



Submission to the Senate Select Committee

on

**The Free Trade Agreement between Australia and
the United States of America**

Peter W Gallagher,
Principal Consultant,
Inquit Pty Ltd.

Contents

Summary	2
Overview	2
Economic evaluation	3
Impact on the multilateral trading system	5
Impact on Australian economic policies	5
Opportunities to ‘leverage’ this agreement	6
About Peter Gallagher	11

Summary

This Agreement deserves the Senate's full support because it offers

1. Important benefits for Australia that are not, at present, available by other means, including through WTO negotiation.
2. An opportunity for Australia to build a broader regional regime that will more closely integrate the economies of the Pacific region through trade agreements

Overview

The Australia-United States Free Trade Agreement achieves a still higher degree of bilateral trade liberalization between two economies that—with the notable exception of US agriculture barriers—were already largely open to each other.

One of the **main sources of benefit** to Australia will be a cut in the mostly low barriers that our laws and regulations still impose on doing business across our borders:

- **Goods**—Australia's already low tariffs on imports of manufactures and commodities from the United States will be eliminated from the first day of implementation. Most US tariffs on manufactures (other than textiles and footwear) and on food (other than sugar, beef, dairy, wine, peanuts and horticulture) will also be eliminated.
- **Services**—the 'negative list' approach with a limited number of exceptions appears to further open up, or at least to bind against future protection, a wide range of sectors including the financial sector on both sides.
- **Government procurement**—Australia will open up its procurement procedures for the first time although exceptions remain in place for a range of programs including the Australian Industry Involvement (AII) Defence purchasing program that the Auditor General found to have un-assessable net benefits, if any¹. The USA will make significant purchasing opportunities available to Australia.
- An increase in the Australian **investment** review thresholds (that seem likely to be extended to other parties, e.g. Japan under the NARA treaty)—although arbitrary, non-transparent, discretionary 'national interest' test remains in place

The Agreement does **not achieve its full potential**, however. Its deficiencies include

1. Omission of **sugar** from any trade liberalization; a flaw that implicitly weakens our case for an ambitious reform of agricultural market-access barriers in the WTO negotiations
2. Omission of an **investor-state dispute settlement** procedure that would make the foreign investment guarantees in the agreement commercially meaningful
3. Omission of any provisions facilitating the **temporary presence of natural persons**—particularly key business personnel—that would have made a significant, practical contribution to economic integration

4. Weak provisions on the **liberalization of dairy** (which never achieves a ‘free trade’ status) and **beef** (which, in theory, remains subject to special safeguard action indefinitely) and **horticulture** (which is burdened with minimum price conditions during the implementation period)
5. Burdensome **rules of origin for textiles** that effectively bar any benefits for Australian manufacturers in the US apparel market

Due to these omissions, the economic benefits of the Agreement are likely to be even smaller than the estimates of its modest potential².

In its assessment of the Agreement, the Senate should **consider the context of this agreement** as well as its specific provisions. The Australian government should **leverage the opportunity** inherent in the Australia-United States Free Trade Agreement to begin to build a broader, more coherent, framework of regional agreements in the Pacific region, untangling the confusing skein of (discriminatory) bilateral and plurilateral trade pacts to which Australia itself is contributing. This framework of regional agreements would realize the benefits promised, but so far not delivered, by the APEC agenda and could begin to

Economic evaluation

By the time the Enquiry convenes, the economic modelling commissioned by the Government will be complete. Plausible results from any model will show

1. Relatively **small static gains** from the Agreement
2. Much more **significant dynamic gains** that will be, however, difficult to identify
3. Fears expressed about potential ‘**trade diversion**’ are overblown

It is important to bear in mind, too, that the economic models will not identify some of the significant value in the Agreement arising from the ‘**standstill**’ commitments that both governments will adopt.

Static gains: We know that these will be small because they measure the price impact on the supply balance in the economy due to the removal of the explicit and implicit taxes on doing business across the common border. The Australian and US economies were already mostly open to each other in both goods and services trade (although not in agriculture) so the response of consumers and producers to the change in prices is bound to be small. A close reading of the study commissioned in 2001 from the Center for International Economics on the benefits of the Agreement show that the expected change in prices for goods (for example) from full liberalization of goods trade is less than 5 percent. This is the *average cash value* of the barriers that the agreement will remove. It does not suggest that there are big changes ahead in prices or in tax transfers.

It’s more difficult to measure the barriers that the two sides maintained to each other’s tradeable services, but the CIE study again suggests that they are relatively small.

The net static gains have to take account, too, of a *one-off* loss of government revenue when the duties are removed, some of which are effectively transfers to foreign exporters whose products are no longer being taxed⁴. Of course, formerly protected industries also consider that they ‘lose’: they lose the higher prices that allowed them to ‘bid up’ the price of their inputs (labour, land, materials). But their ‘loss’ is not a loss to Australia; merely a transfer from them to consumers.

Dynamic gains: These are the principal gains from trade and are always likely to be larger than the static results. Dynamic estimates take account of the second-round effects due to the initial changes in prices and production that result from the removal of taxes on doing business across a border. They show the effects of the *gains from specialization* in trade after resources that were formerly locked into lower value activities move to activities where the economy has greater comparative advantage.

Dynamic gains are harder to identify than the static gains, because neither economic modellers nor governments ever know enough about the market to project where the gains will occur. But they are more crucial than the static gains because they reveal the benefits that flow from the closer economic integration of our economy with the economy of the United States, including productivity improvements in our economy that, from a macro-economic viewpoint, are “nearly everything”⁵ that is needed for higher growth and greater prosperity.

Trade diversion: The potential ‘diversion’ of trade away from third countries whose more competitive supply is masked by the margin of preference created by the bilateral deal is a theoretical objection to any discriminatory agreement. Economists have, since the 1950s, disputed whether diversion would be likely to outweigh the creation of trade (a desirable effect of specialization in production) in a free trade agreement. In the past decade or so, it has become possible to measure the effects of actual FTAs and customs union. The results do not, however, provide unambiguous evidence one way or the other⁶. The already-low average barriers to bilateral trade between Australia and the United States reflected MFN tariff rates that will not change as a result of the bilateral agreement. The margin of preference for *regional* imports—the duty-paid price advantage of regional imports over imports from the rest of the world— will, therefore, also be low after the Agreement comes into effect⁷. In these circumstances, there seems to be a very small danger of trade diversion.

“Standstill”: Some of the benefits of the Agreement are unlikely to figure at all in the economic modelling. The ‘standstill’ provisions of the agreement provide a guarantee against future increases in border barriers in the United States to Australian exports, even on those products and services where the liberalization schedule is extended; even on ‘non-conforming measures’ on items covered by the services sector agreement; even on protection for sugar. The significance of this guarantee can be gauged by the uncertainties that surround trade issues in US Congressional and Presidential elections later this year. Trade policies such as the ‘outsourcing’ of manufacturing and services jobs are a foreground issue; in this environment, and in the future, the

‘standstill’ agreement has a real cash value, not only to Australian exporters but also to investors on both sides of the Pacific.

Impact on the multilateral trading system

This agreement represents a creditable effort by the two governments that meets minimum requirements for compliance with WTO rules⁸, but it is not a ‘beacon’ of reform that might inspire the sort of ambitious outcome that Australia is seeking in the Doha round of WTO trade negotiations.

The single reason is sugar. The omission of *any* liberalization of the most protected product in the US agricultural tariff signals that, even in bilateral negotiation with one of its closest trading partners, the USA is unwilling to adopt a comprehensive approach to the reduction of agricultural barriers. The sugar omission says, as if in neon: “we intend to make exceptions to the liberalization of agricultural markets.”

This is a serious blow to Australian (and Cairns Group) hopes in the Doha round of negotiations on Agriculture. It signals that the USA will not only accept but will even demand that ‘sensitive’ products should remain protected; in the US case, sugar. Once that threshold is crossed, the way is opened up for economies with much longer lists of exceptions (the EU, India, Japan, Korea and many developing countries) to insist on maintaining protection for their own ‘sensitive’ products. Since ‘sensitive’ products are, by definition, those with the highest tariffs there will be little prospect in these negotiations of ‘knocking down’ the tariff peaks that cause so much of the damage in world food markets⁹. The exceptions procedure will also make it more difficult to reach agreement on a simple, uniform, harmonizing formula for cutting agricultural tariffs.

The most regrettable aspect of the sugar fiasco is that even a partial result—an increase in the US import quota—would have avoided this very negative signal.

It is possible that, in the context such as the multilateral round where the potential for *reciprocation* of a United States offer to cut sugar protection would be much greater (than in the bilateral negotiation with Australia), the USA may change tack and pursue a ‘no exceptions’ rule.

We can only hope so.

Impact on Australian economic policies

In 1997, in a paper for the Sydney University Center for American Studies¹⁰ I argued that the Australian government should respond positively to the tentative Clinton Administration signals on a US-Australia free trade agreement. My main reason for advocating the agreement was that it would put extend and lock-in into the program of micro-economic reform in Australia that had been pursued strongly up to the early 1990s but had been allowed to drift as, first, recession undermined the appetite for reform and, subsequently, the focus of the Howard government’s economic restructuring efforts shifted to revenue changing the tax mix.

To a large extent that's just what has happened. Although the tariff reductions and services liberalization are discriminatory, the United States is our largest single trading partner counting goods and services together and is a competitive supplier in many sectors. So it is very likely that this agreement will set the baseline in competitive conditions in the Australian market, particularly for manufactures and services. It will make the remaining, generally low, levels of protection against other suppliers—such as the European Union our second largest supplier of goods and services—less sustainable.

The 10-year elimination of Australian tariff on US motor vehicles and parts is a good example. The Government decided in December 2002 to cut the import duty on motor vehicles from 10% in 2005 to 5% by 2010 but to continue to offer the industry a massive bribe; a \$500 million per year transfer from the so-called "Automotive Competitiveness and Investment Scheme" (ACIS) for a further 10 years from 2005 to its termination in 2015. The Agreement's elimination of the tariff on imports of automobiles from the USA by 2015 sets a baseline for the industry that locks-in that policy decision. Even if no cars are imported from the USA, the option to do at zero tariffs makes it unlikely that the industry would be interested in any increase in protection or even the continuation of a 5% rate on vehicles from other sources. The tariff becomes a competitive disadvantage. Since the ACIS transfer is based on tariff credits, the agreement also has the effect of 'locking in' the planned termination date.

Opportunities to 'leverage' this agreement

A healthy WTO is essential for an economy such as ours, which has only a 1 percent share of world trade and depends on commodities for 40% of exports. The most basic reason is that prices for commodities, and therefore our terms of trade, are formed by access to demand in global markets, not bilateral or even regional trade.

The WTO is, however, only limping along. The collapse of the Cancun Ministerial meeting last September confirmed that the old formulas for managing the global system no longer work. The United States and Europe fumbled their attempts to lead governments to a consensus on serious trade conflicts—some of their own making – and on new directions for the Organization.

The governments of the giant developing economies of China, Brazil and India – who must eventually assume more responsibility for the multilateral system – have begun to exert their own leadership. But, lacking the economic dominance of the United States or the support in WTO that Europe can call-up from its post-colonial hinterland, the roles of the developing giants in WTO remain ill defined. They are individually—and through the IBSA initiative, jointly—attempting to build coalitions of support among other developing countries via regional agreements. China is negotiating regional agreements with the ten members of ASEAN and with Korea; India has begun to negotiate a trade pact that is planned to encompass all of South Asia; Brazil has retained its dominance of Latin America despite US attempts to redraw the regional trade map in the Free Trade Areas of the Americas.

Our trade policy outlook, too, comprises a growing menu of 'free trade' agreements. In addition to agreements with New Zealand and Singapore, the government is ready to ratify this Australia-United States FTA and the agreement negotiated in the past

few months with Thailand. It is preparing to negotiate with China—which is simultaneously negotiating with ASEAN and New Zealand—and it has received an invitation from the ASEAN economic ministers that “defrosts” a proposal for an AFTA-CER regional agreement, frozen by Heads of Government at their the 2001 Chiang-Mai meeting. Finally (for the present) there is the possibility that Australia could revisit its formal relations with Japan, to repair the near *non sequitur* of the last Howard-Koizumi talks.

At present, this prospect is little more than a tangle of separately negotiated trade agreements with varying, overlapping geometries and a confusion of liberalization schedules, rules of origin, coverage and dispute provisions. But it need not be. With imaginative diplomacy on the part of Australia, the tangle could be re-configured a something much more beneficial for our own economy and for the future of the regional economy. The tangle could be re-designed to achieve something not unlike the ambitious “APEC regional agenda”

There is a key difference between the current *collection* of FTAs and the APEC agenda that makes such a “Pacific-wide” free trade zone feasible now, where APEC has stalled.

APEC was founded on a promise of ‘unilateral liberalization’ by each Member economy that, predictably, turned out to be (nearly) empty. The idea that, for example, the USA would consider offering other APEC members, including China, ‘free trade’ by 2010 and await China’s ‘non-reciprocal’ implementation of the same policy by 2020 was little more than wishful thinking. It assumed, wrongly, that an analytical observation (that most small countries liberalize their trade barriers, eventually, on a unilateral basis) could be made the basis of a political program.

The current regional negotiations are, by contrast, based on reciprocal obligations that contain a firm program of access improvements embedded in an enforceable bilateral contract.

But there’s a second difference, too that is more in APEC’s favour. APEC sought a uniform standard of liberalization among members; a single ‘free trade’ ideal. *That* ideal has tangible benefits that a series of reciprocal pacts, each one crafted for the interests of its different members will be hard-put to achieve. A collection of overlapping regional agreements, such as we and other regional economies are now creating, will badly undershoot the potential identified in the APEC idea if it embodies—as a result of the different terms and coverage and rules of origin in each pact—the sort of stultifying complexity, ‘tailoring’ of protection, and even schedule reversals that has dogged, for example, the ASEAN Free Trade Area since 1992.

The benefit for Australia of a broader approach to ‘regional free trade’ is that the more diverse the region and the bigger its membership, the greater our own trade benefits and the smaller the hidden costs of trade-diversion. We should be actively planning to extend to our other trading partners – for example, the other members of ASEAN, Korea and, eventually, Japan – the same arrangements that we have agreed with New Zealand, Singapore, Thailand and the USA and that we hope to put in place with China.

There is no need to resile from present commitments in order to turn the present tangle into a design for regional growth. Also, there are a lot of tricky questions about

how to configure such a design¹². But the he Australian government must take some deliberate complementary steps to get the process moving:

1. Develop ideas for the homologation of existing RTAs based on, for example basic compatibility in coverage, liberalization ‘milestones’, standstill provisions and regional extension of non-border provisions e.g. on mutual recognition. That this ‘homologation’ might take the form of a WTO agreement that extended or replaced the current GATT Article XXIV.
2. Create templates for homologation that could apply to all, or at least a large sub-set, of existing and proposed agreements in the APEC region
3. Advocate the idea with other APEC partners beginning at the APEC Trade Ministers’ meeting in Chile in June 2004

An Australian technology

The Australian government is well placed by experience and by its relations with other countries in the region to transform the RTA tangle in to a re-invigorated APEC process.

Australian governments and their advisors have developed some of the best technologies—combining analysis and diplomacy—for crafting multilateral consensus on trade agreements. The outstanding testament to this capacity is Australia’s *unchallenged* chairmanship of the Cairns Group for most of the past two decades: none of the other members considered it could do the job better¹³.

Also, uniquely among ‘western’ economies, Australia is establishing bilateral economic integration agreements with the mega-economies of both the industrial and the developing world as well as with our immediate regional neighbours. It’s possible that China—which has no experience in the design of a WTO-compliant economic integration agreement such as our agreement with the USA—wants to negotiate with Australia to acquire the technology to manage its own future regional negotiations.

These factors give us, now, both opportunity and the ‘track record’ to advocate a new approach to a regional trade settlement¹⁴.

¹ *Audit Report No.46 2002–03* Australian Auditor General. Accessed at <http://www.anao.gov.au/WebSite.nsf/Publications/899EF35C11B1F5FACA256D3D000605A1>

² *Australia—United States Free Trade Agreement*, Center for International Economics (Canberra), June 2001. CIE pointed to gains of about \$US9 – 10 billion on each side over 20 years: real money, but not a large sum for either economy.

³ Of course, we trade more with the rest of the world than we do with the United States, so the impact of the FTA on the health of the world trading system is hardly a disinterested concern.

⁴ Shares in the transfer depend on the price elasticity of demand for imports. A similar transfer of tax revenues ‘foregone’ by government takes place on the US side. It matters to the outcome of this admittedly flawed cost/benefit assessment how you treat the revenue foregone: as a ‘once only’ transfer or as a stream of future earnings foregone. In my view, no government tax (or transfer) can properly be considered as a

stream of future earnings. Since governments are free to vary any tax at any time, the revenue cannot be thought of as having a ‘future value’ that can be hypothecated to the purposes of the beneficiary or discounted like a security.

⁵ *Australia’s economic ‘miracle’*, Banks G., Australian Productivity Commission, talk to the National Institute of Economics and Business, ANU, Canberra, 1 August 2003. Quoting the US economist, Paul Krugman.

⁶ The WTO rules are spelled out in Article XXIV, Add Article XXIV and the Uruguay Round *Understanding on the Interpretation of Article XXIV*. The Australia-US FTA, *prima facie*, meets all of the requirements except that of Para. 3 of the *Understanding* that clarifies the reference in Article XXIV.5(c) to a ‘reasonable length of time’ for the ‘interim period’—that is for the completion of the liberalization under an FTA. This may be more than 10 years only in ‘exceptional circumstances’ that must be explained to the WTO Council. Since the Australia-US FTA provides for an ‘interim period’ longer than 10 years in the case of many products (dairy, beef, horticulture, peanuts etc), the two Governments may have to explain ‘exceptional circumstances’ to the Council. The *Understanding* does **not** however provide for the Council to approve or disapprove of the explanation, so the question of whether any period would actually be in breach of the *Understanding* on this point is moot.

⁷ Economic impacts of an Australia– United States Free Trade Area, Center for International Economics, Canberra, 2001. Table 4.3 shows that full trade liberalization leads to a change in average import prices of about 5 percent.

⁸ *World Trade Report 2003*, World Trade Organization, Geneva 2003, Box BI.2. For example, although there is little evidence of trade diversion in either the EU or NAFTA, the degree of trade creation *due to the regional agreement* is not very large either. The countries in these regions trade with each other more intensely than with the rest of the world, but not much more so than would be expected in any case, given their geographical contiguity and openness to each other’s markets.

⁹ “Peak” tariffs in industrialized countries are defined by WTO as tariff rates over 15 percent. The highest tariff rates in the United States (as elsewhere) are for the most part the ‘out of quota’ rates on agricultural products where access is controlled by a two-part quota (a ‘tariff rate quota’). In fact, although the *median* US MFN tariff on agricultural products is only 2.7 percent, the mean is almost 12 percent; pulled up by a small number of very high tariff rates including 24 lines with tariffs between 100 and 350 percent. See *Profiles of Tariffs in Global Agricultural Markets* (AER-796), USDA Economic Research Service, Washington D.C., 2001

¹⁰ The effect of border protection for agriculture commodities—particularly in the large industrialized economies— is to depress the world price of those commodities to the detriment of developing countries and competitive exporters like Australia. The ‘peak’ tariffs in products such as sugar have the biggest price suppression effect.

¹¹ “*Australia, United States and Free Trade*”, Center for American Studies, Sydney 1987. At the time this was far from an orthodox view: the government did call for an evaluation of the idea from its advisors, who criticised it strongly for a variety of reasons but mostly because it was not the orthodox view.

¹² Among others: the difficulty of defining regional ‘borders’. Unlike the current non-reciprocal APEC proposals (the “Bogor Declaration”), an APEC configured around reciprocal agreements would probably not be ‘open’ to non-reciprocal non-regional economies. One example of this challenge would be to reconcile an ‘APEC’ design with those agreements, such as MERCOSUR and the proposed MERCOSUR-EC agreement, that comprise some APEC economies (e.g. Chile) but also many non-APEC economies. The answer might lie in a WTO agreement that provided a new

multilateral framework for RTAs. As it happens, the mandate for the Doha Round of WTO trade negotiations *already provides* for the negotiation of new rules and procedures for RTAs (paragraph 29).

¹³ The evidence of the past six months, furthermore, shows that the leadership of the ‘G-20’—half of them Cairns Group members—is discovering for themselves immense challenge of coordination on multilateral agricultural negotiations that Australia has managed all of this time.

¹⁴ To succeed, such a strategy would need the support of both the United States and China. But there is no reason to believe that will be difficult. No matter how warm the bilateral relationship, no ‘mega-economy’ is likely to consider a bilateral agreement with a much smaller economy like Australia as an end in itself: the reciprocal benefit is too small. Although the creation of a multilateral network of RTA’s in which neither provides the ‘hub’ might not be a strategic first choice, there are costs inherent in a hub-and-spoke configuration that each could avoid by being a big node in a more balanced network.

About Peter Gallagher

Peter Gallagher is the Managing Director and Principal Consultant at Inquit Pty Ltd where he provides trade and public policy advice to Australian and international businesses and institutions. His clients include some of Australia's largest corporations and peak industry bodies. He also consults to the United Nations International Trade Centre and to the World Trade Organization.

Mr Gallagher is the Asian region coordinator of the World Trade Net and is the convenor of the Business Forum on Economic Relations with China.

He is the author of a number of books and on-line materials published by the World Trade Organization and edits a trade and public-policy focussed website (<http://www.petergallagher.com.au>) recently nominated by the Australian Financial Review as one of Australia's best sites on trade and economic policy.

[Further details in the attached document]