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8 April 2004

Ms Julia Morris
Inquiry Secretary
Joint Standing Committee on Treaties
Parliament House
CANBERRA ACT 2600

Dear Ms Morris:

Re: Proposed Australia-United States Free Trade Agreement

Thank you for your letter of 30 March 2004 inviting a submission to the Joint Standing Committee on Treaties in connection with its review of the proposed Australia-United States Free Trade Agreement. I enclose a submission for the consideration of the Committee.

The enclosed submission reflects my personal views on certain aspects of the Agreement and should not be taken to necessarily reflect the views of the University of Adelaide, Members of the Institute's Board of Governors or Associate Experts working with the Institute.

If the Committee agrees, I would welcome the opportunity to attend the public hearing on the proposed Australia – United States Free Trade Agreement that I understand is planned for 22 April in Adelaide.

Yours sincerely,

ANDREW L STOLER
Executive Director

Enclosure

PROPOSED AUSTRALIA-UNITED STATES FREE TRADE AGREEMENT

Submission to the Joint Standing Committee on Treaties

Andrew L. Stoler
Executive Director
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The University of Adelaide

This submission supports the proposed Australia-United States Free Trade Agreement (hereinafter "AUSFTA") and recommends approval of AUSFTA by the Parliament of Australia. AUSFTA promises many benefits for both Australia and the United States. At the same time, there are very few readily identifiable areas where AUSFTA could be said to worsen the situation of economic actors in either country relative to the position they would be in without AUSFTA. This submission does not seek to comment on all aspects of AUSFTA but will focus on three points: (1) Opportunities through AUSFTA's ongoing institutional arrangements; (2) AUSFTA and the multilateral system of the World Trade Organization (WTO); and, (3) the limitations of current approaches to economic modelling of agreements like AUSFTA.

Opportunities through Institutional Arrangements in AUSFTA

A good deal has been written already about the important gains to trade expected as a result of AUSFTA's elimination of tariffs, opening of government procurement markets and relaxation of investment restrictions. What is often ignored in analysis is the fact that this will be a living agreement with many institutional arrangements that will make it possible for Australians and Americans to pursue a whole range of liberalisation opportunities (and problem solving) in the future.

Some examples are in order. For services, a formal mechanism is to be established in the services chapter that would encourage mutual recognition of educational and professional qualifications of professional services suppliers. In addition, the text foresees a special professional services working group. A financial services committee is to be established with the goal of considering ways to further integrate the two countries' financial services sectors. AUSFTA would set up a committee to deal with sanitary and phytosanitary (quarantine) issues and there would be a separate Standing Working Group on Animal and Plant Health. Through Article 8.9 of the standards and technical regulations section of the Agreement, Australia and the United States would agree to establish a mechanism to address "issues relating to the development, adoption, application or enforcement of standards, technical regulations and conformity assessment procedures".

For manufacturers, farmers and service industries these institutional provisions have a tremendous potential value. The committees and working groups will be there to solve real regulatory and trade issues as they arise. And they will give the two countries' representatives experience in working together to resolve common problems in ways that can only foster an increased level of trust and respect and an enhanced environment for business confidence.

AUSFTA and WTO

Academic economists are in general agreement that both national and global economic welfare are better served by multilateral trade liberalisation under WTO than they are under preferential

trade agreements (PTAs) such as AUSFTA. There is also 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. On the other hand, those who back a policy of "competitive liberalisation" argue that the multilateral system and its periodic rounds of trade negotiations benefit in important ways from the external pressure of PTAs and also from the fact that PTAs often serve as test beds for liberalisation efforts not yet possible on a multilateral scale. Of course, to have a positive effect on the WTO, a PTA must be complementary to the WTO, not incorporate provisions inconsistent with the WTO and comply with WTO rules governing permitted departure from the non-discriminatory principle of MFN.

A variety of measures are used to estimate the number of PTAs in effect in 2004, but a fairly constant 'best guess' puts the number at between 180-200. This is a large number. It is also clear that the number of PTAs has been rising rapidly in recent years and has shown no signs of slowing in the post-1995 WTO era. Close to a hundred of these PTAs have been negotiated since the WTO entered into force and more than seventy are currently under negotiation. Those who are concerned about the threat posed to WTO by PTAs are alarmed by this steep rise. However, the authors of the World Trade Organization's 'World Trade Report – 2003' note that one explanation for the apparent large increase in the number of PTAs relates to the efforts of former COMECON members to re-establish trade links in the period following the collapse of the Soviet Union – with something like one-third of PTAs in the 1990's being concluded amongst Central and Eastern European 'transition economies'. Notwithstanding such qualifiers, PTAs are clearly in vogue. There are at last count 148 Member governments in the World Trade Organization and a larger number (around 170) participating in the current Doha Round of multilateral trade negotiations. According to the WTO's 2003 Report, the number of Members not party to any PTA stands at just four.

How PTAs and the WTO system interact is part of the subject taken up by a well-known economist, Richard E. Baldwin in a thoughtful 1997 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 system. 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. What is even more interesting about Baldwin's analysis is the conclusions he reaches in respect of how PTA-based initiatives can be an important motor on a national level for multilateral liberalisation. Where exporters are the key pro-liberalisation force in a country and those who compete with imported goods and services are the key protectionists, he argues that any liberalisation (PTA as well as multilateral) that acts to increase exports and imports will tend to enhance the influence of exporters and weaken protectionists. Baldwin's arguments mean that we should expect that a comprehensive and genuinely liberalising accord such as the proposed AUSFTA would enhance the power of pro-trade groups in the USA and Australia. This increases the power of these positive groups in their subsequent arguments in favour of liberalisation through the WTO route, diminishing protectionists' chances of undermining the Doha Round's objectives, *inter alia*, in respect of improved treatment of goods from developing countries.

In terms of the WTO rules for PTAs, AUSFTA is a very good agreement. AUSFTA would certainly be found to be consistent with WTO rules in Article XXIV of the GATT and Article V of the GATS. In the GATT (for goods trade), free trade agreements must provide for the elimination of duties and other restrictive regulations of commerce on "substantially all the trade

between the constituent territories". In the GATS (for services), economic integration agreements must have "substantial sectoral coverage" and must not provide for the a priori exclusion of any mode of supply of services. While it is true that the United States did not agree to relax existing import restrictions on sugar and Australia has not undertaken to remove certain restrictions on services trade, the very nearly total coverage of AUSFTA's planned goods and services liberalisation must certainly be interpreted as satisfying the WTO rules. Unhappily, the Members of the WTO have boxed themselves into a corner over the years that has made it practically impossible for the Committee on Regional Trade Agreements to reach a consensus (one way or the other) on the WTO consistency of such agreements.

Attitude is important as well. Some observers contend that Canberra and Washington have shown through AUSFTA that they have a policy preference for PTAs over the WTO. This, they claim, has harmed the chances for a successful Doha Round of WTO negotiations. In terms of AUSFTA's impact on the WTO negotiations, it could be worthwhile considering whether the proposed Agreement fits the 'policy ground rules' suggested by the WTO in the 2003 World Trade Report (designed to ensure complementarity between the WTO and PTAs. WTO suggests we ask two questions:

- Do Australia and the United States refrain (in the AUSFTA) from engaging in regional commitments that the two countries would be unwilling, sooner or later, to extend to a multilateral setting? The answer in the case of AUSFTA is certainly "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 AUSFTA? 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".

Australia and the United States have been clear from the start that their first priority is a successful conclusion to the WTO round and that AUSFTA and other PTAs they have recently pursued are a way of keeping the process moving forward in the interim. Trade officials in both Canberra and Washington know that "competitive liberalisation" only works as a policy if governments strive for trade liberalisation on a multilateral level as well as through PTAs.

Limitations of Economic Modelling for AUSFTA

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 (for example, services, intellectual property rights, product standards, and government procurement). 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 Paper, the Australian Productivity Commission characterised such modern agreements as 'Third Wave' PTAs. The Commission also implies the obvious: the changed nature of modern PTAs complicates the economic analysis of their costs and benefits. The predominance in modern PTAs of provisions liberalising non-tariff (and often 'non-trade') measures makes traditional economic modelling inadequate at best and misleading at the worst.

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. 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'.

Part of the discussion in Annex 9 to the National Interest Analysis produced in connection with the Joint Standing Committee on Treaties' review on AUSFTA is devoted to the limitations of current economic modelling. These limitations are serious and make discussion of AUSFTA's pros and cons on the basis of modelling results problematic. No economists, here or in the USA have the tools they need for a proper a priori assessment of "third wave" agreements like the AUSFTA. This is because AUSFTA is essentially a non-tariff agreement and the economists are more or less limited to modelling the impact of tariff reductions on demand elasticities. So far, four studies have applied current economic modelling approaches to AUSFTA and they have produced four different results – all of them faulty.

The problem is of course not unique to Australia. The situation is the same in the United States. A Commissioner with the International Trade Commission in Washington has complained that the ITC finds it impossible to show that any FTA entered into by the United States produces a positive gain for the country because (a) the analysis is limited to tariffs and (b) nearly all of the economies with which the USA is concluding FTAs are so tiny relative to US GDP that their evident positive effects are too small to impact on the American scene.

Common sense suggests that we should wait. Australia and the United States need some real life experience with this Agreement before it makes any sense to study its economic impact. Five or ten years will create a database on which the Productivity Commission or another group could conduct a sensible study on the basis of real facts and figures. If it should turn out that Australia has been a big loser at that point, there can be an informed public debate as to what should happen next.

Those seeking to evaluate AUSFTA's benefits and costs need to accept that our current tools to model expected economic effects of modern "third wave" PTAs are insufficient because they cannot yet address the trade and investment effects of non-tariff and "WTO plus" provisions in the PTAs. Tariffs are no longer the central issue in the negotiations. Some important work on estimating the effects of the other elements of the agreements has been done, but we seem to be a long way from being able to conduct reliable overall assessments through consistently agreed means.