While the number of preferential agreements has escalated exponentially, progress in broad multilateral negotiations is effectively at a standstill.

These developments may suggest to some that a rethink of Australia’s commitment to free trade is needed. They would be wrong. The earlier chapters of this report assessed the possible impacts on the Australian economy and elsewhere of highly stylised scenarios that depict a shift internationally towards a more protectionist and distortionary trade policy stance. The analysis demonstrated that if Australia were to follow suit, community wellbeing would decline because of higher prices and reduced consumer choice, and the ability of Australian businesses to participate in GSCs would be limited — ultimately affecting their productivity. For every \$1.00 increase in Australian tariff revenue, economic activity in Australia would shrink by \$0.64 (chapter 4).

However, it would also be a mistake to dismiss the signs of discontent. For many people, income has stagnated, feelings of economic insecurity are more pervasive and income inequality is widening. While these developments are more closely linked to technological disruption (Helpman 2016), and are more pronounced in other advanced economies, they could be exploited. If not addressed, Australia’s poor productivity performance portends a sustained period of low income growth, which could lead some to blame trade and renew calls to protect local jobs and industries.

Even where people support free trade, there are legitimate concerns about particular trade agreements and trading relationships. Past work of the Commission has highlighted how bilateral agreements entail costs and have not always delivered the expected benefits or

²³ Just how much they promote trade depends in large part on the stringency of the rules of origin. Stringent rules, which require a high share of local value added, or considerable product transformation, reduce the ability of firms to use the negotiated preferences (Crook and Gordon 2017).

earned the broad support of the community (PC 2010). Arguably, the limited policy attention given to the distribution of who benefits and to the uneven costs of adjustment associated with reducing protection is testing the social compact that underpins open market policies.

The current environment thus presents a timely opportunity for Australia to evaluate its approach to international trade, and other relevant policy measures. What should Australia do in the face of the new swing towards protectionism? Are there strategies for avoiding the risk of backsliding on protection? How can the costs of adjustment be minimised and the benefits of liberalisation made more inclusive?

This chapter draws on the stylised scenarios and the Commission's model used in previous chapters, and on other analytical work, to discuss the actions that Australia might take on trade and foreign investment policy. It outlines a three-pronged strategy to help achieve better outcomes for all Australians, foster public confidence in open markets and reduce protectionist pressures. The first prong is to continue to work towards freer markets (section 6.2) and to pursue even-handed, rules-based trade agreements (section 6.3). The second prong is to focus on the broader policies that strengthen the workforce's adaptability to changes taking place in the global economy, not just trade (section 6.4). And the third prong is to improve how governments engage with the community about trade and investment (section 6.5).

CONCLUSION 6.1

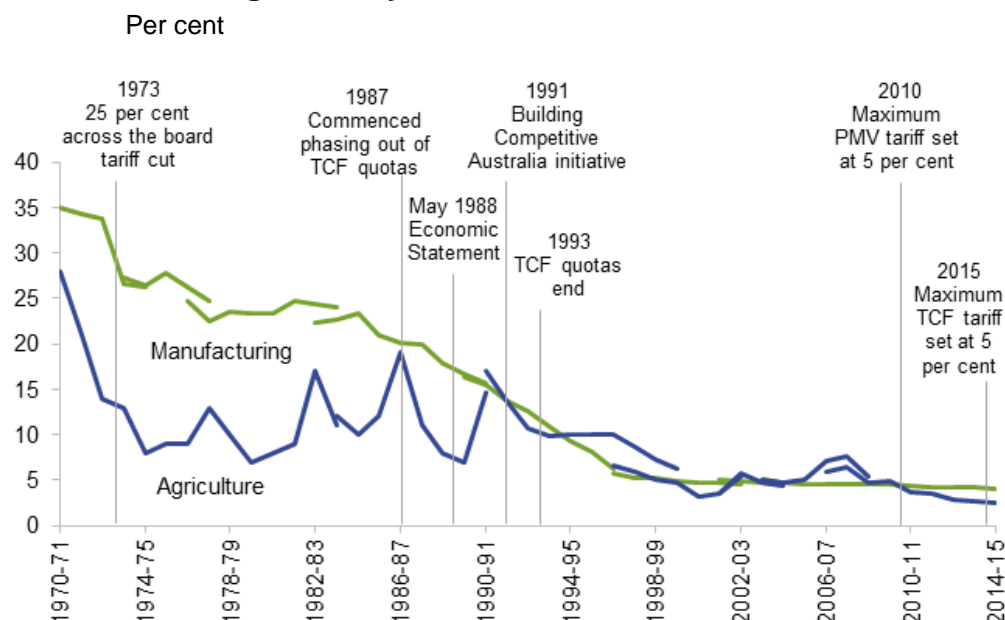
Rising protectionist sentiment and actions in some countries may suggest to some that a rethink of Australia's commitment to free trade is needed. They would be wrong. However, there is a case to better understand and respond to the insecurity concerns of citizens about jobs and incomes that, for many, globalisation has come to encapsulate. The current environment presents a timely opportunity for Australia to evaluate its approach to international trade and investment and other relevant policy measures.

6.2 Continue to work towards freer markets

Substantial scope exists to lower existing trade barriers

Tariff protection for Australian production averaged about 30 per cent at the start of the 1970s, but has since fallen markedly. The first major reduction was in 1973 with a cut in all tariffs by 25 per cent. In the late 1980s and early 1990s there were further substantial reductions in both tariffs and other forms of protection (figure 6.1). Tariffs are now at or below 5 per cent across the board. Importantly, the bulk of the cuts to protection over this period was the result of the unilateral decisions made by Australia.

Figure 6.1 Rates of assistance to manufacturing and agriculture have fallen significantly in recent decades^{a,b}



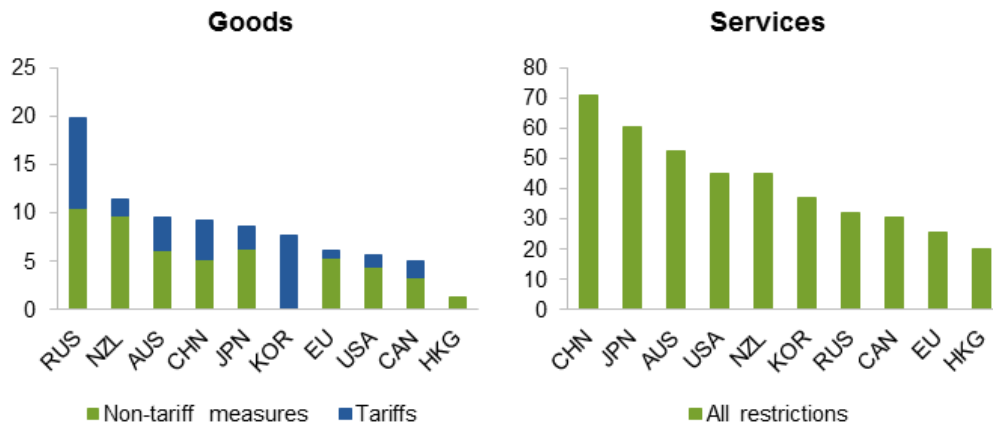
^a Refers to selected agriculture activities up to and including the year 2000-01. From 2001-02, estimates refer to division A of the Australian and New Zealand Standard Industrial Classification which covers agriculture, forestry, fishing and hunting activities. ^b TCF refers to textiles, clothing and footwear; PMV refers to passenger motor vehicles.

Source: Commission estimates (PC 2016b).

Despite these reform efforts, protection in Australia remains higher than in many other developed countries (figure 6.2). Australians would be better off if remaining tariffs were reduced further. However, the bigger prospective gains lie with lowering non-tariff barriers (NTBs) and barriers to services trade in Australia. These barriers take multiple forms (chapter 5) and estimating how much assistance is provided is challenging. For example, requirements that firms bidding for government contracts source or produce locally provide protection, although to what degree is uncertain. However, even using conservative assumptions, some of these barriers to trade are high in Australia and in comparison with other developed countries.

Figure 6.2 **Protection remains higher in Australia than other developed countries^{a,b,c,d}**

Per cent tax equivalent



^a Non-tariff barriers are a subset of the non-tariff measure (NTM) estimates included in the figure for goods. ^b Service barriers are much higher due to differences in statistical estimation; the service values likely include other trade frictions not related to restrictive trade policy as noted in Fontagné, Mitaritonna and Signoret (2016). ^c Due to differing input data sources, goods data is aggregated with 2009 Comtrade data whereas services uses 2011 GTAP data. ^d Small revisions were made to this figure on 27 July 2017.

Data sources: Fontagné, Mitaritonna and Signoret (2016); Kee, Nicita and Olarreaga (2009); PC Global/GTAP 9 bilateral trade values; UN (2017).

Australia could proceed unilaterally to lower barriers

The previous chapter demonstrated the potential lift in living standards that would come from reducing NTBs and barriers to services trade. These would flow even if no marked rise in protection eventuated in other countries (PC 2010). There is no reason why Australia could not proceed unilaterally to lower these barriers. Lowering barriers to *all* countries on a most favoured nation (MFN) basis would confer larger benefits than lowering them preferentially to a relative few. This is because preferential agreements can result in trade diversion, where it is the preferential treatment that makes the agreement partner country the cheaper supplier, giving them an advantage over the lower cost suppliers.

The emergence of GSCs strengthen the case for unilateral action. Today, the research, design, component making, assembly and marketing required to create a product often happen in different parts of the world. Some links in the chain provide services, others provide goods, but they all contribute to the value of the final product. Overall, a significant share of the value embodied in a good exported from one country to another is created in other countries. In the case of the iPhone, for example, only about 5 per cent of the value is added in China and 95 per cent comes from elsewhere (box 6.1).

Box 6.1 **The case of the ‘made in the world’ iPhone**

Looking at where the components of a final product are made alters the way in which trading relationships are viewed. A frequently cited example is China’s exports of iPhones to the United States.

The value of finished iPhones is recorded as Chinese exports and as imports by the receiving country. However, China only contributes around 5 per cent of the value added embodied in an iPhone, mainly in the form of assembly services. The remainder of the value added originates in other countries that supply components and software: Taiwan, Korea, the United States, Germany and others. As such, the iPhone is not made in China as much as ‘made in the world’.

When measured in value added terms, the trade deficit in the US–China iPhone trade is very small. More generally, if the overall US–China trade deficit is recalibrated on a value added basis, it would be reduced by 25 per cent. However, a country’s aggregate trade balance is not altered by measuring trade on a value added basis.

Sources: Dervis, Meltzer and Foda (2013); WTO and OECD (2012).

Because of Australia’s location and its specialisation in the export of raw materials, the foreign value added content of our exports, at around 15 per cent (figure 1.5), is relatively low and primarily lies in mining products shipped to China. For example, Australian iron ore and coking coal exported to China are used to produce steel that is exported to the United States and other countries. Ultimately, however, the benefits for Australia engaging in GSCs do not depend on the type of activities undertaken in the supply chain, but on the extent to which we can become more efficient and extract the full potential from the activities where we have a comparative advantage. Moreover, these activities are not static, domestic reform could reveal new areas of comparative advantage, even if only in one task of the total value of a product or service.

From a policy perspective this means the focus should be on the total value that firms generate and not the share that is being produced domestically. It also means that the ability to participate in GSCs depends on being able to competitively source foreign inputs; foreign inputs are a complement to domestic value added in exports rather than a substitute for them. Openness to foreign investment is also critical as a way into a GSC, as well as bringing in new technologies.

In a world of GSCs, the mercantilist approach that regards tariffs and market access as negotiating coin to be used in exchange for access to a partner’s market misses the point and is clearly self-defeating. Maintaining protectionist measures against imports is the trade policy equivalent of shooting yourself in the foot. Australian export oriented businesses depend on trade and investment openness as well as reliable and competitive energy supplies, efficient customs, port procedures, logistics, communication and transportation networks. Most of the benefits that flow from lower barriers could be achieved sooner with unilateral action, as they do not depend on our trading partners taking similar actions. For example, if Australian energy policy led to reliable and cost-effective supply, the costs of doing business would be lower.

Australia could take a range of unilateral actions. One option would be to extend tariff and other concessions made in preferential trade agreements (PTAs) to other trading partners — that is make them MFN. This would remove the costs associated with complex rules of origin. Another option is to address the many non-tariff measures that add to the cost of doing business across borders. The economic benefits from being a first mover would be predominantly and widely distributed across Australian households and businesses.

CONCLUSION 6.2

The best response to rising protection and other trade developments would be to continue to work towards freer markets.

Australia could proceed unilaterally to lower trade barriers, as most of the benefits do not depend on our trading partners taking similar actions. Scope exists to extend concessions made in preferential trade agreements to other trading partners, and to address the many non-tariff measures that add to the cost of doing business across borders.

The economic benefits from being a first mover would be predominantly and widely distributed across Australian households and businesses.

Barriers to foreign investment

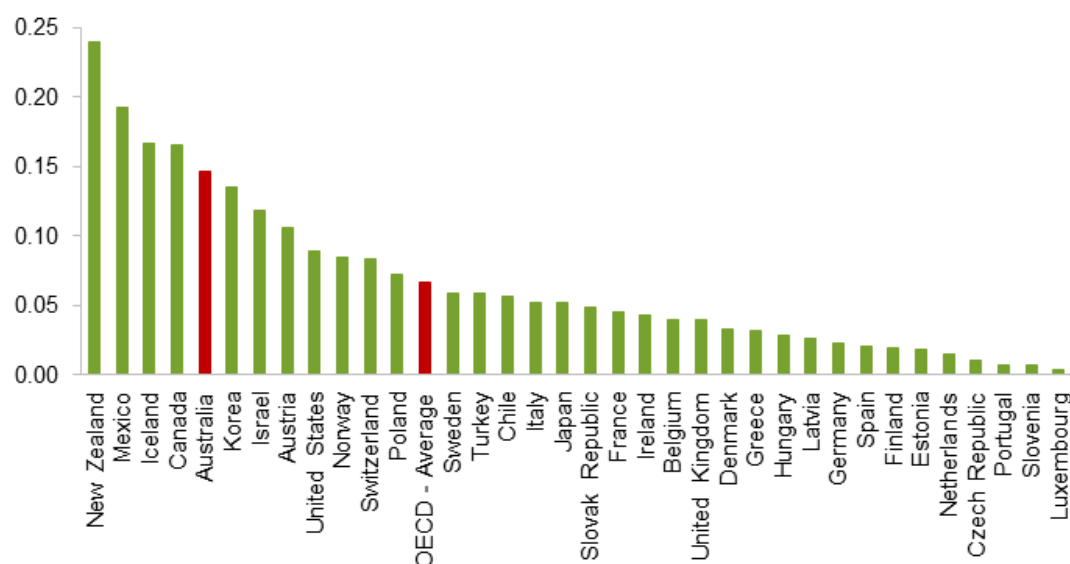
As with non-tariff trade measures, barriers to investment are hard to measure on a consistent basis, due to the myriad ways a government might discriminate against foreign investors. There may be outright limits in specific sectors on equity ownership by foreigners, greater conditionality attached to regulatory approvals, or poor review processes that can act to stop a potential cross-border investment from even proceeding to the approval stage. Also as with non-tariff measures, Australia's foreign investment policy regime is motivated by legitimate objectives. Specifically, they aim to prevent foreign direct investments (FDI) that are not in the national interest, for example, if they pose an unacceptable risk to national security or may erode the tax base. They are not meant to be a barrier to foreign investment that brings net benefits to Australia but can often result in as much without any transparent or explicit cost–benefit analysis.

The OECD publishes information on statutory foreign ownership restrictions, which shows that the degree of investment restrictiveness in Australia has eased over the past couple of decades, but remains at a relatively high level (figure 6.3). This high score partly reflects equity ownership limits in the aviation and communication sectors, but is mostly linked to Australia's screening and approval provisions. FDI proposals subject to screening are rarely rejected, but they often have conditions attached. More broadly, the OECD–UNCTAD monitoring of foreign investment restrictions for the G20 also reveals no evidence of backtracking by countries on their largely open investment policy regimes.

However, existing restrictions on FDI have costs. An OECD study reported that ownership barriers could be depressing FDI stocks by between 10 and 80 per cent, depending on the restriction considered (Nicoletti et al. 2003). A study by the Australian Treasury found

large negative impacts would follow from restrictions to foreign investment inflows (Gali and Taplin 2012). And a Commission inquiry (PC 2016b, p. 527) into the regulation of agriculture concluded that the lower screening thresholds for proposals relating to agriculture introduced in 2015 ‘increase the cost and complexity of investing in Australian agriculture — and ultimately risk deterring foreign investment in the sector — without offsetting public benefits’. The consequence of this may mean Australia’s growth potential and export capacity is lower and our ability to participate in GSCs is curtailed, as often a direct investment is essential to trade.

Figure 6.3 Australia has relatively high restrictions on FDI^a
OECD FDI Regulatory Restrictiveness Index, Selected countries, 2016



^a The FDI Regulatory Restrictiveness Index measures statutory restrictions on FDI across 22 economic sectors. Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is the average of sectoral scores.

Data source: OECD (2017c).

The Commission considers that Australia’s FDI screening processes lack consistency and merit policy attention. The screening thresholds vary by sector and by country, and are generally higher for those countries with which Australia has a preferential trade agreement. One option to simplify the process would be to extend the higher threshold to other trading partners. Some of the screening criteria, particularly when national security concerns are raised, are broad and vague, making regulatory approvals less predictable.

National security concerns have led to the Australian government considering banning outright foreign investment in rail, energy and port assets, as well as creating a Critical Infrastructure Centre to assess the risks of foreign investments in infrastructure. The Centre was created in early 2017, and its work is intended to inform the assessments carried out by the Foreign Investment Review Board. Such a Centre, as well as screening all

investments, should follow clear and transparent guidelines that would help to achieve consistent and predictable approvals for large investments while preserving our vital national security interests.

CONCLUSION 6.3

Australia's reputation as an attractive destination for international investors could be strengthened through more consistent, transparent and predictable foreign investment approval processes while preserving our vital national security interests.

6.3 A better rules-based trade system

In the event of a global rise in protection, Australia would face intense political pressure to follow suit and lift its own barriers to trade and foreign investment. While there is no economic justification to join a trade war and Australians would benefit more, and more quickly, from unilateral action, resisting these pressures would be easier if Australia was part of a coalition of open economies that acted together to pursue freer trade. (The previous chapter illustrated the benefits of a scenario where Australia pursued a strategy of strengthening economic engagement with the fast-growing and like-minded countries in our region.)

Well-designed trade agreements can enable more people to participate in and benefit from the expanded market access opportunities they offer. As demonstrated in the previous chapter, this would help to offset the losses from higher protection elsewhere. The largest prospective benefits would come from agreements negotiated with an extensive group of economies on a multilateral basis.

On the multilateral front, the Doha Round of negotiations occurring under the auspices of the World Trade Organization (WTO) has come to a standstill, and this situation is highly unlikely to change. Moreover, the 'single undertaking' nature of the negotiations means that items cannot be agreed separately — '[n]othing is agreed until everything is agreed' (WTO 2006, p. 1) — and that all members are bound by outcomes in all areas of the negotiations. In the current environment, prospects for consensus at the multilateral level are remote with the possible exception of sector-specific agreements (discussed below).

In response, larger groupings are taking on smaller agendas. The 2015 WTO Ministerial Decision on eliminating agricultural export subsidies and progress towards a Trade in Services agreement are examples of this activity. And many countries are negotiating in smaller groupings, or on a bilateral basis, to make progress where they are able. Australia has been a player in this trend, and has a growing number of PTAs, which lower barriers for agreement partners relative to others (box 6.2).

As well as becoming more numerous, preferential agreements have also become more complex and often lack the institutional and legal strengths of the WTO-led system. The

majority of new agreements coming into force in the past decade have provisions covering 10 or more policy areas, including standards, environmental laws and public procurement. These areas serve to remove obstacles to trade, notably in services, but can also constrain sovereignty.

Past work of the Commission has highlighted how bilateral agreements have not always delivered the expected benefits or earned the broad support of the community (PC 2010). In part, this is due to long phase-in periods for tariff reductions in the most sensitive areas and the costs of navigating multiple agreements with complex rules of origin and regulations, which limit their use by businesses. Recent analysis concluded that rules of origin ‘have become a pernicious barrier to trade for Australian businesses’ (Crook and Gordon 2017, p. 3).

Box 6.2 Australia’s bilateral and regional trade agreements

Australia currently has nine active preferential trade agreements and one regional agreement (with New Zealand and the Association of South East Asian Nations). Negotiations are in train:

- in regional forums — the Regional Comprehensive Economic Partnership, the Pacific Agreement on Closer Economic Relations Plus and with members of the Trans-Pacific Partnership
- on bilateral agreements with the European Union, India and Indonesia (plus, potentially, Hong Kong, and on amending the agreement with the United States).

Australia has also entered numerous bilateral agreements on other aspects of trade. Investment treaties form a majority share of these treaties with 21 bilateral arrangements (AustLII 2017).

Australia’s bilateral and regional trade agreements in force

New Zealand	Singapore	United States	Thailand	Chile	ASEAN & NZ	Malaysia	Korea	Japan	China
1983	2003	2005	2005	2009	2010	2013	2014	2015	2015

There is considerable scope to improve Australia’s approach to trade and investment agreements. Prioritising regional and sector-specific agreements, rigorous upfront due diligence on the impacts of prospective agreements and their net benefits, and better consultation processes would help to achieve better outcomes and foster public confidence in open markets.

Regional and sector-specific agreements should be prioritised

Regional or plurilateral agreements can be a pathway towards securing the benefits of multilateral reform. Initiatives of this kind are on an entirely new scale and can be a world apart from traditional bilateral preferential arrangements. As long as participating countries account for a large share of world trade and remain open to additional participation by

countries committed to meeting these standards, a regional approach to cooperation complements and brings many of the benefits of multilateral agreements.

To date, perhaps the sole leading example of this genre of trade agreement is the Agreement on Trade Facilitation, which recently came into force. Regional agreements such as the Trans-Atlantic Trade and Investment Partnership and the Trans-Pacific Partnership come close in some respects, although neither are in force and the future of the Trans-Pacific Partnership without the United States is unclear, as is that of the Trans-Atlantic Trade and Investment Partnership.

In the near term, a more prospective area for reaching consensus for further liberalisation lies with sector-specific agreements. These are plurilateral agreements negotiated between subsets of WTO members and can be inclusive or exclusive (box 6.3). The inclusive variety has less restrictive trade preference arrangements, and exclusive agreements negotiated under the auspices of the WTO offer some benefits. In particular, they provide a pathway through which non-participant countries can subsequently opt to accede to a completed agreement. WTO processes also potentially make the content of agreements more transparent and the application of WTO dispute settlement processes could lead to more coherent and consistent outcomes.

Box 6.3 Types of sector-specific agreements

There are two main types of sector-specific agreements.

- *Inclusive* (or critical mass) agreements are negotiated on a most favoured nation (MFN) basis and typically come into effect when signatories account for 90 per cent or more of world trade in the product area in question. The Information Technology Agreement is an example, and illustrates the potential for plurilateral agreements to act as a stepping stone to multilateral liberalisation. Partners to the original agreement, concluded in 1996, numbered 29. Over time, the number of participants has increased to 82, accounting for 97 per cent of world trade in information technology products (WTO 2017a, p. 1).
- *Exclusive* agreements are negotiated on a non-MFN basis. Benefits are restricted to participants, making them easier to negotiate. The Trade in Services Agreement currently under negotiation is an example; the Agreement on Government Procurement is another.

Source: Draper and Dube (2013).

Australia is a participant in plurilateral negotiations on a Trade in Services Agreement (in conjunction with 23 parties including the European Union and the United States) (DFAT 2016c), and an Environmental Goods Agreement (involving 18 participants representing 46 countries) (DFAT 2016b). Australia also participated in the expansion of the Information Technology Agreement, agreed to by over 50 WTO members in 2015, and has sought accession to the Agreement on Government Procurement (DFAT 2017c). Australia should continue to work with like-minded countries in the WTO to pursue the groundwork needed to secure genuine multilateral trade liberalisation through the development of inclusive plurilateral and sector-specific agreements. The importance of strengthening in an

even-handed manner the rules-based system governing international trade, which has underpinned the growth in world trade and prevented backsliding into protectionism for the last 70 years, cannot be underestimated.

CONCLUSION 6.4

A plurilateral approach to trade negotiation can bring many of the benefits of multilateral negotiation and may be a stepping stone to multilateral liberalisation. Australia should continue to invest effort in the development of plurilateral or sector-specific agreements, especially those that allow most favoured nation treatment and that can be incorporated into the World Trade Organization.

Only preferential agreements with net benefits should proceed

Despite the issues raised by PTAs, they are an option for reducing barriers to trade and investment in partner countries in situations where broader agreements are unlikely to be reached. The benefits will vary with the characteristics of the agreement and of the trading partners. They are likely to be higher from non-preferential agreements that adopt the MFN principle. Where there are a large number of parties to an agreement, cumulation (treatment of inputs from any partner country as local content in calculating the rules of origin) can come close to MFN treatment, as it expands the share of exports that are eligible for the preference (usually through lower tariffs).

Given the complexity and diversity of agreements, the Commission and others have previously argued the case for adopting a more evidence-based approach to developing trade agreements (JSCTIG 2015; PC 2010, 2015b). It is important that the benefits and costs of a proposed agreement are assessed upfront, and compared with the net benefits of other options for achieving similar reductions in trade and investment barriers.

Australia's approach to the assessment of PTAs could be much improved. Current processes fail to assess the impacts of prospective agreements adequately and they do not systematically quantify the costs and benefits of agreement provisions and alternative arrangements, such as unilateral reform (PC 2010).

CONCLUSION 6.5

Preferential trade agreements are an option for reducing barriers to trade and investment in partner countries. They should only be pursued if a strong case can be made that there is a net benefit and in situations where broader agreements are unlikely to be reached. Agreements that adopt the principle of most favoured nation or cumulation (treatment of inputs from any partner country as local content) have been shown to generate higher benefits.

Consultation processes could be improved

The increasing depth and breadth of issues covered by trade agreements has amplified the importance of good consultation processes in their negotiation. Australians would benefit from processes that enabled greater consultation and transparency in the development of trade agreements. A Commission study in 2010 identified a range of concerns with Australia's processes for developing PTAs, including a 'lack of transparency, coverage and pace of consultations (particularly once negotiations have begun)' (PC 2010, p. 301). Five years later, a Parliamentary inquiry drew a similar conclusion, noting '[t]here is potential ... to make these processes more transparent and open to involvement from business' (JSCTIG 2015, p. vii). Greater transparency, the inquiry argued, 'would assist government decision making during the negotiation process, increase public confidence, and facilitate business planning based on likely benefits and opportunities' (JSCTIG 2015, p. vii).

The Department of Foreign Affairs and Trade provides information and avenues for interested parties to contribute to the development of PTAs. However, the information provided limits the ability to engage in a meaningful manner and falls short of community expectations. For example, participants in the Commission's inquiry into intellectual property arrangements voiced substantial concerns regarding lack of transparency about what is being negotiated in international trade agreements, and inadequate opportunities for public input (PC 2016a), as did contributors into an inquiry into the Trans-Pacific Partnership (JSCOT 2016).

While not everyone can be in the negotiating room and there are risks of succumbing to vested interests, consultation processes could be enhanced. For example, confidentiality agreements could be used to enable formal consultation on draft treaty text with stakeholder bodies during the negotiation process. This would help to identify where benefits are likely to lie, and where costs might be imposed. Similarly, engaging with parties capable of offering critical assessment of proposals, not just parties seeking an advantage or protecting a constituency, would improve the process.

Once a draft agreement is completed, exposing it to public scrutiny before it is signed into law would also help meet community expectations for a more inclusive consultation approach. Giving interested parties the opportunity to evaluate and comment on an agreement draft would build a better understanding of the role of trade in the economy as well as a better appreciation of the choices and their respective pros and cons. This would help to combat perceptions that secrecy during negotiations leads to sub-optimal outcomes for some members of the community and to build support for open markets.

CONCLUSION 6.6

Trade policy making and processes for negotiating trade agreements need to become more open and consultative about the pros and cons of proposed agreements. Confidentiality agreements should be used to give a much broader range of stakeholders — including those capable of critical assessment — access to draft treaty text during the negotiation phase and draft agreements should be exposed to public interest assessment before being signed into law.

6.4 Making trade work for all

Australia and other countries have reaped substantial benefits from trade liberalisation, but trade policy alone cannot ensure that the full potential benefits of liberalisation are realised. Structural change, whether driven by trade, technology, or other factors, means that some people have to change jobs, imposing costs upon them, and some capital loses its value unless it can be repurposed. This dynamic is not new, nor is it unique to Australia. Indeed, the process of resource reallocation is the basis of improved economic performance and the lifting of living standards. However, structural adjustment is slow and rarely happens smoothly. The more drawn out and disruptive the process, the larger the costs. Policies that facilitate adjustment can reduce these costs.

Moreover, even though the nation overall is better off from trade liberalisation, not everyone, or every community is a winner. While much of the adjustment associated with trade liberalisation reform in the 1990s is now likely to be complete, further liberalisation of both tariffs and other barriers to trade would create further adjustment pressures. The adjustment burden associated with past liberalisation was often concentrated on particular groups (while the benefits were spread more diffusely). Lower skilled and older workers employed in sectors where competition with imports intensified tended to be harder hit. Furthermore, those who lost employment were often concentrated within industries and, sometimes, geographic areas, with limited alternative prospects. History shows that these workers typically had a difficult time regaining employment. And, when adjustment costs extend to the local community, they can instil a feeling of being left behind. Assessment of the costs and benefits of potential new agreements would help to identify those who would lose from further liberalisation.

More generally, economies are always being buffeted by shocks. Today, new digital technologies are one of the major sources of adjustment pressure, although for many the perception remains that Australia's economic problems are attributable to open trade policies. In one recent survey, only half of Australians stated that they saw globalisation as a force for good (Wade and Ting 2017). In another, while nearly 80 per cent of respondents thought that globalisation was mostly good for Australia, only 55 per cent thought that free trade was good for creating jobs (Oliver 2017). Regardless of its source, rapid change and a sense of economic insecurity have contributed to erosion in community trust towards globalisation and to pressures for protection from international competition. These

pressures have so far been less evident in Australia than in some other advanced economies, thanks in part to Australia's well targeted social safety net.

Successive governments have attempted to manage the adjustment costs and build support for reform through a range of other policies. These include the suite of policies that support macroeconomic stability and growth, the education and training policies that aim to build solid foundation skills and enable participation in further training and reskilling for displaced workers, and the labour force policies that influence how readily firms can adjust the size and composition of their workforce. Moreover, housing, taxation and investment policies can influence geographic labour mobility. Governments can consider a range of reforms to improve the effectiveness of these policies in supporting structural adjustment (PC 2014).

These companion policies can serve to lessen the disruptive impacts of reform, create an environment that spreads the benefits of globalisation more widely, assist those who lose their jobs to find new work as quickly as possible, and provide a reasonable standard of living for those for whom the process of regaining employment takes longer. They have a vital role to play as the second prong of a strategy that responds to the rising pressure for trade and investment protection.

CONCLUSION 6.7

Trade policy alone cannot ensure that the potential benefits of liberalisation are fully realised or widely distributed. Companion policies are needed to manage the impact of reforms (and other disruptive developments), create an environment that spreads the benefits of globalisation, and assist those who lose their jobs to find new work.

However, the policies supporting structural adjustment should be effective whatever the source of the adjustment pressures. And if those policies are not working well for workers (and stranded capital) displaced by liberalisation, they are unlikely to work well for workers (and stranded capital) displaced by other external and internal sources of structural change.

There is only limited and mixed evidence on how effective policies are in supporting adjustment to change and in extracting the maximum potential from open markets. This is because policies have rarely been evaluated to establish what works well (see, for example, PC 2017).

The evidence that is available suggests that the targeted social safety net generally works well (OECD 2016b). Similarly, recent analysis suggest that the suite of companion policies designed to facilitate and smooth adjustment work well, but there is scope to improve their effectiveness. For example:

- the OECD (2016a) noted that Australia has been relatively successful in providing new (albeit sometimes lower quality) jobs to displaced workers. Among the OECD's

recommendations were greater targeting of assistance to individuals' needs, expanded provision of training for displaced workers, a longer period of notice for collective dismissals and piloting of intensive employment services

- a Commission assessment of impediments to geographic labour mobility concluded that reform of taxation and housing policies and of occupation licensing would lessen impediments to labour mobility (and have broader economic benefits) (PC 2014).

The most effective strategies to facilitate adjustment merit investigation and existing policies should be regularly evaluated.

There are also some policies and government decisions that act to prevent change from occurring. These include localisation rules, regulatory measures that favour domestic companies and products and an increased propensity to use trade remedies (anti-dumping duties, countervailing measures and safeguards) in response to perceived unfair competition by others. They focus on protecting existing jobs and capital, egregious misuse of which amounts to protectionism by stealth. While they may provide some palliative respite, they do not encourage activity based on real comparative advantage and risk triggering reprisals.

Regional adjustment funds that support a targeted sector or provide area-specific assistance for individuals and businesses disrupted by trade have been a fairly common response to structural change, but past experience with such schemes has not been positive (IMF, WB, WTO 2017). 'Although government expenditure on projects can create short-term employment, it often does little to support transition and long-term sustainable growth in regions' (PC 2017, p. 2). Strengthening the social safety net would generally be the preferred approach to support those who are adversely affected by structural change.

Moreover, there is an inherent inequity in providing special assistance to those whose job loss can be traced to international competition while denying access to other workers facing similar adjustment pressures linked to other causes. They may also set an unhelpful precedent, reduce worker incentives to retrain or move and business incentives to innovate (slowing adjustment), and be difficult to end. Recent analysis by Forbes and Barker (2017, p. 12) found that:

... policy interventions that focus on the skills and mobility of people who were previously employed are likely to be more effective in ensuring re-employment than supporting businesses to stimulate local employment.

If in exceptional cases adjustment packages are used by governments, then it is preferable that they focus on supporting people in regional communities or workers in affected sectors to adapt, rather than helping businesses or industries, and that they are based on clear principles. Work by the Commission and others (OECD 2005; PC 2017) has outlined such principles. In particular, regional packages should be: compatible with generally available safety net measures; built on a region's strengths; centred on developing the capacity of the community and the connectivity of the region to domestic and international markets; focused on re-employment; time limited; cost effective; transparent; and have governance

arrangements that ensure accountability for taxpayer funds used. Similar principles apply for packages aimed at assisting workers in affected sectors.

CONCLUSION 6.8

Australia's targeted social safety net generally works well and strengthening it is the preferred approach for supporting those who are adversely affected by structural change. The suite of policies that foster macroeconomic stability and growth, workforce, education and training policies as well as taxation and investment policies that influence geographic mobility also have a vital role to play.

The most effective strategies to facilitate adjustment merit investigation and existing policies should be regularly evaluated to ensure they deliver their intended outcomes.

6.5 Better engagement with the community

The third prong of a strategy to lower pressure for higher protection centres on better engagement with the community around the case for free trade and about the policies in place to manage the costs of adjustment and to support a more inclusive sharing of the benefits from open markets. This is needed to build community acceptance for open markets, which too often is taken for granted. Without this acceptance, it will prove very difficult for governments to continue implementing trade and investment liberalisation policies.

Public misconceptions about international trade abound. Surveys show that public opinion is often based on skewed views about competitive advantage and perceptions of fairness. Lowering obstacles to trade is often seen as benefiting other countries, and most people oppose free trade agreements if they believe they will lead to the loss of existing jobs, even if the community benefits overall and the net effect on employment is positive (Baron and Kemp 2004; Rho and Tomz 2017). But research also shows that when individuals understand the implications of protectionist trade policies, they are more likely to support free trade (Rho and Tomz 2017).

Governments are beginning to recognise that the case for open markets cannot be taken for granted. The promise of a long term growth dividend from structural reform is not enough to allay concerns about the future. Governments are becoming aware of the need to engage the community in an open discussion about trade. The OECD (2017b, p. 18) has recently expressed this sentiment:

We have to change *how* we engage. In the impact of trade, context matters, geography matters. So we need to go local and engage with people where they live. We need to work much more upstream to extend understanding beyond the trade community and before specific agreements. We need to bring trade debates to everyday forums, and reconnect it to everyday experience. Engaging more at the local level may also help better upstream understanding of the likely impact of trade reforms on communities, including in the context of other factors affecting

people at the same time, such as housing and credit markets, alternative employment possibilities, and the availability of social services.

In Australia there has been limited investigation of community concerns about trade and of the more recent consequences of freer trade for Australia. One notable exception is recent work by the Department of Industry (Tuhin and Swanepoel 2017). Taking advantage of previously inaccessible data on the ABS business register, they were able to illustrate that exporters are more productive and pay higher wages than firms focused solely on the domestic market.

More work of this kind is needed to understand how trade affects our economy, how governments, businesses and households have responded and how different groups in the community perceive these effects.

For engagement to be meaningful it must not just focus on the positive news stories. It will be important that the Government acknowledges that, while the community overall will benefit, there will sometimes be members of the community who are losers. At the same time, the community needs to understand what is at stake if tariffs and barriers to trade are reinstated. The Government needs to explain how, and why, the community benefits from trade liberalisation.

CONCLUSION 6.9

Better understanding of community concerns about free trade, improved engagement with the community around the case for open markets and clearer communication about the policies in place to manage the costs of adjustment are needed to build community acceptance of open markets.

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