DISCUSSION PAPER

The Implications of The AUSFTA For Government Procurement:



What Will Australia
Win and Lose

Executive Summary

This paper examines the implications for Commonwealth and State Government procurement policy, industry development policy and employment opportunities arising from the government procurement provisions in the proposed Australia - United States Free Trade Agreement (AUSFTA). Key aspects of findings of the AMWU's analysis include:

- 1. The recently released Centre for International Economics (CIE) Report contains only a partial analysis of government procurement:
 - The report does not deal with state government procurement.
 - The report significantly overestimates the potential gains for Australian firms in exporting to the US procurement market.
 - The report incorrectly assumes that the changes to Australia's procurement regime will not lead to any increase in Australian procurement going to US suppliers and other importers.
 - No attempt is made to assess the impact of abandoning "buy Australian" policies on industry development in Australia.
- 2. In contrast the AMWU analysis of the government procurement provisions of the AUSFTA covers both state and federal procurement. The AMWU estimates that the total US procurement market is likely to be around \$300 billion. However, the data available on foreign access to the US procurement market leads us to conclude:
 - Better access to US Federal and State procurement markets is likely to lead to Australian firms winning less than \$100 million worth of procurement contracts (they already win \$50 million now without the agreement).
 - By 2010, or shortly thereafter, Australia will lose in the vicinity of \$400 million to imports as a result of changes to local procurement policies.
- 3. In support of the above estimates, the AMWU's analysis provides detailed reasons why the proposed procurement policies in the AUSFTA are likely to result in only limited gains to Australian suppliers.

- 4. Both the Commonwealth and the States have received substantial legal advice about the implications of the procurement agreement. Unlike America which has a low cost appeals system, Australia will rely on American firms testing the Australian court system in appeals on due process in tendering and other issues. This will inevitably introduce major uncertainties, delays and substantial costs, particularly in the first several years of the agreement. This could have substantial detrimental consequences for Australian suppliers and State/Commonwealth Governments as the Hughes Case with the C.A.A. on air traffic control systems demonstrated.
- 5. The paper discusses the negative impact that the proposed AUSFTA will have on Australia's capacity to use procurement programs as a lever to promote industry development and employment. The AMWU gives specific examples of State government programs that would not be allowable under the proposed AUSFTA.
- 6. The paper makes the important observation that no Canadian provincial government has agreed to be bound to a procurement agreement with the United States. This is despite the Federal Canadian government signing the World Trade Organisation Government Procurement Agreement.

The paper concludes by arguing that Australia should not have agreed to include procurement provisions in the proposed AUSFTA. The procurement provisions will have a negative effect on local jobs and industries because of the loss of government preferencing of locally sourced goods and services. Perhaps of greater long term significance, Australia will be giving up its current capacity to promote growth in industries of the future such as biotechnology and life sciences, information and comunications technology, electronics and advance materials.

If the proposed agreement is nevertheless ratified by both nations in substantially its current terms the paper argues strongly that Australian State Governments should follow the Candian example and refuse to be bound by the procurement provisions in the proposed AUSFTA.

Australia's Opportunity in the U.S.A. FTA Procurement Agreement: The Potential Size of the Prize

Unfortunately there is no readily available study showing the costs and benefits of Australia agreeing to the AUSFTA and the implications for Government procurement. The CIE study of the AUSFTA released April 30 2004 has half a dozen pages on procurement related issues but it is seriously flawed. The CIE study concludes:

- The Federal U.S. procurement market that Australia can access will be worth around A\$200 billion. The CIE chose to leave out the 27 American States who may also participate or explain why another 10 including California who signed up to the WTO Government procurement agreement in the mid 1990's, are to this point choosing not to participate.
- Of this \$200 billion the CIE notes that Canada wins around \$650 million or around 0.3% of the total federal procurement market.

Accordingly the CIE concludes as follows:

"The Canadians currently make up approximately 0.3 per cent of the US government procurement market through the CCC (CCC 2000). This is worth about \$650 million per year. This figure may underestimate the Canadian share of the market given that it does not include contracts won by Canadian companies independently of the CCC.

While there is no necessary limit to the size of the market that Australian suppliers could achieve, it would be difficult to predict that we would exceed the market share of the Canadians in the short to medium term. It is likely that we would receive a smaller share of the market.

As the Canadian economy is 1.8 times larger than the Australian economy, it might be reasonable to assume that Australia could achieve a market share of about 0.17 per cent of the US Government procurement market, or \$360 million per year. However, this may still be optimistic because the trade and business relationship between Canada and the US has traditionally been stronger than the trade and business relationship between Australia and the US.

Canada is the largest US market for exports and the largest supplier of US imports. Total trade (exports plus imports) between Canada and the US is 20 times as large as total trade between Australia and the US (reflecting, in part, the tyranny of distance). If Australia was to gain only 1/20th of the procurement market that Canada has, we would expect less than \$50 million a year (which is approximately what Australia is already supplying to the US government, even without the Agreement). However, the closeness of the relationship between Canada and the

US has been reinforced by NAFTA and so we could expect Australia to improve relative to Canada upon AUSFTA entering into force.

The likely outcome probably lies somewhere between \$50 million and \$360 million of supply to the US Government per year. Anecdotal evidence suggests that several Australian firms are eager to take advantage of the new US Government procurement market when it becomes available (see chapter 9 for a case study). For the sake of this exercise, we have assumed that the Australian share of the US government procurement market will increase from around \$50 million a year to \$200 million a year (around 0.1 per cent of the total US Government procurement market).

In addition, it is likely that most of this will be concentrated in the \$25 billion market for General Services Administration (GSA), also referred to as Federal Supply Schedule contracts, as this market is easier to break into and offers greater security of work¹."

Having concluded that Australia already wins A\$50 million in the U.S. Federal procurement market and this will rise to \$200 million (or 0.1% of the \$200 billion Federal procurement market) the CIE then concludes Australia has nothing to lose from making the required changes to its own procurement arrangements. The CIE chose not to deal with Australian State Government participation. While having yet to agree, all State and Territory Governments are already included in the draft annex chapter of the procurement agreement (that lists what State Government agencies will be covered). It is common knowledge that the States are being ``pushed" by Canberra to sign up to the Agreement and this will have consequences. As for Federal procurement, the CIE concludes that the only cost to the Commonwealth is administrative changes and ``approaches zero for the purposes of evaluation" ².

So even without considering the situation of the state governments on both sides of the agreement the CIE apparently concludes that Australia wins \$150 more in exports (going from \$50 million to \$200 million) with no apparent increase in imports. In fact the benefits could be even higher with ``higher quality tenders and some increase in competition", in Australia's procurement market.

The problems with the CIE's analysis are highlighted by the following propositions:

• According to the CIE Canada wins 0.3% of the U.S. Federal procurement market and Australia will win 0.1%. So Australia will win one third of what Canada wins.

^{1.} CIE: Economic Analysis of AUSFTA April 2004 pg 46

² CIE: opt cit pg 47.

 However Canada's economy wide share of U.S. imports of goods and services is 16.7% and Australia's 0.7%.

Why will Australia win one third of what Canada wins in the procurement market when we only win 4% of what Canada wins economy wide (0.7% is 4.2% of 16.7%)?

- The CIE also suggests "most" of Australia's additional wins through exports will be to the \$25 billion GSA procurement market. If "most" means say \$75 million that amounts to 0.3% of \$25 billion. Why will Australia win 0.3% when the CCC (in the same paper quoted by CIE) says Canada only wins 0.1% of the U.S. non defence Federal procurement market?
- The CIE study provides no insights into the consequences of State Government participation on either side of the agreement; and it fails to provide any meaningful analysis of the consequences of changing the Australian Federal procurement market and limiting the capacity of the Commonwealth to pursue industry development objectives.

Simply put, the CIE analysis suggests participation in the procurement agreement is "all gain and no pain".

Given that neither the CIE, or DFAT in its National Interest Assessment (NIA) have shed much light on the potential benefits of the procurement agreement (let alone the costs), we briefly examine both in the following short overview.

The Prime Minister Mr Howard and the Trade Minister Mark Vaile have argued on several occasions that the USA FTA gives Australian business an unprecedented opportunity to win business from the A\$200 billion U.S. Federal Procurement market covering virtually all Federal Government agencies in the United States.

Currently Australia is largely excluded from the opportunity as it is not one of more than 80 countries ``designated" under the U.S. Trade Agreement Act or have a specific agreement on procurement with the United States. Nor is Australia part of the WTO Government Procurement Agreement. With access now available if Australia signs up to the U.S. FTA the question is how much of the \$200 billion opportunity can Australian firms expect to win and how much of that will go to our producers of manufactures.

For the moment we will put to one side issues about whether \$200 billion is the right number. Accordingly the first issue to be addressed in answering this question is to estimate the import share of this \$200 billion market and what Australia could realistically achieve from this import share. As one Canadian Report from the Canadian Commerce Corporation (CCC) put it, ``no estimate is available for the total amount of U.S public procurement contracted to foreign suppliers. The General Services Administration does however, report 14,824 federal procurement contracts awarded to foreign contractors amounting to just under \$4 billion or only 2% of the Federal Governments total procurement budget (1998)" ³

Another way of estimating the import share of this \$200 billion procurement market is to use the situation in Canada as a proxy for the United States. According to the WTO the import share of the Canadian procurement market for goods covered by the GATT Agreement on Government procurement is 14% 4. With Canada's import share of GDP around three times that of the United States (35% compared to 12%) this would suggest that the import share of the U.S. procurement market for goods might be a third that of Canada's, or up to 5%.5

Higher estimates of the import share for the U.S. procurement market were reported in a 1996 study by Hoekman and reported by the BIE as around 8%. However that same study (based on early 1990's data) also found the import share in Canada was 19%, while the most recent WTO estimates noted above put the goods import share at 14%. There is also some difficulty in determining whether the 8% estimate applies to goods and services combined when it is generally acknowledged that the import share for services would be considerably lower than for goods. Hoekman also is reported to have found that these import shares remained fairly constant over a decade. These variations in estimates suggest that the import share for goods in the U.S. Federal procurement market may range from say 4% to 8% while for services the import share is most likely to be closer to 2%.

In considering both goods and services, the Canadian Report above also suggests that in the non defense US Federal procurement market Canada only wins 0.1% of total procurement. If Canada's market share of imports economy wide is similar to its share of the non defense Federal procurement market this suggests imports would be less than 1% of the U.S. non defense Federal procurement market. Even if, as argued by CIE, not all Canadian exports to the U.S procurement market go through CCC it is hard, on this estimate, to get an import share above 2%. This reinforces a view that the services import share is 2% or less while the goods import share may be closer to 5% than 8%.

So what might Australia's share of the U.S. Federal procurement market be?

According to a Report prepared by CSES for Victoria's Manufacturing Industry Consultative Council Australia's market share of goods imported into the United States

⁵ Source: DFAT: The APEC Region Trade and Investment 2002 (For Canada/U.S import data economy wide)

³ Source: www.ccc.ca/eng/images/content/market_research/market-us-no-defence-procurement.pdf

⁴ Source: WTO WT/TPR.5/53 Trade Policy Review pg 76 - 79.

⁶ The estimates from Hoekman are reported in BIE : WTO Agreement on Government Procurement : Implications for Australia of Accession 1996.

(economy wide) over the past five years has averaged just over 0.5% ⁷. A reasonable assumption might be that this is also what we achieve in the procurement market.

However the American procurement market is both goods and services and while statistical records show some analysis by sector it is not easy to estimate the breakdown between goods and services or the import share of either ⁸. Under its WTO GPA commitments the United States provides statistical information on procurement in terms of goods, services and construction. There are significant methodological problems in this classification system but based on our assessment of the data the goods component of the U.S. procurement market is close to 60% with services/construction making up around 40%. While Australia's import share for all U.S. goods imports has averaged just over 0.5% over the past five years the share of Australian exports of commercial services to the U.S. accounts for almost double its goods share. That is, around 1% of U.S. imports (economy wide) of commercial services come from Australia. A reasonable assumption might be that this is also what we achieve in the procurement market.

It is also the case that Australia's share of goods imports to the U.S. procurement market is likely to be lower than 0.5%. In part this is because our exports of processed foods over the past five years have achieved a share of total U.S. imports (economy wide) of more than 4% and account for more than 25% of Australia's total merchandise exports to the United States. The U.S. procurement market is much less process food intensive than the total economy.

Our ETM exports on the other hand have accounted for just under 35% of Australia's total merchandise exports to the U.S. over the past five years; and our ETM import share of the U.S. market has averaged only 0.26%. The U.S. procurement market for goods is likely to be more ETM intensive. Thus to assume that over time our share of goods exports to the U.S. procurement market reaches our economy wide goods import share of just over 0.5% is highly optimistic.

The gains Australia might achieve will not occur immediately. The overvalued Australian dollar is likely to hold back our exporters for the next several years. The import market shares quoted previously occurred during a five year period when the Australian dollar averaged less than 60 cents U.S. There is also the ``learning curve" effect of tendering for work in the U.S. procurement market. Discussions with our contacts in Canada suggests that there was a substantial learning curve effect for Canadian exporters to participate in the U.S. procurement market and it is still a matter of some contention about how much there how contestable access really is and much is really

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⁷ All Import share data for Australian goods into the U.S. economy in this paper (unless otherwise specified) come from CSES: ETM Exporter Study Stage One: For Victoria's MICC Dec 2003. The five year period referred to is actually 4 years and 8 months covering the period 1999 to August 2003.

⁸ Federal Data Procurement Centre: The Federal Procurement Report 2002 provides a breakdown of U.S. Federal procurement using FSC Groups and NAICS classifications. However these are not easily translated into goods/services for the procurement that would be covered by the FTA. Nor do they provide data on imports.

⁹ For extensive coverage of the concerns of Canada and the European Union on how the U.S. Procurement System (subject to the WTO GPA) works in practice see: WTO Committee on Government Procurement: Review of National Implementing Legislation - United States 15 June 2001.

There are several other factors that need to be taken into account when estimating the potential wins for Australia from the U.S. procurement market for goods and services.

- a) The U.S. is going through a strong ``protectionist" period, particularly given what happened to American manufacturing during the 2000-2003 period when more than two million manufacturing jobs were lost. Not surprisingly bills have been introduced into both the Senate and the House (by Senator Feingold from Wisconsin and Representatives Brown and Ryan from Ohio) to ``toughen up" the American procurement system and restrict imports. While both bills are ``buried" in committees for the time being it would be surprising if the American procurement market did not become less supportive of imports over the next several years. This is also happening at the State Government level.
- b) In both the Department of Defence and civilian agencies very large corporations (Lockheed, Boeing, University of California, Ratheon, Bechtel, Northrop, Alliant etc) are the major players and some Australian firms already are subcontractors for these majors or service the procurement market from their American based operations or in Joint Venture arrangements. In this respect there is already some market access for Australian firms (with CIE suggesting Australian exports of around \$50 million) and one must be careful (when using market share data) not to double count.
- c) Even after the U.S. Australia FTA comes into effect American exports to Australia of some products such as pressure vessels will enter duty free while most Australian exports of pressure vessels to the U.S. will not be allowed because they do not meet U.S. standards. There is likely to be a number of manufactured products where this is a problem. While mutual recognition of standards is to be addressed by the parties at a later date, there is little evidence to suggest it will not continue as a significant impediment to Australian exports to the United States (both in the procurement market and economy wide) 10.

An additional complication in estimating the size of the potential prize from Australian exports to the U.S. procurement market is what might be won at the U.S. State Government level. During the 1990's 37 U.S. States signed up to the WTO Agreement on Government Procurement. However only 27 have indicated a preparedness to sign up to the Australia-U.S. FTA so far with major exclusions including California.

¹⁰ The ambiguity and uncertainty associated with the AUSFTA mechanisms for mutual recognition of standards is dealt with in some detail in the submission to the Joint Standing Committee on Treaties by the National Association of Testing Authorities, Australia (submission number 23). This ambiguity may also be affected by Article 15.6 of the Procurement Chapter and requirements for utilising international standards in technical specifications in Government tenders.

There are also significant differences in how the U.S. State Governments participate including:

- City or county level governments are not included.
- Each state has the right to exempt certain agencies.
- Many of the U.S. States that signed up to the WTO GPA exempted a number of sensitive procurement areas such as motor vehicles, construction grade steel, printing and construction services.
- The \$ value thresholds for items included in the WTO GPA for the U.S. States are also different (above \$477,000 for goods and \$6.7 million for construction contracts) than the Federal level procurement thresholds in the U.S. Australia FTA.
- A number of preference and set aside arrangements for small business (usually defined in U.S. manufacturing as firms with less than 500 - 1,000 persons employed) apply at both the state and federal level.
- While the CIE has not examined the U.S. State procurement system the same Canadian Report they quote from is quite scathing about access and security of access to that part of the American procurement market:

"Access for Canadian suppliers to U.S. State and local procurement markets is extremely limited thanks to the purchasing preferences exercised under Buy-America and other restrictions and set asides favouring local, small and minority businesses." 11

This may suggest a lower import share in the State procurement market than in the Federal procurement market.

In discussions we have had with Australian State Government officials involved in procurement and the AUSFTA there was a sense of frustration about getting meaningful statistics on how much American State Government procurement would actually be included and what the existing import share was. Simply put, everyone is still trying to get a handle on how much of the procurement market is really contestable. One rule of thumb we could use comes from the study of Deloitte, Touch Tohmatsu in 1994 where they estimated that the U.S. offer to join the WTO GPA included state and utility entities whose procurement that would be included was just under 40% of that of the U.S. Federal procurement offer 12. Thus a working assumption might be that the 27 states in the U.S.

¹¹ Canadian Commercial Corporation 2000 : Non-Defence Procurement Market Opportunities in the U.S. www.ccc.ca/eng/images/content/market_research/market-us-non-defence-procurement.pdf. Accessed 1 May 2004.

¹² Deloitte, Touche, Tohmatsu International: Study of Procurement Opportunities: European Union, Government of the United States. Houston March 1994 quoted in DFAT: WTO Agreement on Government Procurement: Review of Membership Implications 1997.

who have agreed to be part of the AUSFTA might add another A\$100 billion to the procurement market Australia would be competing for.

Thus if we accepted these assumptions, the combined Federal/State U.S. procurement market subject to the AUSFTA might be in the vicinity of A\$300 billion. Of this amount the import share for goods is probably in the range of 4% to 8% with a higher share in the Federal procurement market than in the State market. For services an import share of 2% or less is probably a realistic assumption.

It is certainly possible (as was the case in estimating import shares) to get both higher or lower estimates than \$300 billion. For example in its WTO GPA data the United States submissions show a combined (Federal plus 37 states and related agencies) \$ value of purchases of more than \$US 400 billion, which when converted to Australian dollars at current exchange states would suggest a procurement market in excess of \$500 billion 13. Similarly if certain exclusions are made when there is no actual/potential contestability for foreign suppliers (due to exemptions, set aside arrangements for small business, national security considerations etc) a much smaller estimate of the U.S. procurement market that would be covered by the AUSFTA is possible.

However, at this stage we can at least draw together some working assumptions about what Australian expoters might win from accessing the U.S. procurement market. This can then provide a benchmark against which we can compare what Australian firms stand to lose through the opening up and ``reforming" of Australian Government procurement practices at the Federal and State level.

Our preliminary assessment of what Australia might win from the U.S. procurement market is set out in Table One (covering Federal and 27 States).

As the table suggests:

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• Australia is unlikely to win more than \$60 to \$70 million per annum in exports to the U.S. procurement market in any given year over the short to medium term. If manufactures account for 75% of our goods share then it would, on the numbers above, be unrealistic to assume more than around \$30 million in additional exports. Only some of these export wins will represent additional economic activity for two reasons. First there will be some substitution effects from domestic Australian production. Secondly these estimates will include some of Australia's current indirect participation in the procurement market (put at \$50 million by CIE). For the reasons stated earlier (exchange rate and learning curve effects of

¹³ WTO: Government Procurement: Statistics Reports under Article XIX:5 of the GPA 1996 to 2002. Several State officials we spoke with were dismissive of the notion of a \$200 billion Federal procurement market or \$300 billion if 27 States are included. They expect the actual figure (for the Federal market) to be about \$76 billion once proper exclusions are taken account of. While we accept this, the import share can only be calculated on the total which is what we have used. We also agree with them that the real issue is how well placed Australian firms are to win exports in this market regardless of how "big" the market is.

exporting to the U.S. procurement market) it would take several years to achieve even these small gains.

The bottom line is that while the CIE sees \$200 million of exports to the A\$200 billion procurement market, our analysis suggests that Australia wins less than \$100 million of exports from a \$300 billion procurement market.

Table One: Preliminary Estimates of Australian Exports to the U.S. Procurement Market					
	Scenario One	Scenario Two			
A \$ value of U.S. Procurement Market Covered by AUSFTA					
A) Total	\$300 Billion	\$300 Billion			
B) Goods	\$180 Billion	\$180 Billion			
C) Services	\$120 Billion	\$120 Billion			
A \$ Value of all Imports to the U.S. Procurement Market					
A) Total	\$11.4 Billion	\$13.2 Billion			
B) Goods	\$9 Billion	\$10.8 Billion			
C) Services	\$2.4 Billion	\$2.4 Billion			
A\$Value of Australian Exports to the U.S Procurement Market					
	\$60 Million	\$67 Million			
A) Total	\$36 Million	\$43 Million			
B) Goods C) Services	\$24 Million	\$24 Million			

Notes: The table (in scenario one) assumes that the import penetration ratio for goods is 5% and services 2%. Australia's share of imports into the U.S. procurement market is (after a lag and fall in the exchange rate) 0.4% for goods and 1% for services. (broadly the same as its economy wide import share). For scenario two the import share in the Federal procurement market for goods is set at 7% and 4% for the State procurement market. For services a 2% import share is set for both.

That does not mean Australia cannot or should not do better. But when undertaking a national interest calculation of the potential benefits (to be used later in comparison to the potential costs) it is prudent to be realistic and conservative, particularly at a time when national sentiment in America is particularly strong about "buying American" and protecting American

economic and and services.	national	security	interests	in trade	in high	technology	goods

What Australia could lose if Federal and State Governments sign up to the AUS FTA and the Procurement Agreement

Since the CIE has provided no analysis of what Australia might lose by making the changes required to Federal and State procurement arrangements this section of the paper explores this issue.

The United States clearly believes that having Australia signed up for the Procurement Agreement will result in wins for the United States. As pointed out in the USTR 2004 National Trade Estimate Report on Foreign Trade Barriers.

"Australia is the only major industrialized country that is not a signatory to the plurilateral WTO Agreement on Government Procurement (GPA). As such Australia is not bound by the GPA's rules on open and non-discriminatory policies in government procurement. At both the Commonwealth and State/Territory level, requirements for offsets and similar GPA inconsistent arrangements are systemic. Domestic supplier price preferences are common at the State/Territory level. Under the Australia and NZ Government Procurement Agreement, New Zealand suppliers are afforded domestic supplier treatment. The Australian Government has participated in the WTO Working Group on Transparency in Government Procurement and negotiation of an Agreement on Transparency in Government Procurement. If enacted, the FTA would commit Australia to open its government procurement market to U.S. suppliers, giving U.S. suppliers on important advantage over other foreign competitors 14."

It is also clear that in signing up to the AUSFTA Australian Governments would be required to make a number of changes to procurement practices:

- At the Federal level Australia will need to modify the Australian Government Supplier Arrangement Assessment Procedure as well as policies such as the Model Industry Development Criteria applied to contracts of \$5 million or more.
- At the State level, price preference arrangements where they exist as in NSW will need
 to be altered, and programs such as the Victorian Industry Participation Plan amended,
 at least to the extent that they only apply to small and medium size enterprises
 however defined. The offset arrangements pursued in sectors such as ICT contracts
 would also have to be changed.

The required changes at the state level and their implications for promoting industry and regional development through government procurement will be quite significant and have not been adequately taken into account by the Commonwealth or the CIE.

¹⁴. U.S.T.R National Trade Estimates Report April 2004.

In commenting on DFAT's National Interest Analysis (NIA) of the AUSFTA the NSW Government in its submission to the Joint Standing Committee on Treaties pointed out:

"The NIA reports the anticipated benefits of the proposed AUSFTA, but does not adequately reflect the costs of participation. For example, in respect of government procurement, the NIA does not report the need for Australian governments to forego industry development initiatives including regional development, a significant aspect of procurement policy" 15.

Some of these changes will inevitably mean some Australian firms will lose orders to importers.

However the most profound change will be in terms of what Australian Governments will not be allowed to do in the future with respect to offsets. As the draft agreement states:

"With regard to procurement covered by this chapter, a procuring entity may not seek, take account of, impose or enforce offsets in the qualification, and selection of suppliers, goods or services in the evaluation of tenders, in the award of contracts prior to or in the course of the procurement process."

Offsets are defined in the agreement as:

"Any conditions or undertakings that require use of domestic content, domestic suppliers, the licensing of technology, technology transfer, investment, countertrade or similar actions to encourage local development or improve a party's balance of payments."

This will affect a wide range of existing procurement practices. For example for information/communication/technology (ICT) tenders in excess of \$250,000 in Queensland there is currently a requirement to provide industry development statements on the benefits to local industry and this counts for at least 10% of the weight of the tender. This would not be allowed if Queensland signed up to the U.S. FTA procurement agreement. 16

More importantly these restrictions on offsets (while partly but not exclusively excluding SME's) would prevent or at least seriously constrain future Australian Governments from designing local industry participation programs not in existence today that aimed to ensure local industry benefits from participation in new technologies or new emerging products through the use of Government purchasing.

¹⁵ NSW Government submission to Joint Standing Committee on Treaties April 2004 page 7.

¹⁶ For some insights into Queensland's approach to Government procurement and ICT industries see www.iie.qld.gov.au/comminfo/ciab/downlowds/gr/indpl.pdf. Accessed May 1. Queensland had already determined to change these arrangements to make them more effective. However the offsets provisions in the AUSFTA are so wide ranging and all encompassing that Queensland, if it signs up to the procurement chapter, will never be able to use offsets again, or employ approaches similar to those currently in place for ICT.

Of course in Australia, the State Governments could follow the lead of Canada's Provincial Governments who have consistently refused to sign up to the WTO GPA provisions even though the Canadian Federal Government has. The Canadian Provinces have never accepted that countries like United States provide fair access to Canadian suppliers under the provisions of the WTO GPA. In addition they have maintained a position that what they gain by utilising procurement as an industry development tool for local industry exceeds the potential benefits on offer from access to other countries procurement market through the WTO GPA. As the Federal Government of Canada told the WTO in its last trade policy review:

"The Provinces having reviewed the offers from other signature countries, particularly that of the United States, have concluded that they would not be prepared to commit to coverage of their entities until such members were prepared to improve market access in sectors of priority interest to Canadian suppliers and to agree to circumscribe the use of small business set asides (Buy American provisions) in a manner that would provide Security of Access" 17.

The real question is how much will we lose, particularly Australian manufacturers, if Federal and State Governments do sign up to this procurement agreement.

In assessing what Australia might lose, a major concern about forgoing the potential of new innovative Government procurement policies (because of the restriction on offsets in particular) is how this would diminish the capacity of the nation to enhance Australian Industry participation in knowledge and R+D intensive activities such as ICT, new materials, advanced manufacturing technology etc. As previous studies have shown such activities have a much higher share of high wage/high skill jobs and are expanding more rapidly as a share of world trade ¹⁸.

Since the Inglis Inquiry into Government procurement (particularly technology intensive products) in the 1980's, Australian governments (both State and Federal) have pursued a variety of policies to encourage Australian industry participation in knowledge and technology intensive activities through government purchasing.

¹⁷ WTO: Trade Policy Review of Canada: WT/TRP/5/53 pg 79

¹⁸ Nixon Apple: Export and Innovation Led Growth: The Future Contribution from NSW and Australian Based Manufactures: Oct 2003 pages 32-33 and 36-37.

Particularly important programs that were established by the Commonwealth at the end of the 1980's included the Partnerships for Development Program and the Fixed Term Arrangements Program. Essentially such programs required major multinational corporations in the Information Technology Industries to undertake more R&D, and exports from Australia as well as involve SME's in order to get access to the Commonwealth Government procurement market as endorsed suppliers. While estimates vary, there is evidence to suggest Australia achieved significant benefits from using these procurement arrangements to stimulate local industry participation in knowledge and R&D intensive activities ¹⁹. Even if such schemes in the future were modified to be more WTO consistent they would not be allowed under the offset provisions governing the AUSFTA.

The history of the development of world leading companies in advanced technology goods and services in the United States demonstrates just how important the linkages between Government procurement and R&D contracts have been to America's strength in knowledge and technology intensive industries. As the U.S. National Research Council of the National Academies has pointed out:

"The unprecedented challenges of W.W.2 generated huge increases in the level of government procurement and support for high technology industries. Today's computing industry has its origins in the Government's wartime support for a program that resulted in the creation of ENIAC, one of the earliest electronic digital computers and the Government's steady encouragement of that fledgling industry in the post war period. Following W.W.2 the Federal Government began to fund basic research at universities on a significant scale

These activities were complemented by aggressive procurement efforts during the cold war when the government continued to emphasize technological superiority as a means of ensuring U.S. security. Government funds and cost plus contracts helped to support enabling technologies such as semi conductors, new materials, radar, jet engines, missiles and computer hardware and software.

In the post cold war period the evolution of the U.S. economy continues to be marked by the interaction of Government funded research and procurement and the activities of innovative entrepreneurs and leading corporations.

In the last decade of the 20th century Government support was essential to progress in areas such as micro electronics, robotics, biotechnology, nanotechnologies and the investigation of the human genome. Patient Government support also played a critical role in the development of the internet (whose forerunners were funded by the Defence Department and NSF). Together, these technologies make up the foundation of the modern economy.

¹⁹ For a summary of these programs and their impact see P Sheehan et al: The Rebirth of Australian Industry (Chapter 4) and P. Sheehan et al: Australia and the Knowledge Economy (Chapter 7)

As Vernon W. Ruttan has observed "Government has played an important role in technology development and transfer in almost every U.S. industry that has become competitive on a global scale". Importantly the U.S. economy continues to be distinguished by the extent to which individual entrepreneurs and researchers take the lead in developing innovations and starting new businesses. Yet in doing so they often harvest crops sown on fields made fertile by governments long term investments in research and development."²⁰

Whether for semiconductors through American Government procurement for the Minuteman guided missiles and the Apollo Space Program or other technology applications:

"Government procurement enabled U.S. firms to improve yield and efficiency through volume production and encouraged wider application of IC technology, first in military, then in commercial technologies."

In other nations such as Japan and Korea national objectives for participation in the manufacture of advanced technology products was also linked to preferential procurement of computers and telecommunications. For the European Union and others it has been significant not just in the purchase of goods and services but in validating standards for technology products/services that can provide advantages to the supply chain of firms backed by one nation against another.²¹

The problem for Australia is two fold. First there are those who would argue that despite the WTO GPA and its rules, other nations have still managed to use procurement to the advantage of their domestic firms in support of their national economic development objectives; and that Australia's "Westminster traditions" and commitment to "economic rationalism" will result in our firms losing out as Australia abides by the letter and the spirit of the Agreement and others do not. As DFAT pointed out in its review of the implications of Australia signing up to the WTO GPA in 1996-97:

"A view expressed during the consultations was that foreign government buyers were inherently discriminatory against all but domestic suppliers and that membership of the WTO GPA would not modify this tendency. There was also a degree of scepticism about whether the large economies do, in fact, uphold their obligations under the Agreement; and whether if Australia joined it would be the only one to live up to its commitments."²²

21 Charles W. Wessner opt cit; see also Laurie Tyson: Who's Bashing Whom: Trade Conflict in High Technology Industries Washington 1992; and also Thomas R. Howell: Competing Programs: Government Support for Microelectronics (particularly on the debate about standards for wireless technologies).

²⁰ Charles W. Wessner: Editor: Board on Science Technology and Economic Policy: National Research Council of the National Academies 2002 pp 47-50.

²² DFAT: WTO Agreement on Government Procurement: Review of Membership Implications 1997 page 44.

The second, and by far the most significant problem for Australia is that America, Japan and the European Union's utilization of Government procurement in the past helped provide them with the advantages that they have today in advanced technology industries, so that other mechanisms (such as R&D contracts, collaborative public-private sector programs, or more developed private sector venture capital markets, etc.) can now be utilized to secure further advantage. Australia is significantly behind these nations in knowledge and technology intensive industries and Australia is significantly behind the leading OECD nations in its R&D spend and its private sector venture capital investment levels. Simply put in agreeing to participate in the procurement arrangements of the AUSFTA we would be giving up the opportunity, in many instances, to use strategic procurement to help catch up and to link it to other industry development programs to build firm capabilities and position ourselves in key market niches where sustainable competitive advantages can be developed (in advanced technology products in particular).

This point is reinforced in an article by the AFR's Peter Roberts and his summary of Harvard University Associate Professor of Innovation Johathan West's presentation to CEDA's Innovation Conference.

"Professor West says that Australia's traditional economic policy settings have failed to build a national position in the most recent technological revolutions in computer software and electronics.

Stemming from a failure to establish financial and organisational vehicles to manage special risks in technological innovation, this shortcoming was threatening to repeat itself in biotechnology.

"No successful innovating country today relies on free markets alone to finance innovation," Professor West said.

".... Markets alone neither enable innovators to capture sufficient returns, nor to ensure adequately against the consequences of failure."

Professor West said traditional economics had served Australia well in previous technological areas, allowing the country to participate in the electro-mechanical industrial revolution of the early 20th century as both a producer and consumer of technology.

However, an over-reliance on such "routine" economics might now be retarding the country's innovation performance.

"Nothing intrinsic to Australian society, geography or demograph says it cannot develop world-class technology companies," he said.

Professor West said Australia had developed little venture capital, especially in technologically risky sectors. Its large companies were low spenders on research and development, and governments did not share innovation risk except in a "scattering" of programs designed to help start-ups.

Professor West said the government could reduce innovation risk by providing tax concessions or preference to local suppliers over foreign rivals.

"None of the vehicles most successful in innovating nations that are employed to manage innovation risk are well developed in Australia."²³

These weaknesses in Australia's innovation system and how Australia lags behind other nations in the manufacture of advanced technology products will not be resolved overnight. Even the much anticipated Government package "Backing Australia's Ability Mark 2" is largely additional commitments in a "forward estimates budget approach". It is unlikely to do more than continue what already exists; and even this will take a number of years to really begin to make a difference.²⁴

This situation should make policy makers reflect on what we will actually win from Australian exports of advanced technology products to the U.S. procurement market compared to what we stand to lose by forgoing, to some extent, the ability in the future to link strategic Government procurement contracts to R&D contracts and venture capital backed firms who often need a win in the Government market to demonstrate the track record required to win export contracts.

A recent study of America's trade in advanced technology products helps clarify this issue. Utilising the most recently released U.S. Census Bureau data on trade in advanced technology products (ADP) the study defines ADP as:

- Biotechnology and Life Sciences
- Opto-Electronics
- Information and Communications Technology
- Electronics
- Flexible Manufacturing Systems
- Advanced Materials
- Aerospace, Weapons and Nuclear Technology

Our calculations of data provided in that study show:

 Australia's exports of these products to America are only 9% of what we import from America. While U.S. exports of all goods and services to Australia only account for 1.6% of total U.S. exports, these exports of ADP account for 2.25% of all U.S. exports to Australia. By contrast Australia's exports to the U.S. account for 0.7% of all U.S. imports. But these Australian exports of ADP only account for 0.18% of all U.S. imports of ADP.

In other words, after putting to one side what we already achieve and will achieve in the future through the American Defence Procurement market our other exports of ADP to

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²³ The Australian Financial Review - www.afr.com - Thursday 29 April 2004

²⁴ The Age : "Budget a \$5 billion win for Science" Sunday May 2 2004 and Labor Senator Kim Carr's remark that "the Government needed to spend \$4.8 billion just to maintain status quo."

the non-defence U.S. procurement market are unlikely to be more than a few million dollars (compared to what would otherwise be the case without the agreement).²⁵

By contrast Australian Government procurement at both the Commonwealth and State level is very ADP intensive. We will lose a lot more than a few million dollars by forgoing the opportunities to use this ADP intensive procurement to help Australian based firms develop global market niches that have sustainable competitive advantages. More importantly the restrictions on procurement in the proposed agreement will diminish our capacity to forge new linkages between R&D contracts, venture capital backed firms, government procurement and other mechanisms to strengthen industry and regional clusters who are part of the ADP supply chain.

This does not mean that we will not be able to develop some innovative approaches that continue to foster Australian industry development. Rather it is to suggest that it will be less than what is required given how far behind Australia is and how much remains to be done to "anchor" new goods/services production of technology intensive activities in this country.

The central issues discussed so far can be summarised as follows:

- Australia currently has the potential to use Government procurement to stimulate our ICT and other knowledge intensive industries. It is not using that potential to the fullest extent possible today; nor do policy makers know what possibilities might exist in the future to use such policies or what activities would be most beneficial to apply them to.
- But what we do know is that the offset provisions of the AUSFTA, as well as the other changes required, will seriously diminish our capacity to negotiate with large multinational corporations to enhance Australian industry participation in such activities. The agreement will also constrain policy makers from using procurement for giving preference to larger Australian based business trying to commercialise new technology and leverage up Government contracts to move from the domestic market to export markets. Just how much we will be able to achieve through SME participation (that is partially exempt from the agreement) remains a question warranting further attention.
- It is also in our view most probable that the compliance arrangements and new procurement practices required under the Agreement will diminish a culture in public procurement agencies that seeks to build the capacity of Australian industry through government procurement. The effect of this must not be underestimated and like so many other things cannot be accurately measured by any econometric model. In part this change in culture will come from new compliance arrangements for challenges to Government tender decisions. As the Australian Information Industry Association said in its recent submission.

Opportunities or Loss of Special Status : Nov. 2003.

²⁵ E.H. Pregg: The Threatened U.S. Competitive Lead in Advanced Technology Products: Manufacturers Alliance/MAPI March 2004 (Table 1 page 2 and Table 30 page 27. For Australia - U.S. Overall Import Shares - see: M.T. Yeung, and W.A. Keir Canada and the Australia-U.S. Free Trade Agreement: Enhanced

"The section (of the procurement agreement) on domestic review of supplier challenges will introduce inefficiencies into the market which currently exist in the U.S. The current situation in the U.S. is that the losing supplier challenges all major tender decisions. The result being that suppliers incur additional expenses, time and risk whether successful or challenging" ²⁶.

Both the Commonwealth and the States have received substantial legal advice about the implications of the procurement agreement. Unlike America which has a low cost appeals system, Australia will rely on American firms testing the Australian court system in appeals on due process in tendering and other issues. This will inevitably introduce major uncertainties, delays and substantial costs, particularly in the first several years of the agreement. This could have substantial detrimental consequences for Australian suppliers and State/Commonwealth Governments as the Hughes Case with the C.A.A. on air traffic control systems demonstrated.

Even the CIE analysis acknowledges this when it says "disputes will be settled in a court system which will add discipline to the behaviour of Australian bureaucrats." It only takes a handful of significant dispute settlement cases going through the courts to significantly reinforce a risk averse rules based compliance culture in Government purchasing agencies at the expense of a culture supportive of values and practices conducive to strategic government procurement to foster Australian industry participation.

In addition this change in culture will also be reflected in how public purchasing agencies interface with the industry capability network agencies (formerly known as the Industrial Supply Office Network) and others whose priorities are to find domestic suppliers to replace imports. Increasingly the public sector purchasing agencies will resort only to conventional short term cost based calculations of "value for money" and neo classical economic notions of cost/benefit based on narrow measurements of "consumer welfare" (as utilised by CIE). This will preclude (or at least marginalise) other equally valid comparisons of pursuing industry development objectives. The choice is quite stark. As the U.S. National Research Council of the National Academies puts it:

"Some nations pursue consumer welfare as an implicit if vaguely defined goal, while other nations adopt explicit national economic strategies designed to pursue national economic strength through the acquisition of the capability to manufacture high technology products."²⁷

But the matter does not end here. It is clear that those agencies in State governments dealing with industry development issues in procurement believe that the legal text of the agreement allows them considerable room to develop new initiatives for SME's (however defined) as occurs in the American system. We do not question the good intentions of this proposal. However we point out several constraints that will limit its

²⁶ AllA submission to Joint Standing Committee on Treaties April 2004 pg 5.

²⁷ Charles W. Wessner opt cit page 134.

effectiveness, and because of this limited effectiveness will also lead to additional imports rather than domestic production.

- 1) It has taken the United States several decades to make their small business set aside arrangements work (much to the consternation of their trading partners). Even with a 3 year phase in period the States will find it difficult to really make such a system effective. There is unlikely to be any phase in period for the Commonwealth.
- 2) At the State level the Treasury Department is increasingly involved in procurement and will probably act as a significant constraint to industry department officials looking to build State procurement policies around SME's. Legal challenges are likely to reinforce this tendency and give Treasury the upper hand.
- 3) At best SME's represent 25% of the value of Government procurement. The other 75% of Government purchasing will be severely constrained in its capacity to promote industry development objectives.
- 4) Should State Governments find, in several years time, that the constraints to pursuing industry development objectives through Government procurement are too great there is little practical possibility of withdrawing from the agreement. It's easy enough to add more government agencies to the list of those covered by the agreement but virtually impossible to withdraw from the agreement. Hence the serious reservations that must be expressed again about signing away the use of offsets forever.

In summary then there are at least two factors which will lead to more imports into the Australian procurement market at the expense of local production.

- a) Changes related to exising preference policies and other arrangements as they currently exist.
- b) The opportunity cost of forgoing the future use of innovative new procurement policies to increase Australian industry participation and build firm level capabilities, particularly in knowledge and technology intensive activities.

The question of course is can we estimate what the cost of this would be compared to winning up to \$50 million in additional exports through enhanced access to the U.S. procurement market.

To begin addressing this question requires estimating the size of the Australian government market that would be subject to the procurement arrangements under the FTA. This presents similar problems to the ones encountered when estimating the size and import content of the American procurement market including:

 The Productivity Commission has estimated Australia's Government Procurement Market as 10% to 15% of GDP. However from this one must deduct those areas that would not be included in the FTA procurement arrangements (i.e. local government purchasing, much of defense procurement, motor vehicle purchases, other exemptions etc).

- The most significant problem is determining whether and when State Governments would sign up, particularly since if they do determine to participate they have up to three years to put in place the necessary changes and have some flexibility in defining exemptions and contract thresholds to which the agreement would apply.
- There are no reliable estimates for the import share of Government procurement. We know that under Victoria's Industry Participation Plan (VIPP) in 2001-2002 some \$800 million in contracts were tendered (with VIPP applying to orders over \$3 million in metropolitan centres and over \$1 million in regional Victoria) with local content (being Australia/New Zealand content) being just under 85%. However in 2002-03 14 VIPP projects valued at over \$198 million were completed (some of which originated prior to 2002-2003) with local content only being 54%. Nor does this necessarily represent the situation in other parts of Government purchasing in Victoria that would be subject to the FTA 28:
- It remains unclear how the Federal or State Governments would define small/medium size businesses (SME's) who are largely excluded from some of the more restrictive provisions of the FTA. We do know from studies undertaken by the Commonwealth of Federal Procurement over certain thresholds that around 25% of the dollar value of contracts awarded went to firms employing 200 or less persons (on a full time equivalent basis) ²⁹.
- The import share of manufactures purchased by Australian Governments that would be covered by the FTA would be much higher than in the United States for a number of reasons (particularly the absence of a significant ICT manufacturing base in Australia).
- While the FTA procurement arrangements would only apply to U.S. goods and services
 it is hard to imagine that it could be implemented in such a way as to exclude all
 imports from other countries in competitively tendered situations.

One way of taking these factors into account and quantifying the outcome would be to replicate the BIE study of 1996 that took a range of government procurement instruments and calculated their tariff equivalent effects. Through a general equilibrium model the tariff equivalent effect of abolishing these procurement instruments is then assessed.

²⁸. If only major Government Departments in Victoria are included in the procurement agreement coverage then by 2005 approximately \$3.0 billion would be subject to the agreement rising to around \$4 billion by 2010. Coverage of the outer agencies would take this higher, if such coverage was extended during the 2005-2010 period.

²⁹ Dept of Finance and Administration: Procurement Policy and Practices: Statistics on Commonwealth Contract Notifications 1999-2002.

Two outcomes are possible from such an approach:

- a) In an Orani type CGE model there would be net gains as the increase in imports that followed the abolition of procurement policies was accompanied by lower prices which were stronger than the income effects of lost domestic production. This is in fact what the BIE found in 1996.
- b) In the NIEIR Institute multi purpose model there would be net losses as the lower prices accompanying the increase in imports were more than offset by the contraction in domestic economic activity from local suppliers losing orders.

In fact the NIEIR modelling of such an effect would be supplemented by survey evidence to determine:

• To what extent have domestic firms put in place productive capacity and R&D programs, and other measures to participate long term in this government market; and therefore with reduced certainty because of the abolition of the supporting procurement policies to what extent will the response be far higher than just the loss of one contract. In other words, to what extent would capacity, R&D etc. be substantially rationalised given the changed expectations following on from the abolition of supporting government procurement policies. Such an approach is likely, in our view, to be more realistic; and such an approach is likely to show far larger negative effects relative to the marginal positive effects that would result from a conventional CGE modelling exercise.

However such an approach would only capture what was done in the past or what we continue to do today. It will not capture the opportunity cost of new innovative purchasing arrangements that would be constrained by the very wide ranging definition of offsets contained in the agreement. To do this would require modelling such alternatives while using some previous policies (such as Partnerships for Development Program and Fixed Term Arrangements) as a proxy. Again it is our assessment that the potential benefits such modelling would demonstrate would be quite significant.

In a world of perfect information and where the national interest assessment process managed by DFAT was more than just giving the Trade Minister a story with all the "positive spin" and ignoring the downside potential of an FTA this is what would happen.

In such a world there would also be a confidential strategic and operational report involving government officials, private sector players and strategic consultants that focused on a number of issues including:

- a) If some measures had to be abolished how could they be replicated by other means and how might State-Federal co-operation help leverage up the benfits.
- b) Is their benefit in keeping the States out for now and signing up only to the Federal procurement market (like the Canadians)?

- c) What new approaches could be built around SME's, and how could a strong leadership role from the State Premier ensure that Treasury/Finance officials did not limit such approaches unnecessarily.
- d) Would a better alternative be to take procurement out of the agreement altogether and consider the WTO GPA in 2010 rather than a series of bilateral FTA's and the administrative dilemma's this will cause in the future? Is it the case that State purchasing officials will not discriminate against non-American tenders in the procurement process under the AUSFTA which effectively means Australia has opened its procurement market to all importers but only secured export access to one of the 80 countries in the WTO GPA (the U.S.)? Is it also the case that the BIE in 1996 estimated Australia's export gains through the WTO GPA would be more than 20 times greater than what we win from the American procurement market alone? If this is the case why did we not do this and tell the Americans we would do this, so procurement could be left out of the AUSFTA agreement altogether? Would such an approach also be better served by an appeals mechansim outside Australia's court system or do the courts (with all the potential problems) represent the best option? How would the States and the Commonwealth collaborate to get "WTO GPA ready" by 2010 on both the use of new innovative procurement arrangements to promote industry development on the one hand; and to prepare our exporters for competing in the procurement market of other nations.

Unfortunately, none of this thinking is evident in the CIE/DFAT National Interest Assessment which is devoid of strategic analysis let alone even the most basic data that would be required to make appropriate judgements about the costs and benefits of participation. Accordingly, we make no apologies for providing our best assessment on the costs of Australia signing up to the procurement arrangements based on a qualitative assessment of the issues.³⁰

Based on these and other considerations, table two below provides our preliminary estimates of what Australia could lose from changing Government procurement as required by the AUSFTA. In summary:

- Towards the end of the current decade the dollar value of the Australian procurement market subject to the AUSFTA (both Federal and State) is likely to be in the order of \$15 to \$25 billion. It is likely to grow at a rate similar to nominal GDP (around 6% per annum).
- While the existing import penetration ratio is uncertain the long term economy wide trend of gradual increases in the import share of economic activity is likely to continue in the procurement market as well.

³⁰ None of this is to imply that there have not been constructive and "engaging" discussions between the States and the Commonwealth. Rather it is to reiterate that the National Interest Assessment process has not been adequate in bringing these issues to the centre of the agenda.

- However compared to what would otherwise be the case we believe it is reasonable to assume that by the end of the decade or shortly thereafter Australia will have lost somewhere between an additional 1% to 3% of the procurement market to imports as a result of:
- a) The changes required to existing purchasing arrangements.
- b) Forgoing the opportunity to design, develop and apply new procurement policies, particularly offset arrangements that enhance Australian industry participation in knowledge and technology intensive activities.
- c) The changes that will occur in the culture of government procurement agencies that will diminish the emphasis given to enhancing the opportunities for Australian industry participation.

At the end of the day this assessment is a matter of judgement based on experience and discussions with a number of our colleagues. We know of no econometric model that can adequately capture future human behavior, political imperatives or other factors that will influence the actual outcomes. Hopefully in the future those politicians and public servants responsible for assessing FTA's will take the national interest test far more seriously than has been done on this occasion so that a proper informed analysis can be undertaken.

Table Two: How Much Might Australian Industry Lose By Making the Changes to Government Procurement Policies Required by the AUSFTA				
	Scenario One	Scenario Two		
A \$ Value of Australian Procurement Market (both Federal and State) covered by the AUSFTA	\$15 billion	\$25 billion		
A\$Value of loss of Australian market share of 1% to 3%	\$150 million to \$450 million	\$250 million to \$750 million		

Note: The mid point of the two scenario's would be approximately \$400 million. Less than half this sum would be U.S. imports because of our assumption of putting in place new policies not currently in operation that will affect all imports, not just those from the U.S. Thus the \$400 million involves no double counting of imports from other countries that U.S. imports would substitute for. We have taken that into account. This estimate also captures a small part of the flow on effect described earlier (page 24) from how this would be modelled by NIEIR if full information was available. More than half of the \$400 million would be manufactures.

However the bottom line is this. Even a loss of 0.5% of the Australian procurement market to imports would more than offset the gains we are likely to achieve in exports.

In an era of increasing competition in global markets and with trade liberalisation initiatives restricting the capacity of Government to influence economic outcomes, government procurement is one of the few policy levers left that can be retained to foster industry development. The capacity to do this will be seriously diminished by Australian participation in the AUSFTA.

Conclusion So What's The Bottom Line

Given the lack of detailed and accurate data on either the American or Australian procurement markets and what might actually be contestable, as well as realistic import share data by product group, it is certainly possible to come up with very different estimates of the costs and benefits of Australia agreeing to the AUSFTA.

However our preliminary assessment is that the procurement arrangements in the U.S. - Australia FTA will result in net negative effects for the Australian economy as a whole and manufacturing in particular.

This is because:

- a) Both the CIE and DFAT (in its National Interest Assessment) have overstated the potential benefits and ignored significant dimensions of the potential costs.
- b) Australia's innovation system is weak, its capability in technology intensive goods and services underdeveloped, and forgoing the possibility of pursuing certain industry development objectives to change this through government procurement will diminish further the nation's opportunity to commercialise new technologies and develop niches in global markets with sustainable competitive advantages.
- c) Agreement to change Australia's procurement system will have administrative costs that have not been accounted for; and these changes will also to some extent, change the culture of public sector purchasing agencies making them less disposed to pursue "buy Australian" policies or more targetted and specific industry development objectives. This change will not go unnoticed in the private sector either in terms of their preparedness to participate in the Government procurement market, or in responding positively to Government "jaw boning" and "encouragement" when undertaking their own purchasing to support local industry participation in large private sector projects in the energy, resources and manufacturing sector.
- d) Australia is not "FTA" ready". Our dollar is overvalued making our exports to the American procurement market far more expensive than 18 months ago when the FTA with the U.S.A. began to be seriously considered. And "protectionist sentiment" in America is likely to see their procurement market less rather than more receptive to imports. Australia's ETM export growth has been weak for some time and Government support (through EMDG etc.) is considerably less than it was in the mid 1990's. In addition, as shown in Appendix One to this discussion paper, there are a number of key performance indicators related to R&D, venture capital and high technology exports that strongly suggest the States are not "FTA ready" and should not give up offsets and the capacity to link industry development outcomes to Government procurement.

These and other factors suggest to us that our additional export wins of say \$50 million (on top of the \$50 million we achieve now, and about half that being in manufactures) will be considerably less than around \$400 million of opportunities we are likely to miss out on by changing our existing Government purchasing arrangements (this being the mid point of scenario's one and two in table two). Such change also includes forgoing the use of offsets and other arrangements that may not be in place today but which if implemented could facilitate significant additional net benefits, particularly in technology/knowledge intensive goods and services.

We believe it is incumbent on the State Governments to organise detailed and substantial briefings amongst themselves, their Canadian counterparts and others to explore:

- Why No Canadian Province has ever agreed to be a party to a procurement agreement with the U.S. and the problems they see.
- Why Canadian exporters have had so much difficulty accessing the U.S. Procurement Market.
- What industry and trade policies are required to achieve Australia's strategic economic development objectives and the contribution required from Government procurement policy, particularly for technology/knowledge intensive goods and services.

Since all State Labor Industry Ministers are meeting in Melbourne on May 19, the opportunity exists to begin such a process.

Until these and other issues are addressed no State Government should sign up to the Procurement Agreement. The time has come to search for more reliable information upon which good public policy can be constructed rather than rushing to the agreement table to sign up today.

And the time has also come for all levels of Government to collaborate in finding new innovative arrangements for using public procurement to help build the economic capacity of the nation and its ability to provide working people and their communities with more secure, better paid, higher skill jobs.

APPENDIX ONE:

How FTA Ready are the States to Forgo Offsets Forever and Dimish their Capacity to use Procurement to Promote Industry Development

Table three below shows the most recent data for NSW, Victoria, Queensland and South Australia for 3 key performance indicators that can be improved by Government procurement through offsets or other industry development criteria utilised in Government purchasing.

Table Three: How "FTA Ready" are the States: Key Performance Indicators Related to the Consequences of Forgoing Offsets Forever

	NSW	VIC	OLD	SA
Growth in Business 1. Research and Development Expenditure (Constant 2000-2001 prices) % per annum				
A) Economy Wide1986-87 to 1995-961995-96 to 2001-2002	11.8%	9.3%	13.2%	12.0%
	2.4%	1.4%	5.4%	4.9%
B) Manufacturing1986-87 to 1995-961995-96 to 2001-2002	10.3%	8.2%	18.9%	9.0%
	-2.7%	-0.3%	-1.2%	-0.5%
2)\$Value of all Venture Capital Investment as % of Gross State Product 1996-2002 Compared to:				
A) Canada/United States B) Leading European Union Nations	50%	31%	13%	12.5%
	71%	44%	19%	18%
3) Exports of ICT and Electronics: % per annum				
A) 1990-97	13.6%	20.3%	17.4%	8.1%
B) 1997-2002	-11.5%	-6.9%	9.2%	5.2%

Source: R&D data from ABS 8104 updated at August 7 2003 with National Accounts GDP deflator. Venture Capital is investments at the seed, start-up, early expansion stage. The benchmarks and measurement are explained in: N. Apple: Export and Innovation Led

Growth: The Future Contribution from NSW and Australian Based Manufacturers Oct. 2003 pp 19, 42-43) page 9 for R&D data). ICT Export Data in CSES: Report to MICC Dec. 1 2003 (tables 7.1 to 7.6).

These 3 performance indicators include:

- 1) Research and Development: A possible requirement in offset obligations is to require multinational corporations gaining access to large government contracts, to facilitate additional research and development in the State where procurement access is being sought. The data in the table suggest:
 - After the strong R&D growth in the decade to the mid 1990's real R&D growth has stagnated since and gone backwards in manufacturing. None of the States would appear to be "FTA ready" in terms of giving up the possibility to secure R&D offsets through Government procurement.
- 2) Venture Capital: Most State procurement officials we talked to agreed with the following proposition:
 - The great difficulty in signing up to the procurement agreement is that the constraint on offsets is so wide ranging and it is difficult to foresee what we might want to use them for in the next 5 to 7 years. Yet in signing we are forgoing their use "forever".

While the States have not used offsets to encourage major multinational corporations to invest in Australian businesses at the seed, start up, early expansion stages (directly or through a fund as is done in the U.K. by oil and gas companies) it is certainly an option worth looking at. The great advantage of such an approach is that such venture capital investments:

- Are likely to provide a 15% (post tax and fees) return to investors.
- It stimulates the growth in new knowledge, intensive high growth Australian firms (often commercialising technology) without "compromising" the specific tender in the procurement process.

The key performance indicators in the table clearly show the four States are not "FTA ready" in terms of giving up the possibility to secure venture capital offsets through Government procurement. Even NSW, the State with the highest levels of venture capital investment as a share of GSP in the seven years 1996-2002:

- Only had investments in venture capital that were 50% of the levels achieved in Canada and the United States.
- Only had investments in venture capital that were 71% of the levels achieved in the leading nations of the European Union.

Even when the data is adjusted for the "dot com - dot gone" boom bust cycle there is substantial under investment in all four States in venture capital.

3) High Technology Exports: A possible requirement in offset obligations is to require multinational corporations gaining access to large government contracts to facilitate additional high technology exports. While caution must be exercised in how this is achieved the outcomes can be substantial for additional high wage-high skill jobs.

The data in the table suggest there has been a collapse (particularly in NSW and Victoria) of exports of information communication technology (ICT) products and electronic products since the mid 1990's.

None of the States would appear to be "FTA ready" in terms of giving up the possibility to secure high technology export offsets through Government procurement.

These estimates raise substantial questions for the Premiers of NSW, Vic., Qld. and SA. Our estimates suggest these four States are likely to have procurement of \$10 to \$15 billion (collectively) "bound" by the conditions of the FTA by 2010. Apportioning the gains in exports and loss to imports suggested earlier in this paper would involve:

• The four States winning less than \$40 million of additional exports to the U.S. procurement market while losing some \$250 million to imports from the changes they must make to procurement policies (a net loss of \$210 million).

It would seem that the potential gains through offsets from R&D, venture capital and high technology exports could be quite substantial for these States. The employment implications of losing \$210 million versus say winning the same amount is likely to involve 5,000 to 10,000 jobs (full-time equivalent) with aggregate average weekly earnings per job more than a third higher than all other jobs in these States.

Postscript: May 10 2004

Following completion and distribution of this discussion paper it has come to our attention that:

- a) The Australian States at a meeting of Trade Ministers with Mark Vaile on Friday, May 7, agreed to be included in the procurement agreement subject to clarification of legal issues in bid challenges.
- b) That California and possibly several of the other States in the U.S. have agreed to be included.

None of this changes our assessment in this paper. At most the inclusion of additional American States could increase Australia's possible additional exports by up to a third (i.e. \$50 million now without the agreement and up to an additional \$65 million in the future rather than an additional increase of less than \$50 million).

We also note that on page 25 of the Discussion Paper the number of countries signed up to the WTO GPA should be 27 rather than 80.

We intend to hold further discussions with all levels of Government and Opposition Parties on why the Procurement Agreement is not in the national interest.

And finally, we express both our surprise and anger that any level of Government decided to sign off on the Procurement Agreement prior to the conclusion of the Senate and Joint Treaty Committee deliberations.