

Australia-USA Free Trade: Competitive Liberalisation at Work in 2003

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A little less than two years after its launch, the World Trade Organisation's latest round of multilateral trade negotiations, the 'Doha Development Agenda', has failed to live up to original expectations. The collapse of the Cancun Ministerial meeting in September, coming on top of missed negotiating deadlines earlier in 2003, has lowered expectations and made completing the round on schedule (before the end of 2004) problematic. 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) — a term which will be used to refer 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. One of the more significant of these efforts is the negotiation of a bilateral 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 few economists 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 seem to be in a bad way?

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.

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Local debate relative to AUSFTA has moved on rapidly from its initial stages when one would find a plethora of newspaper articles and Op-Ed pieces arguing against the negotiation of this proposed agreement. For better or worse, the idea that AUSFTA will be a feature of Australia's economic and political future now seems to be a foregone conclusion. Commentators no longer discuss whether there will be an agreement, but what will be its eventual content and likely impact on Australia and on this country's trade and political interests with third parties. Of course, this does not mean that everyone is enthusiastic about the agreement.

The agreement that will emerge from the negotiations is likely to be a comprehensive agreement of a type that would pass muster under the relevant WTO provisions governing PTAs. AUSFTA is unlikely to result in any significant trade diversionary effects and will contribute to (not detract from) a successful WTO 'Doha Round'. Moreover, the evidence thus far on economic benefit suggests that the USA and Australia will both realise welfare gains from this agreement.

Multilateralism Versus Regionalism

Before analysing the AUSFTA-specific negotiation in any detail, we briefly review the 'multilateralism' versus 'regionalism' debate. As noted above, 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 PTAs. 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. There are also those who seem to argue that there is no such thing as a 'good PTA' because any and every PTA inevitably incorporates 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 label, this group is referred to as the 'Bhagwati Camp' in acknowledgement of Professor Jagdish Bhagwati of Columbia University who is probably the person most closely associated with an ongoing effort in support of this view. Here in Australia, there are a number of adherents to the Bhagwati Camp, the most active of which seem to be associated with the Australian National University.

A variety of measures are used to estimate the number of PTAs in effect in 2003, but a fairly constant 'best guess' puts the number at around 175-180. 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 Organisation'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 Organisation and a larger number (around 170) participating in the current Doha Round of multilateral trade negotiations.¹ According to the WTO's 2003 Report, the number of Members not party to any PTA stands at just four.² This has got to be cause for concern in the Bhagwati Camp.

All economists see value in multilateral liberalisation but not all think there is nothing good that can come out of PTAs. Some economists even see the possibility for PTAs to contribute to further liberalisation on a global level through the multilateral system of the WTO. A lot depends upon the nature of the PTA at issue, however, and later in this paper I plan to examine aspects of the likely result of the AUSFTA negotiations from the standpoint of whether it contributes or distracts from a WTO result and whether it contributes to the economic welfare of its participants.

For now, the question is whether or not — with the Doha Round in some trouble — it is a good idea to be negotiating a PTA between the United States and Australia. How PTAs and the WTO system interact is part of the subject taken up by Richard E. Baldwin (1997) 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 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. This leads us right into the discussion of PTAs and multilateralism and the notion of a 'competitive liberalisation' linkage between the two approaches.

The term 'competitive liberalisation' may well have been coined by Fred Bergsten (1996) when he laid out his views on how preferential trade agreements had worked in the past to stimulate progress in negotiations on the multilateral front, and how a combination of multilateral and preferential efforts might be pursued in a strategy to achieve global free trade. In the very beginning, it was the formation of the European Communities (EC) that led the USA (which could not itself join the EC) to push for the Kennedy Round of multilateral GATT negotiations. Other notable past examples of preferential trading agreements contributing to constructive pressure on the multilateral system include the pre-

¹ The rules agreed for the current round of negotiations permit the participation of those non-Members in the WTO that are in the process of acceding to the Organisation.

² As of March 2003, WTO (2003:46) listed Hong Kong, China, Macao, China, Mongolia and Chinese Taipei, but noted that of these only Mongolia was not engaged in PTA negotiations. Since then, Hong Kong, China and China have concluded a 'Closer Economic Partnership' agreement.

Tokyo Round enlargement of the European Communities and developments in APEC and NAFTA's finalisation in the early 1990's at a time when the Uruguay Round was in real trouble. Bergsten also credits PTA negotiating efforts in the post-Uruguay Round period with keeping up the momentum for trade liberalisation. I would agree with this view. Given the disastrous situation of the WTO system in the 18 months following the 1999 meeting in Seattle, it is probably a very good thing that trade liberalisation efforts were not identified solely with the global system. Bergsten is clearly of the view that while the global multilateral system is the best approach, the 'competitive liberalisation' aspect to PTAs helps to get us where we want to be (global free trade) at the end of the game.

Back to Richard Baldwin's paper which should be required reading for anyone interested in this debate. Many others have argued that the rise in regionalism grew out of frustration with the cumbersome multilateral process and that the straw that broke the camel's back came when one of the system's main defenders, the USA, abandoned its preference for the multilateral system in favour of PTAs. 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'. Baldwin (1997:884) concludes that:

'Rejecting the standard explanation is important since, if it is wrong, many fears concerning regionalism are misplaced. Regional liberalisation did not occur because regionalism was easier, so regional agreements are not necessarily substitutes for multilateral liberalisation. Moreover, since the U.S. was always prepared to pursue regional and global liberalisation in tandem, resurgent regionalism does not mean that the U.S. is disaffected with the WTO-centred system.'

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.

To illustrate the approach, consider how episodic GATT rounds started a liberalisation dynamic in industrialised nations. Announcement of a reciprocal trade talk multiplies the ranks of pro-trade forces by making exporters — normally indifferent to domestic protection — opponents of domestic import barriers. The same goes on in other nations, so the resulting political equilibrium involves liberalised domestic and foreign

markets. While the liberalisations are phased in, export interests get stronger as they expand output and employment. Import competitors get weaker as they scale back or shutdown. (p. 885)

Baldwin argues that each time this cycle is repeated, whether the impetus is bilateral or multilateral, pro-trade forces will be relatively stronger than protectionists at the start of the process. Of course, he also acknowledges that the direction of this dynamic depends upon the nature of the trade agreement. The argument would break down in the face of a negotiation designed to result in an agreement aimed at giving protective cover to import-substituting industries — as in Europe's CAP or certain South-South PTAs. But, in general — and for the purpose of this paper — Baldwin's arguments mean that we should expect that a comprehensive and genuinely liberalising accord such as the proposed AUSFTA will 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.

Not surprisingly, not everyone has read or agrees with Baldwin. One of the recent Australian-based economic examinations into the proposed AUSFTA clearly started from the premise of the Bhagwati Camp and concluded (with little background explanation) that the bilateral agreement would not only produce likely economic losses for Australia but would also work against the interests of Australia in seeing a successful conclusion to the WTO round (ACIL Consulting, 2003). This is a dubious proposition. Apart from the convincing arguments such as those advanced by Baldwin, it is obvious that officials at the highest levels in both Canberra and Washington recognise the limitations of the bilateral route. Progress in AUSFTA is seen as helping to advance a shared interest in the WTO round. US Trade Representative Bob Zoellick has said repeatedly that a necessary criterion to be fulfilled before the United States will enter into a PTA negotiation with another country is that the country in question must be prepared to cooperate with the USA toward a successful outcome in the WTO negotiations.

AUSFTA — A 'Third Wave' Agreement

Not only are there a great deal many more PTAs 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 Organisation 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 (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. No discussion of a PTA at this stage is complete without reference to tariffs and this is also necessary here due to its relevance to a later portion of this paper. But the primary focus will be on those aspects of the AUSFTA we can reasonably expect to be ‘Third Wave’ or ‘WTO-Plus’.

In its report, the Productivity 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. 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 per cent *ad valorem* and more than 30 per cent of MFN tariff rates are duty-free. (WTO 2002a:xxii and 25). The situation in Australia is not too much different: the average applied MFN tariff is just 4.3 per cent and almost half of all tariff lines (48.2 per cent) are duty-free for MFN trade. Only about 15 per cent of all Australian tariff lines qualify for the designation ‘tariff peaks’ (WTO 2002b:x and 30).

This relatively low incidence of tariffs has several important ramifications for the AUSFTA:

- With some obvious exceptions, tariffs are not a major impediment to US-Australian trade and therefore not the most problematic aspect of the negotiation.
- 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.
- The low tariff levels applicable to MFN imports probably significantly reduce the probability of welfare-diminishing trade diversion (discussed later).

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 per cent duty dating from the Americans’ ‘Chicken War’ with Europe several decades ago. Of these sectors, it

is likely that only the beef, dairy and sugar tariffs are difficult issues in the negotiations and that (based on what happened in the USA-Chile Agreement) the issue there is not whether, but how fast, tariffs would be eliminated under the bilateral AUSFTA.

The impact of the low or duty-free tariffs is probably more significant in the rules of origin area. 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. 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 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 at present. PTA rules of origin have no significance 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 five per cent.

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 are likely to be made 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.

Third Wave Issues and Precedent

In April 2003, the Department of Foreign Affairs and Trade (DFAT) tabled a major submission to the Senate Foreign Affairs, Defence and Trade Committee, a substantial portion of which is addressed to aspects of the AUSFTA negotiations (DFAT, 2003). In Annex C of the submission, DFAT lays out nearly four pages of Australian objectives in the negotiations, with more than half of the text devoted to objectives in non-traditional 'third wave' areas.

In addition, 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 with respect to 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. DFAT (2003:66) states Australian objectives in respect of an enhanced framework to govern bilateral investment flows, the reduction of unnecessary regulatory impediments to Australian investors doing business in America and protecting aspects of Australia's own foreign investment review policy. While WTO GATT Article III has been interpreted as not permitting discrimination against imported products in a local content sense (the basis for the TRIMS Agreement) and the GATS provides for the possibility of 'Mode 3' commitments, there are no general investment-regulating provisions in the WTO today. In the Doha Round, the European Communities and Japan have pushed for negotiations aimed at a framework agreement for liberalising commitments in respect of rules governing foreign direct investment. India, together with a number of other developing countries, have strongly opposed the investment initiative in the WTO talks. Developing countries' refusal to agree to negotiations in this area contributed importantly to the collapse of the Cancun meeting.

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 Treatment — defined as treatment no less favourable than that accorded, in like circumstances, to its own investors — is a key concept in any agreement addressed to trade and investment. The USA-Chile, USA-Singapore, and Australia-Singapore agreements state 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 that would appear to be channelled through the International Centre for Settlement of Investment Disputes (ICSID). The USA-Chile text goes into considerably more detail on the operation of the dispute process than does the Australia-Singapore agreement. One discernable difference between the two texts seems to be the provisions in the USA-Chile text providing 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. This seems broadly consistent with DFAT's stated objectives and this

is what the business community (speaking through 'AUSTA') says it wants in this bilateral agreement.

Intellectual property rights

Intellectual property rights (IPR) is another important 'WTO-Plus' area for AUSFTA. Only two and a half pages of the Australia-Singapore FTA are concerned with Intellectual Property compared to twenty-seven pages of text in the USA-Singapore FTA Agreement. The American agreement with Chile is not much different. Protection of IPR through the WTO is currently constrained by what was on the books in 1993 (when the WTO Uruguay Round negotiations concluded). A lot has changed in the past ten years, both technologically and in terms of what has transpired in both the American and Australian markets.

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.' (DFAT, 2003:66)

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 (compared to 50 years for TRIPS). 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 (US Trade Representative, 2003).

Trade in services

Trade in services has been a controversial area for AUSFTA and this is not surprising, given the long history of NGO attacks on the WTO GATS agreement. While Australia seeks enhanced access to the American market for trade in services, an effort is made to appease the NGOs through a promise by Canberra that 'the outcome of the negotiations [will not be allowed] to limit the ability of government to provide public services, such as health, education, law enforcement and social services' (DFAT, 2003:66). Australia has also been notably sensitive to the perceived interest of the USA in using this negotiation to get at restrictive measures such as Australian TV content regulations.

Although the GATS agreement at the WTO covers services trade, and many aspects of the bilateral negotiations are similar to those followed in Geneva (such as commitments that vary according to the modes of delivery), there are important fundamental differences between GATS and AUSFTA. 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. This means we start from the assumption that everything is covered — with full national treatment — unless exceptions and reservations are 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 recognises both national sensitivities and economic realities. In the Uruguay Round, the negotiations were threatened with failure at a certain point by continued US-EC argument over audiovisual services. In the end, the US decided to settle for an arrangement that more or less recognised the status quo and a tacit understanding that restrictions would not be tightened or extended to new areas (satellite or computer-based broadcasting).

Not much has changed in Hollywood's view. 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. The United States' position is not so accommodating on the question of possible restrictions on broadcasting over the Internet or through other newer technological means. 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 between the United States Trade Representative and the Chilean Minister for Foreign Relations. A similar approach should be possible in the AUSFTA context.

Labour and the environment

Whether provisions like those found in the Chilean and Singapore Agreements with the USA relative to trade and the environment or trade and labour qualify as 'WTO Plus' is a matter for individual appreciation. Nevertheless, it is clear that the Trade Promotion Authority (TPA) legislation in the United States that governs American participation in these PTA negotiations gives USTR little room for manoeuvre. There will need to be TPA-consistent provisions upholding labour and environment concerns even if it looks ridiculous for the USA to demand that Australia enforce its own labour laws on its own workforce. This is a 'make it or break it' part of the deal. What will be interesting to see is whether a 'good' TPA consistent outcome on trade and labour or trade and the environment will be

sufficient to ensure, for example, AFL-CIO or ACTU endorsement of an AUSFTA outcome.

Economic Analysis of AUSFTA

The economics of AUSFTA deserve further comment. This paper is being written in late October 2003, two years after the Centre for International Economics (2001) produced its initial study on the estimated effects for Australia and the United States of AUSFTA. Since that time, others have produced economic modelling studies designed to predict the impact of the agreement. There are at least 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.

Trade creation or trade diversion

A trade agreement begets trade creation when a lowered or eliminated barrier to imports leads to a domestic supplier being displaced in its home market by imports from a more efficient, lower cost, overseas competitor that now can export into the market. Trade creation enhances economic welfare both in the importing country, where consumers get something at lower prices, and in the exporting country — which now has the possibility of greater production, exports and higher national income. Trade diversion, on the other hand, means that instead of buying from the lowest cost, most efficient supplier, buyers in the importing country are diverted from those optimal suppliers to higher cost, less-optimal producers from another source who have gained an artificial (but not real) advantage in the marketplace as a result of a discriminatory PTA. Trade diversion is immediately bad for the efficient exporter who now sees his product displaced and ultimately bad for the importers in the consuming country, who would be better off with the absolutely lowest price product — something that would theoretically be possible through multilateral liberalisation and non-discrimination.

The importance of non-tariff liberalisation in AUSFTA should be clear from the earlier discussion of expected ‘third wave’ elements to the agreement. An examination of the possible trade creation/trade diversion effects of AUSFTA requires us to focus, somewhat artificially, on the expected effects of tariff reductions or elimination.

Nearly all of the economic modelling which is possible today and which can be used to look at questions like trade creation and trade diversion relies heavily on estimations of demand elasticities and likely changes in trade flows from price effects arising out of tariff reductions or eliminations. Earlier, we discussed the tariff structures of the USA and Australia. Clearly, the nearly 50 per cent of Australian tariff lines now applied at duty free and the more than 30 per cent of US duty-free tariff lines are irrelevant in terms of tariff preference effects on trade creation or diversion.

What about trade diversion? Take imports into the US market as our example. This will only occur in a situation where a non-Australian supplier to the American market is capable of producing and selling a perfectly competitive product at a competitive margin to the Australian producer less than 101 per cent of the MFN tariff into the US market. For sake of argument consider tennis racquets. Suppose the average American tariff on tennis racquets is 5.5 per cent. A Malaysian tennis racquet producer will be preferred over an Australian when the former sells at \$50 (duty-paid price \$52.75) and the latter at \$51 (duty-paid price \$53.81). AUSFTA would, however, result in classical trade diversion were duties eliminated on the Australian tennis racquet because it would now sell (duty-free) in the USA market at \$51 versus \$52.75 (duty-paid) for the Malaysian racquet. But if the Malaysian's initial price is normally more than 5.51 per cent cheaper than the Australian's price (\$48.19), then the elimination of the duty in favour of the Australian will not lead to trade diversion in tennis racquets because landed, duty-paid prices in the American market will be \$51 for the Australian and \$50.84 for the Malaysian.

Given the low average tariff rates, and the fact that many of both USA and Australian tariffs are duty-free, the question one really needs to ask is how many cases could there be where Australians are selling products to the USA (and vice versa) at prices that reflect these (very narrow) margins of competitiveness with third parties? The elimination of a five per cent tariff in the United States is not likely to see Australian producers suddenly taking over market share from (for example) Chinese competitors (if there are any products at all where Australian and Chinese companies operate at such competitive margins).

The economic modelling is not much help to us. 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. 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. If we care about the economic effects of PTAs as much as we do about their political impact (and we should), we need to encourage further research into this problem.

Investment considerations

When the Productivity Commission released its 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 (Productivity Commission, 2003:Chs 5 and 6.2). 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.

While the Productivity Commission did not study the likely impact on the USA or Australia or third parties of the currently proposed AUSFTA, it did point out the changed nature of modern PTAs relative to past agreements. What was important, in their view, is that if one leaves the tariffs to the side and focuses on the impact on trade and investment of non-tariff trade liberalisation, one gets a much different picture.

The Productivity Commission's working paper sums up its consideration of the effects of non-trade provisions in 'third wave' PTAs (Productivity Commission 2003:101-102):

Chapter 5 does find evidence that foreign direct investment responds significantly to the non-trade provisions of PTAs. Interestingly, this is in contrast to a lack of response of FDI to bilateral investment treaties.

Further, for most of those agreements where non-trade provisions have affected FDI, the result has been net investment creation rather than diversion.

Although it is a weak test, this suggests that on balance, the non-trade provisions of these PTAs have created an efficient geographic distribution of FDI. This is consistent with the fact that at least some of the non-trade provisions (e.g. commitments to more strongly enforce intellectual property rights) are not strongly preferential in nature.

Further, the theoretical literature has stressed that if the non-trade barriers are of the sort to raise the real resource cost of doing business, rather than simply to create rents that raise prices above costs, then preferential liberalisation will be beneficial, even in the absence of net investment creation.

However, the trade that may be generated from the new FDI positions may still be diverted in the 'wrong' direction in response to the trade provisions of PTAs, and may therefore contribute to the net trade diversion found in chapter 4.

Thus the results of this research suggests that there may be real economic gains from the non-trade provisions of third-wave PTAs, but they also suggest that there are still economic costs associated with the preferential nature of the trade provisions. And these costs could be magnified in a world of increasing capital mobility.

Thus, the findings of this research on the effects of non-trade provisions of PTAs are more positive than those on the trade provisions. This suggests that there could be real benefits if countries could use regional negotiations to persuade trading partners to make progress in reforming such things as investment, services, competition policy and government procurement, especially if this is done on a non-preferential basis.

Overall economic impact of AUSFTA

As noted earlier, 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 study by the Centre for International Economics 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 relied almost entirely on studying the impact on trade of tariff elimination. Different inputs and assumptions produced different results. The CIE found big gains (a four per cent increase in Australian GDP by 2010). The ACIL Consulting study predicted ‘slightly detrimental’ effects to the Australian economy from completely free trade with the USA. John Gilbert (2003) also based his analysis only on tariff movements and found small welfare gains for both Australia (0.02 per cent of GDP) and the United States (0.01 per cent 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 (Andriamananjara and Tsigas, 2003).

From this discussion, it would seem that traditional approaches to estimating the effects of modern PTAs do 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, and business-to-business facilitation arrangements.

If we are going to try to judge the economic impacts of these ‘third wave’ agreements, we need to find a better way to assess the impact of non-trade elements on post-agreement trade and investment flows. There is some important work going on today by researchers such as those in the Productivity Commission. This is an area that should be given priority attention in order to give the assessment of PTAs some enhanced credibility. Otherwise, we will be condemned to arguing on the basis of one group’s speculation against another’s (like the four very different studies referred to above).

Concluding Observations

There is no doubt that a successful conclusion to the Doha Round of WTO multilateral trade negotiations has to remain the primary objective of governments and business seeking economic growth through trade liberalisation. Multilateral negotiations deliver much more significant results than bilateral or regional agreements and avoid the potential negative effects that preferential agreements

might cause through trade or investment diversion. The issue addressed in this paper is whether there may be some positive value added through bilateral preferential agreements — particularly at a time when the multilateral process has stalled.

We need to realise 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. Economists should give this problem some priority in their research. So long as the issue remains unresolved, debate over the merits of PTAs is likely to rest more on political than economic arguments.

PTAs are also not ‘one size fits all’ agreements. They differ widely depending upon which countries are involved in the negotiations. There are ‘good’ PTAs and ‘bad’ PTAs from the standpoint of whether they contribute positively or negatively to global economic welfare and whether or not they could be seen as complementing the multilateral negotiating effort. This paper does not suggest that all PTAs are good, but it does posit that the Australia-USA FTA now under negotiation will be one of the ‘good’ agreements.

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? 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? 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 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. ‘Competitive liberalisation’ only works as a policy if governments strive for trade liberalisation on a multilateral level as well as through PTAs.

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