

**Australia – USA Free Trade:
Competitive Liberalisation at Work for South Australia**

Andrew L. Stoler¹
Executive Director
Institute for International Business, Economics and Law
The University of Adelaide

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A little less than two years after its launch, the World Trade Organization's latest round of multilateral trade negotiations, the "Doha Development Agenda", has failed to live up to original expectations as to what would be the state of play at this point in time. Meanwhile, Australia and the United States, arguably two of the strongest supporters of the multilateral trading system are each working hard on a number of preferential trade arrangements (PTAs)². One of the more significant of these efforts is the negotiation of a bilateral

¹ The speaker served as Deputy Director-General of the Geneva-based World Trade Organization (1999-2002) and is a retired senior official of the Office of the United States Trade Representative, Executive Office of the President.

² In this speech, I will use the term Preferential Trade Arrangement (PTA) to refer generally to those bilateral and plurilateral trade agreements envisaged in the WTO GATT 1994 (Article XXIV) and GATS (Article V) Agreements. Although customs unions will be included by reference, the bulk of the discussion will be directed at free trade agreements that do not call for common external levels of protection.

Australia – US free trade agreement (AUSFTA) linking the two countries in what would be a combined market of over 300 million consumers.

This sounds impressive, but you will probably not find a serious economist anywhere likely to argue that a bilateral preferential free trading arrangement like AUSFTA would produce greater gains than a successful WTO round. On top of what some argue is a distraction from a needed focus on the WTO talks, the negotiation of the bilateral agreement is consuming no small amount of scarce human and budgetary resources. The acceleration of the negotiating time frame (with an objective of finishing in 2003) has not made matters any easier. So why are Canberra and Washington expending considerable time and resources on AUSFTA when the WTO negotiations are in such strife?

The answer lies in part in the exercise of a policy of “competitive liberalisation” embraced and espoused by politicians and negotiators in both the United States and Australia. AUSFTA and similar initiatives are designed to complement the negotiating effort in Geneva by putting additional external pressure on other players in the Doha process while at the same time producing tangible (and earlier) trade benefits for the business communities in Australia and the USA.

There is also an undeniable (and undenied) political and security aspect to the AUSFTA negotiation that should not be ignored in any discussion of this ambitious initiative.

Multilateralism v. Regionalism

Before getting into the AUSFTA-specific negotiation in any detail, it is worthwhile spending a little time on the “multilateralism” v. “regionalism” debate. There is a general appreciation for the idea that PTAs in certain circumstances can lead to economic effects (trade diversion and misallocation of investment) that actually produce losses in economic welfare. There are also those who seem to argue that there is no such thing as a “good PTA” because any and every PTA is likely to have inevitably discriminatory features that undermine the health of the inherently superior multilateral system. This group is also likely to add that the demonstration effects of PTAs encourage others to do likewise --exacerbating the seriousness of the attack on the MFN principle. For want of a better term, I will refer to this group as the “*Bhagwati Camp*”³. Here in Australia, there are a number of local adherents to the *Bhagwati Camp*, the most active of which seem to be associated with the Australian National University.

³ Professor Jagdish Bhagwati of Columbia University is probably most closely associated with an ongoing effort in support of this view. He has written and spoken extensively on the topic.

How PTAs and the WTO system interact is part of the subject taken up by Richard E. Baldwin in a thoughtful analysis of the causes of regionalism. His general conclusion is that there is no convincing evidence to support the notion that the negotiation of PTAs has hindered multilateral liberalisation or harmed the WTO system⁴. Among other things, Baldwin points out that those countries and regional groupings that most pushed for multilateral liberalisation over the history of the GATT and WTO are the same ones that masterminded and extended liberalisation of trade on a PTA basis

Through his examination of a series of historical developments and the politics surrounding the negotiation and approval of trade agreements, Baldwin succeeds in refuting the argument that PTAs are pursued because they are “easier” than multilateral negotiations under the WTO. He also counters the theory that the big increase in the number of PTAs in recent years can be traced to a conversion of the USA from a “multilateralist” to a “regionalist. To my way of thinking, what is even more interesting about Baldwin’s analysis are the conclusions he reaches in respect of how PTA-based initiatives can be an important motor on a national level for multilateral liberalisation. Baldwin, in effect, provides the intellectual

⁴ Richard E. Baldwin, “*The Causes of Regionalism*” in *The World Economy*, Vol. 20, No. 7, pp. 865-888. [London, 1997]

horsepower to back the arguments in favour of competitive liberalisation.

AUSFTA – A “Third Wave” Agreement

Not only are there a great deal many more PTAs around in 2003 than we saw just a decade ago, but the nature of these agreements is considerably different from bilateral and plurilateral agreements negotiated in the period prior to the establishment of the World Trade Organization in 1995. The scope and coverage of modern PTAs go far beyond the preferential lowering of tariff barriers to include most if not all of the non-tariff aspects of the WTO system (e.g., services, intellectual property rights, product standards, government procurement, etc.). Many PTAs also go beyond the coverage of the WTO in “WTO-Plus” disciplines related to areas like competition policy, investment regulation, dispute settlement, and standards relative to protection of the environment and rights of workers. In its May 2003 Staff Working Paper⁵, the Australian Productivity Commission characterised such modern agreements as “Third Wave” PTAs.

In its report, the Productivity Commission also implies the obvious: the changed nature of modern PTAs complicates the

⁵ Australian Productivity Commission, *“The Trade and Investment Effects of Preferential Trading Arrangements – Old and New Evidence”*, Staff Working Paper, Melbourne May 2003

economic analysis of these agreement's costs and benefits. This is a point I have tried to get across to audiences here in Australia. The predominance in these modern PTAs of provisions liberalising non-tariff (and often “non-trade”) measures makes traditional economic modelling inadequate at best and misleading at the worst. More on this later.

Tariffs and “Rules of Origin”

Modern PTAs like AUSFTA – especially in cases like this where two developed countries are concerned - are not primarily about eliminating tariffs, even if tariff elimination is an understandable and necessary objective of the talks. One reason for this is the fact that tariffs (at MFN rates) are not, generally speaking, much of a problem in trade between the United States and Australia. In the United States, the average MFN tariff stands at just 5.4 percent ad valorem and more than 30 percent of MFN tariff rates are duty-free.⁶ The situation in Australia is not too much different: the average applied MFN tariff is just 4.3 percent and almost half of all tariff lines (48.2%) are duty-free for MFN trade. Only about 15% of all Australian tariff lines qualify for the designation “tariff peaks”⁷.

⁶ World Trade Organization *Trade Policy Review of the United States 2001* (WT/TPR/S/88) pp. xxii and Table III.1, page 25, Geneva, January 2002.

⁷ World Trade Organization, *Trade Policy Review of Australia – 2002* (WT/TPR/S/104) pp. x and Table III.1 (p.30), Geneva, August 2002.

This relatively low incidence of tariffs has several important ramifications for the AUSFTA. (1) With some obvious exceptions, tariffs are not a major impediment to US-Australian trade and therefore not the most problematic aspect of the negotiation. (2) The large number of tariff lines allowing for trade between the two countries duty-free (and into the two countries from third countries at duty-free rates) reduces the significance of potential problems related to complexities in rules of origin. (3) The low tariff levels applicable to MFN imports probably significantly reduce the probability of welfare-diminishing trade diversion.

As far as I can tell, the impact of tariffs on significant amounts of trade reasonably likely to flow between the two countries were it not for a genuinely protective effect of duties is probably limited to imports into Australia from the United States of motor vehicles and parts. In the American market, the protective effect is felt in the cases of “out of quota” beef, dairy and sugar agricultural exports as well as “light trucks” (“Utes” in Australia) falling under the 25% duty dating from the Americans’ “Chicken War” with Europe several decades ago.

The *Bhagwati Camp* makes frequent use in its criticisms of PTAs of Bhagwati’s “spaghetti bowl” argument. The argument posits that differing and overlapping rules of origin resulting

from PTAs can be so complex as to be trade inhibiting in themselves and they will so complicate traders' lives as to actually contribute to higher costs of doing business under a PTA, as well as contributing to trade diversion pressures.

But it seems to me that, on a practical level, in order for rules of origin to be a major issue in AUSFTA, tariff barriers between the USA and Australia and between both countries and third parties would need to be considerably more significant than they are today. PTA rules of origin have no significance at all in the case of MFN duty-free trade and where MFN tariffs are very low, traders will not bother with the rules if compliance costs are high. Remember, average MFN rates in both countries across-the board are only about 5 percent.

In addition, AUSFTA can reasonably be expected (under optimistic scenarios) to enter into force around 1 January 2005. The first cuts in tariffs (many of which will go immediately to duty free) of the Doha Round may kick-in just 12 months later. The point is that the commercial need to spend a lot of time worrying about rules of origin due to the difference between MFN and preferential tariff rates in an AUSFTA context is not very apparent. Complex rules of origin make for a pretty good "spaghetti bowl" speech, but where tariffs are relatively unimportant, the argument is not very compelling.

Agriculture

There will be elements to the FTA with important implications for agriculture – and South Australia's interests in agriculture trade. It will be important for Australia to use the FTA to secure improved access to the USA market for beef, dairy products and sugar – products that are all now heavily protected in the USA by tariff rate quotas with very high out-of-quota duties. Enhanced access to the American market is also important to the future of the wine industry in this country.

For their part, the Americans are looking for changes in the way the AWB conducts its operations and have suggested it would be important to review the scientific basis for many of the quarantine measures now maintained by Australia.

Last Sunday, I saw Andrew Lindberg on television maintaining that the AWB should be off-the table in the negotiations with the USA and that his firm's monopoly operations do not distort trade in wheat. He also argued that the system is the only way for Australian producers to get top dollar for their crops.

Historically, the U.S. view has been that the government granted monopoly leads to a lack of transparency and that single desk operators should consequently be forced to publicly notify purchase and sales prices as well as transactions costs. We will see what happens to the single desk in the FTA, but I can tell you that I have met some people here in South Australia who wouldn't mind seeing some changes to the way AWB conducts its business.

Both the USA and Australia subscribe to the WTO agreement on sanitary and phytosanitary measures and both agree that quarantine measures are necessary and should be based on scientifically sound risk assessment. But this does not amount to a blank check in setting quarantine regulations and testing methods. A lot of people believe certain Australian quarantine measures are over the top. In July, the US won a WTO case against Japanese fire blight restrictions. Australia has been excluding apples from New Zealand and elsewhere using similar restrictions. And I won't say any more about this issue at this stage other than to note that I don't know of anyone who has ever successfully imported a chicken into this country.

To be credible Washington will need to find ways to significantly liberalize existing barriers to beef, dairy and even sugar imports from Australia. With a degree of creativity in the

negotiations, this should be achievable. For example, the Chilean agreement's provisions for market access in agriculture seems to have both good news and bad news for Australia. For beef, Chile will gain unlimited access to the U.S. market at in-quota tariff rates after just four years. In dairy (cheese, milk powder, condensed milk and "other" dairy products), Chile will see quantities available to its exporters increased by around seven percent every year until limitations are fully removed in year 12. In sugar, the year-on-year increase is only five percent, but restrictions on quantities are again totally removed in year 12.

The good news is that nothing has been kept off the table and even these sensitive products will be subject to eventual full liberalisation in the USA. The bad news is that it may take a few years to get there – at least in dairy and sugar.

Beef looks easy. Even the Chilean deal would give greatly enhanced access to the US market for South Australian beef producers.

Dairy is a little harder, but should be workable. Australian dairy exports to the USA in 2001 amounted to just US\$ 84.3 million and a four-fold increase in that trade (an amount Australia might reasonably be expected to achieve over the

medium-term if trade were liberalized) would put total imports from Australia at just 1.8 percent of the gross value of producer milk receipts in 2001. The prospects for meaningful early access will be increased to the extent that the South Australian dairy industry can work with Canberra to negotiate new categories for certain specialty cheeses.

Sugar is an altogether different question. Sugar policy in the United States market has fostered price levels so high that other industries like corn sweeteners depend upon continued high sugar prices for their own continued profitability. Happily, sugar is not a big issue for this State in the FTA.

Recently I attended a conference in Perth where the President of the Western Australian Wine Industry Association, Denis Horgan, suggested that access to the American market is critical to the survival of Australia's 1,581 small and medium wineries. Horgan maintained that small wineries in Australia are being locked out of the domestic market by the Wine Equalisation Tax that results in their having to pay two and a half times the tax per litre that the 20 majors accounting for 95 percent of domestic wine sales do. This – he said - leaves the small operators with no alternative to exporting if they are to remain commercial viable.

The USA is now the largest market for WA premium wine and the industry has a number of objectives in the AUSFTA negotiations designed to increase its access, including issues relating to tariff reduction, labelling and distribution. These issues are all the more important given that South African and Chilean wines now enjoy preferential access to the American market.

Certainly an outcome seen as good for the Western Australian wine industry will be of benefit to the South Australian industry as well.

Third Wave Issues & Precedent

Both Australia and the United States have recently concluded PTAs with Singapore and it seems that both delegations to the AUSFTA talks have found these bilateral precedents useful in guiding their own discussions. Those who would doubt the “third wave” nature of the AUSFTA exercise are well-advised to consult the results of the recent American negotiations with Singapore and Chile, both of which led to PTAs now approved by the U.S. Congress and due to enter into force in the not too distant future. Of course, AUSFTA is its own negotiation and it is a negotiation between two “developed” countries with high standards and low levels of protection vis each others’ trade, so there may be limits to which these earlier

agreements might be seen as precedents in the AUSFTA context. That said, who would imagine either side going back to Congress or the Parliament with a result that was not “better” than that achieved with the developing country partner?

Investment

Investment is very much a “WTO-Plus” or “Third Wave” aspect to AUSFTA. Eleven pages of the Australia-Singapore agreement are devoted to investment. The USA-Singapore investment chapter runs to 42 pages and there are 37 pages in the US-Chile agreement on investment. National Treatment⁸ is a key concept in any agreement addressed to trade and investment and both the USA-Chile⁹ and Australia-Singapore texts state early on that investors from the other party will be given national treatment in relation to the establishment, acquisition, expansion, management, conduct, operation, sale or other disposition of investments in its territory. Both agreements also contain reservations to national treatment commitments for non-conforming measures at central or regional government levels and provisions for investor-state dispute settlement. One discernable difference between the two texts seems to be the provisions in the USA-Chile text providing

⁸ National Treatment is defined as treatment no less favourable than that accorded in like circumstances, to its own investors.

⁹ These general provisions also apply in the case of the US-Singapore FTA.

detailed rules prohibiting or otherwise disciplining the use of “performance requirements” associated with investment approvals.

Certainly, AUSFTA will contain a significant chapter on investment guarantees. Precedent indicates likely rules governing national treatment, most favoured nation, performance requirements, remittances restrictions, expropriations and compensation and some form of investor-state dispute resolution.

Earlier this year, when the Productivity Commission released a new study of past PTAs (most of which did not include the participation of Australia) it suggested that there was perhaps a more significant aspect to study: the impact of PTAs on investment flows. For the first time, the researchers began to look at how the changed nature of the modern PTAs affected their impact on trade and investment patterns. Trade impacts were seen as important, but so too were influences on investment.

On the basis of what the Productivity Commission has found in its study, as well as what its counterpart organisations have found in their own studies in the USA and elsewhere,

it seems more likely that a modern AUSFTA-type agreement would produce trade-related investment-creation or investment-diversionary effects than trade creation or diversion in the classic sense. I won't go into the Productivity Commission calculations here, but the researchers found that in most PTAs there was evidence that FDI responded significantly to non-trade (third wave) provisions of the PTAs and that the result has been net investment creation rather than diversion.¹⁰

The Productivity Commission study suggests further that non-trade provisions in the PTAs “have created an efficient geographic distribution of FDI” and that these kinds of positive effects mean real benefits could be in store as a result of regional negotiations leading to meaningful reforms in competition policy, investment regulation, procurement, etc.¹¹

To me this sounds like potentially good news for South Australia. From every Economic Development Board document I have ever seen, it seems to me that this State has a lot to offer the foreign investor and is actively in search of additional FDI that will help to grow the State's economy.

¹⁰ Productivity Commission at page 101.

¹¹ IBID at 101-102.

Intellectual Property Rights

IPR is another important “WTO-Plus” area for AUSFTA. However, the IPR area is likely to be contentious in the negotiations. The DFAT submission to the Senate appears to foreshadow this when it lists as an objective ensuring:

“that Australia remains free to determine the appropriate legal regime for implementing internationally agreed intellectual property standards, maintaining a balance between the holders of intellectual property rights and the interests of users, consumers, communications carriers and distributors, and the education and research sectors.”¹²

On the basis of what has happened in the American agreements with Chile and Singapore, Australia can expect substantial pressure to change certain of its approaches to copyright protection. This will include enhanced technical protection for digitised copyrighted materials as well as a likely demand from Washington for extension of post-author copyright protection for a period of seventy years (vice 50 years for TRIPS).

¹² DFAT Submission to the Senate, page 66.

Specific practices in Australia that have been targeted by the USA for attention in AUSFTA include Australian policies in respect of parallel imports for CDs, books, DVDs, software and electronic games and the possibility that Australia might allow “spring-boarding” by generic pharmaceutical companies to allow immediate marketing approvals on expiration of patents held by others.¹³

South Australia aspires to become a knowledge-based economy. This makes sense. We are also in a pretty good position, with a strong biotech research base and important defence-related IPR-intensive industries. Overall, while consumers might not like some of the FTA-induced changes, the State economy probably has more to gain than to lose from stronger intellectual property rights protection.

Trade in Services

Very significantly, the AUSFTA services negotiation will be a “top-down” negotiation based on a negative list of exceptions to coverage as opposed to the GATS “bottom-up” positive list approach. In laymans’ terms, this means we start from the assumption that everything is covered, - with full national treatment – unless exceptions and reservations are

¹³ US Trade Representative, National Trade Estimates Report on Foreign Trade Barriers, 2003.

agreed to the contrary. What does this mean for TV content quotas?

Once again, previous agreements give us some guidance. In the Chilean agreement, “culturally”-based restrictions in broadcasting were also at issue. The challenge is to find a way to satisfy both sides with a reasonable approach that recognizes both national sensitivities and economic realities.

What we can expect in the Australian case is what we saw in the US-Chilean agreement. Australians will not be asked to roll-back existing TV-content requirements, but at the same time they will likely be asked not to maintain a wide-open “anything goes” approach to the possibility of further restricting foreign content.

Media dissemination format is another question. Most likely, USTR will want an understanding that restrictive policies should not be extended to new technologies’ dissemination of audiovisual content. In the case of Chile, the tacit understanding as to the status quo was reflected in an exchange of letters.

To the extent that South Australia’s film industry worries about these things, I don’t see any real cause for concern in the likely provisions of the FTA.

Economic Analysis of AUSFTA

Altogether, I know of four quantitative studies that purport to assess the economic welfare aspects of AUSFTA and they come to four very different conclusions. There are also divergent views as to the potential impact of this possible agreement on trade creation and trade diversion. Of the four studies, one found trade diversion and trade creation, with trade creation in AUSFTA calculated as greater than estimated diversion. Another found little trade creation and a great deal of damaging trade diversion. The third and fourth examinations didn't deal with trade diversion on an AUSFTA-specific basis. For my money, the analysis in all of the studies suffers from credibility in that the modelling is inherently incapable of addressing trade creating and diverting effects due to “non-trade” “third wave” provisions in AUSFTA.

The “third wave” character of AUSFTA seriously complicates the job of anyone attempting to predict its economic impact on the United States or Australia. The CIE Study did try to use information from the Productivity Commission and elsewhere to take account of some non-trade influences, mainly

in services, but the other three studies basically relied entirely on studying the impact on trade of tariff elimination.

Different inputs and assumptions produced different results. The CIE found big gains (a four percent increase in Australian GDP by 2010). ACIL's study predicted "slightly detrimental" effects to the Australian economy from completely free trade with the USA. John Gilbert – a Utah State University researcher,¹⁴ also based his analysis only on tariff movements and found small welfare gains for both Australia (0.02 percent of GDP) and the United States (0.01 percent of GDP) – ascribed to an expected improvement of both countries' terms of trade with non-members of AUSFTA. Finally, researchers at the United States International Trade Commission have published an analysis of possible free trade agreements between the United States and sixty-five other countries and found that a PTA between the United States and Australia would be beneficial to both – but not by very much.¹⁵

As I have said before, and as is now supported in part by the Productivity Commission's latest effort, traditional approaches to estimating the effects of these modern PTAs do

¹⁴ CGE Simulation of US Bilateral Free Trade Agreements, John Gilbert, Department of Economics, Utah State University.

¹⁵ Soamiely Andriamananjara and Marinos Tsigas: "Free Trade Agreements with the United States – What can we learn from 65 simulations?", USITC, Washington, DC, June 2003. An agreement with Australia was the 28th most beneficial to the USA of 65 possible agreements. An agreement with the United States created benefits to Australia only 35th out of 65.

not really work. Today, both the Australian and American economies are overwhelmingly services economies, yet the general equilibrium GTAP-type models basically ignore services. More importantly, they also ignore in their limited economic predictions, the potential impact on trading and investment relationships due to negotiated changes affecting technical barriers to trade, intellectual property rights protection, competition policy, mutual recognition agreements, removal of investment restrictions, changes in visa requirements, business-to-business facilitation arrangements and so on.

If we are going to try to judge the economic impacts of these “third wave” agreements, we had better find a better way to assess their non-trade elements’ impact on post agreement trade and investment flows. Otherwise, I am afraid it is just going to be one person’s speculation against another’s (like the four very different studies referred to).

From an economist’s viewpoint, there is some good news on this front. There has been some work done by the Productivity Commission on the issue of quantifying the effects of services liberalisation. In addition, very shortly, the OECD will be releasing a very interesting paper on modelling the economic benefits of services trade liberalisation. With a bit of

luck we may be able to do more meaningful assessments of third wave agreements before too long.

Concluding Remarks

I am not, nor do I purport to be, a serious economist. I am, however, fairly well experienced in trade policy and the political economy of trade negotiations. I am also someone who has devoted the bulk of my career (more than twenty years) to the multilateral system and I have no argument with the economists that put the multilateral system ahead of PTAs on the basis of their contribution to economic welfare.

I would be the last one to support just any PTA as a good PTA. But I do know a lot about what is going on in this one and I know the people who are negotiating the deal. It will be a good deal. In terms of AUSFTA's impact on the WTO negotiations, it could be worthwhile considering whether it fits the "policy ground rules" suggested by the WTO in the 2003 World Trade Report (designed to ensure complementarity between the WTO and PTAs).

Do Australia and the United States refrain (in the AUSFTA) from engaging in regional commitments that

governments would be unwilling, sooner or later, to extend to a multilateral setting? I think the answer must be yes.

Would Australia and the United States agree to a system that would map and monitor the timing and conditions attached to the non-discriminatory, multilateral application of commitments made in their bilateral PTA? Here again, considering the standing commitments made in the APEC context and the position both countries have taken in Geneva in the Doha Round, the answer must once again be yes.

I am pretty sure that AUSFTA will be an agreement that Richard Baldwin would find likely to contribute to the eventual success of the Doha Round. And I am pretty sure that we are talking about competitive liberalisation that works for the interests of this state. Thank you for your attention.