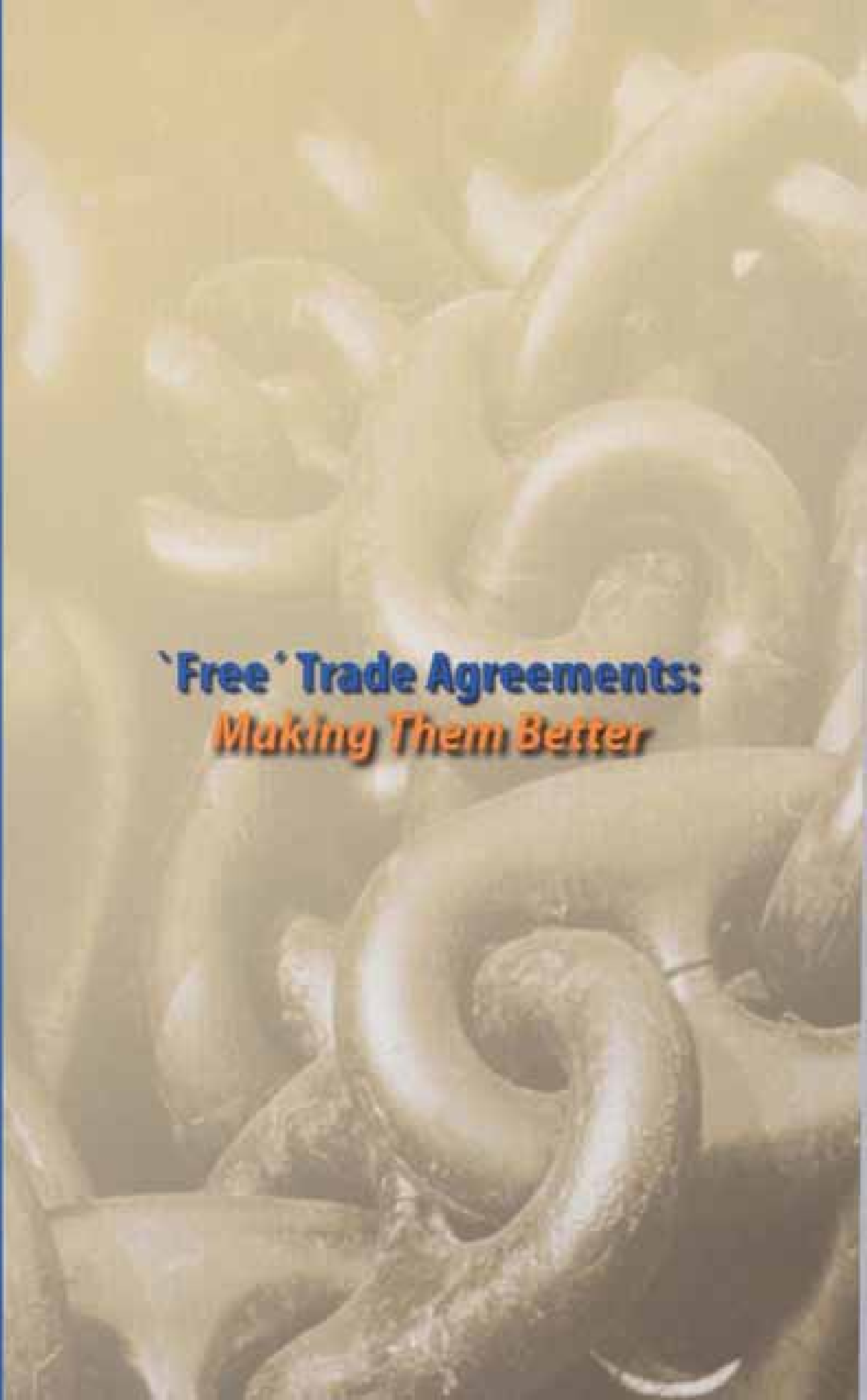

`Free' Trade Agreements:

Making Them Better

‘FREE’ TRADE AGREEMENTS

Making Them Better

Prepared by
John Humphreys and Andrew Stoeckel

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Rural Industries Research and Development Corporation
Level 1, AMA House, 42 Macquarie Street
Barton ACT 2601

P O Box 4776 Kingston ACT 2604

Telephone +62 2 6272 4819
Facsimile +61 2 6272 5877
Email rirdc@rirdc.gov.au
Internet http://www.rirdc.com.au

Centre for International Economics
Marcus Clarke Street & Edinburgh Avenue
Canberra ACT 2601

GPO Box 2203 Canberra ACT Australia 2601

Telephone +61 2 6248 6699
Facsimile +61 2 6247 7484
Email cie@TheCIE.com.au
Internet http://www.TheCIE.com.au

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FOREWORD

Australia exports around two thirds of its agricultural production by value. Access to world markets is therefore crucial to the fortunes of Australian farmers. So Australia — and other countries — put considerable effort into reducing the high barriers to agricultural trade.

There are two ways to reduce other countries' barriers to trade. One is multilateral negotiation, with the current Doha round of trade talks underway. But the going is slow. A second route is to form bilateral and regional trade agreements, which preferentially reduce barriers to trade among members. The number of agreements is exploding as countries ensure they are not left out.

Bilateral trade agreements are controversial for two main reasons. One is that they do not necessarily make a country better off. Second, they can hinder multilateral efforts to free up trade. This study concludes that this second aspect is unresolvable. Therefore this study poses the question: are there things that can be done to ensure bilateral agreements — which countries will keep on negotiating anyway — are more likely to be beneficial? The answer is yes, and a checklist of ten actions to this end is developed.

Peter O'Brien
Managing Director
Rural Industries Research and Development Corporation

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SUMMARY

- The World Bank estimates that one-third of global trade now takes place between countries that have some form of reciprocal regional or bilateral trade agreement. While international trade is a good thing, it does not necessarily follow that regional preferential trade benefits trading partners or the multilateral world trading system.
- Free trade agreements (FTAs) may not always be beneficial because they are by definition preferential — they discriminate against countries not included in the agreement. A more useful and comprehensive description is *preferential trade agreements* (PTAs).
- The preferential nature of PTAs is cause for concern. The discrimination is twofold. One is against countries not in the bilateral or regional trade agreement. The other is the discrimination against trade in agriculture, which is often left out of such agreements.
- The number of PTAs has been increasing in recent years. The number of agreements recognised by the World Trade Organisation (WTO) has gone from six in 1970 to 206 today. Yet more are on the way. There could be over 300 by the end of 2005. Many others remain unreported to the WTO.
- Reasons for the growth in PTAs include the slow pace of liberalisation through the WTO, the fear of being left behind by other countries entering FTAs and a reduced commitment to the principles of free trade.

- Like them or not, PTAs are a part of the modern trading environment that open up a new range of opportunities and challenges.
- While free trade creates win–win outcomes, PTAs are not free trade and can sometimes result in more costs than benefits. Costs and benefits need to be assessed for each PTA.
- Whether a PTA creates a net benefit depends on four factors — the trade impacts, competition impacts, non-trade effects and political economy consequences.
- PTAs can create **more trade** between member countries. If this trade is new trade, it is called *trade creation* and it creates a benefit. If this trade is diverted from lower-cost supplying countries then it is called *trade diversion* and it creates a cost. Either outcome is theoretically possible and empirical evidence has shown that some PTAs are net trade creating and some are net trade diverting. To fully understand these trade effects it is necessary to consider PTAs in a global economy-wide framework.
- Cheaper imports and more robust **international competition** from a PTA can lead to productivity improvements as firms are forced to innovate and imitate world's best practice in order to stay competitive. The competition benefits from trade are less certain than the trade benefits. However, growing econometric and anecdotal evidence suggests there is some competitive benefit from trade.
- PTAs often include several **non-trade issues** that can cause negative or positive net impacts. Two issues of particular relevance are changes to investment rules and changes to trade risk and certainty. Investment liberalisation and increased certainty can provide significant benefits. But PTA negotiations increasingly consider more domestic issues such as intellectual property,

competition rules and regulation of the labour market and the environment. The value of including these auxiliary areas is questionable.

- PTAs are constrained by several limitations. Important multilateral issues, such as the reform of domestic subsidies, are often excluded from PTA considerations. Also, rules of origin and safeguard measures are common and costly elements of PTAs.
- The **political economy impact** of PTAs is difficult to assess and impossible to quantify. Depending on its nature, a PTA can either complement or substitute for multilateral negotiations. The growth of PTAs around the world could result in several outcomes: free trade, the formation of several large trading blocs or a complex mesh of overlapping and inconsistent agreements.
- Debates about the virtues and vices of PTAs have occupied the attention of economists for years. This book does not attempt to resolve the debate either for or against PTAs. That debate remains inconclusive today for good reason: there is no empirical test that could resolve that debate. Given the 'stampede' by countries to form as many PTAs as possible and the difficulty of changing that, a more fruitful approach is to adopt the suggested checklist of points to enhance the good things about PTAs and minimise the bad things (see box 1).
- The costs of PTAs can be reduced in a number of ways:
  - The success of multilateral negotiations would make PTAs less relevant. PTAs are a second best avenue towards complete free trade and if multilateral trade liberalisation through the Doha round of trade talks could be accelerated then PTAs would become redundant;

1 Ten-point checklist for better PTAs

1) Is the price reduction maximised?
2) Are ‘problem’ industries included in the PTA?
3) Is the PTA comprehensive, including substantially all trade that would have occurred under free trade?
4) Are the rules of origin simple, consistent and flexible?
5) Does the PTA increase certainty for trade and investment?
6) Does the PTA also liberalise investment rules?
7) Is the PTA free of any ‘new protectionist’ measures, such as unnecessary environment, labour market or competition law requirements?
8) Are the details and consequences of the PTA well understood following a transparent process and independent analysis?
9) Have PTA partners reinforced their commitment to the WTO and is there a sunset clause to multilateralise the PTA?
10) Does the PTA allow for expansion to include new members and potential integration with other PTAs?

- GATT Article XXIV that permits countries to form bilateral or regional trade agreements requires that PTAs cover ‘substantially all’ trade. This requirement should be clarified and enforced and should be taken to mean substantially all (taken to mean 95 per cent) of the trade that would occur under free trade; and
- To help improve the quality and consistency of PTAs, the WTO could develop and promote a PTA template for member nations to use. Such a template could make use of the ten-point checklist.

- Outside of the WTO, countries can maximise their benefits from PTAs in a couple of ways:
  - With or without a WTO template, countries should develop consistent rules for trade negotiations and consider each PTA in the context of the ten-point checklist.
  - Countries genuinely interested in pursuing free trade could establish a non-region specific, fully comprehensive evolutionary PTA. The rules of the PTA would specify the requirements for membership, but would not specify the members. Any country that complies with the membership requirements would be included.

1 INTRODUCTION: IN PURSUIT OF FREE TRADE

In a profession best known for disagreements and uncertainty, the benefit of free trade is one of the few issues on which economists are quite certain. Best explained some 200 years ago by the classical economists[1], free trade between nations offers the possibility for more goods to be consumed while fewer resources are wasted. More controversial is the issue of how trade liberalisation should be pursued — which is the topic of this book.

The benefits of free trade

Everybody trades. In our everyday lives, people specialise in doing what they're good at and buy everything else that they need.

People do not build their own houses, milk their own cows, construct their own television and make their own movies. Instead, people specialise at something they are good at (building houses *or* milking cows *or* constructing televisions) and exchanging this for money. That money is then used to buy the other things in life that are wanted. This is what trade is all about.

---

[1] Most particularly by Adam Smith and David Ricardo.

If people were forced to consume only what they could produce they would be much poorer. The ability to specialise and trade allows us to significantly increase total consumption. The benefits are obvious. The same benefits of specialisation and trade apply at the national level. The economic theory developed to describe this phenomenon is called the *theory of comparative advantage.*

Theory of Comparative Advantage

The theory of comparative advantage has been described as one of the few areas of economics that is neither obvious nor unimportant.[2] The theory suggests that a country gains if it specialises in producing (and exporting) those goods and services that it is *relatively* good at producing, and importing goods and services that it is *relatively* bad at producing.

One important conclusion of this theory is that it is not necessary for a country to be the best in the world before it can reap the gains from trade. It is enough for a country to simply specialise in what it is better at, and it will be able to purchase more products than it would be able to produce domestically. For example, a country would export cars if it was more efficient at producing cars than anything else — even if it was not the best in the world at producing cars.

Winners and losers from trade

Opening up a country to international trade creates winners and losers, at least in the short term. The winners in trade are those people who participate in the trade. For example, when a person from Portugal eats a steak imported from Brazil, both the Portuguese consumer and Brazilian

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[2] Buchholz, T.G. 1989, *New Ideas from Dead Economists: An Introduction to Modern Economic Thought*, Penguin Group, USA, p. 71.

producer are winners. If a buyer and seller were not made better off because of a trade, then they would not voluntarily choose to trade with each other.

Initially, the losers from new trade are those people who are no longer included in the trade. Using the above example, as Portuguese consumers are now eating Brazilian steaks, the Portuguese cattle farmers lose. But Portuguese cattle farmers are now free to make something else they are relatively better at producing than their Brazilian counterparts, say wine. This wine is exchanged for the Brazilian steak. The end result is that both the Portuguese and the Brazilians can now consume more of both steak and wine — a win–win outcome.

Chart 2 shows that the benefit to consumers of importing cheaper products exceeds the cost to producers. In addition, an increase in imports will be matched by an increase in exports[3], which will benefit exporting industries.

The conclusion that trade with lower cost producers gives a net benefit to a country is widely accepted as one of the few certainties of economics[4].

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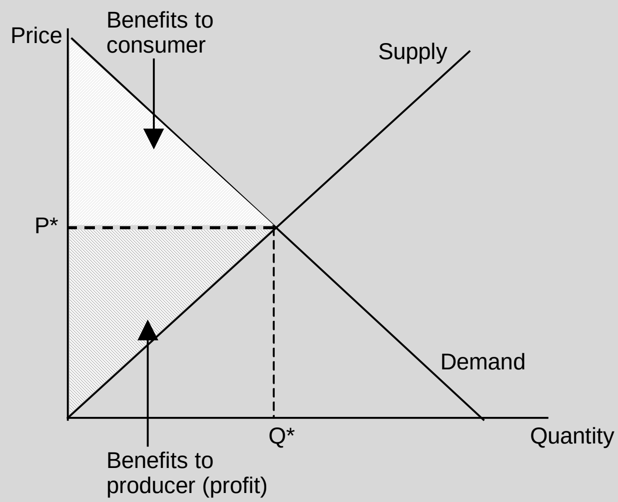
[3] Assuming a constant capital account in the long term, the exchange rate will adjust to ensure that the trade balance (exports–imports) remains stable.

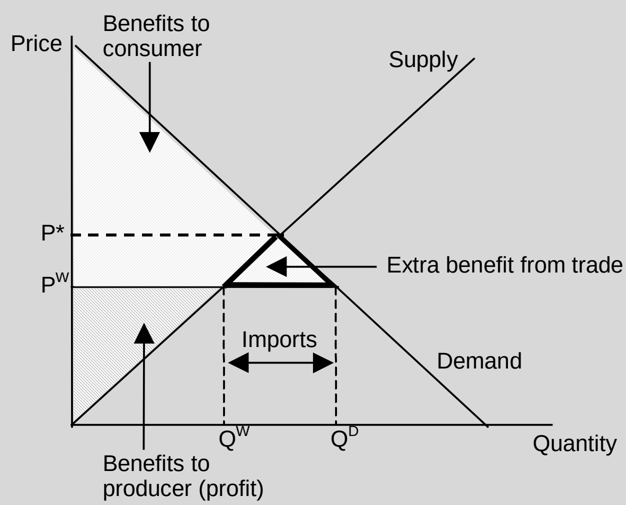
[4] A large number of books have been written on trade issues. Two worth noting are Bhagwati, J. 2002, *Free Trade Today*, Princeton University Press, USA, and Irwin, D.A. 1996, *Against the Tide: An Intellectual History of Free Trade*, Princeton University Press, USA.

2 Non-trade versus trade

No trade



Introduce trade – move to world price p^w



Three approaches to trade policy

While economists agree on the goal of free trade, there is still considerable disagreement on how to achieve this goal. There are three alternatives, discussed in box 4:

1) trade reform can be pursued as domestic policy and a country can liberalise *unilaterally* without regard to the policies of other nations;

2) countries can agree to liberalise trade *multilaterally*, through the auspices of the World Trade Organisation; or

3) countries can form preferential trade agreements with one or more other countries and liberalise *regionally* or *bilaterally*.

Unilateral liberalisation

As trade benefits all countries that participate, restricting trade harms all countries, including the country that implements the protection. If trade protection harms the nation that imposes it, then there is a strong argument to simply remove those harmful restrictions unilaterally[5].

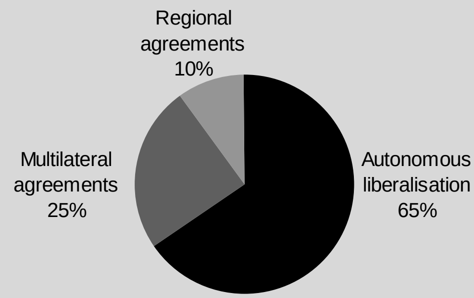
Unilateral liberalisation has arguably been the most effective method of liberalisation. Many countries have benefited from unilaterally reducing trade restrictions in the past two decades[6]. The World Bank reports that 66 per cent of the total tariff reduction between 1983 and 2003 was a result of

---

[5] One exception to the benefits from unilateral liberalisation occurs when a large country can influence the world price of a commodity. However, as Krugman notes, this argument 'plays almost no role in real-world disputes over trade policy'. Krugman, P. 1997, 'What Should Trade Negotiators Negotiate About?' *Journal of Economic Literature*, Vol. XXXV, March, pp. 113–120.

[6] Bhagwati notes this trend in Chile, Australia, New Zealand, Indonesia, Singapore, Hong Kong and some countries of Eastern Europe. Bhagwati, J. 2002, *Free Trade Today*, Princeton University Press, USA.

3 Share of total tariff reduction, by type of liberalisation (1983–2003)



Source: Martin, W. and Ng. F. 2004, Sources of Tariff Reductions. Background paper. World Bank 2005, *Global Economic Prospects: Trade, Regionalism and Development 2005*

unilateral liberalisation[7]. By comparison, 25 per cent of the total tariff reduction was the result of multilateral agreements and 10 per cent was due to regional trade agreements (chart 3)

Impediments to unilateral liberalisation have tended to be more political than economic. If the potential losers from reform are well organised, they can sometimes exert enough political pressure to block liberalisation. For some people, fear of change may make them sceptical of reform.

In addition, while a nation benefits from unilateral liberalisation, it would be more beneficial if all countries liberalised. It is argued that this can be best achieved through multilateral liberalisation where countries agree to give up their trade restrictions at the same time. Such a process can also help to ease domestic political pressures.

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[7] World Bank 2005, *Global Economic Prospects: Trade, Regionalism and Development 2005*, The World Bank, Washington DC, p. xvi.

4 Benefits and costs of different trading approaches

	Benefits	*Problems*
Unilateral	Can achieve significant benefits without the need for international negotiations	Cannot reduce the trade restrictions of other countries Domestic political opposition
Multilateral / WTO	Can achieve the greatest benefit of complete trade liberalisation Can address subsidies	Requires difficult international negotiations which results in a slow pace of reform Reforms can be modest due to compromises Domestic opposition to the WTO
Regional / preferential	Can be achieved quickly with fewer political impediments Can be more comprehensive than other approaches and include non-trade issues	May not actually provide a net benefit Could result in competing trade blocs Often do not address subsidies

Multilateral liberalisation

Multilateral liberalisation should be the least controversial form of trade liberalisation and has the highest potential benefits. Multilateral liberalisation offers the possibility of a better outcome than unilateral liberalisation because it involves other countries also reducing their trade restrictions. Not only are the gains larger, but by internationally coordinating the reform the adjustment costs can be lower. However, the vehicle for multilateral liberalisation — multilateral trade talks conducted under the auspices of the World Trade Organisation (WTO) — has attracted a significant amount of protest both from people opposed to trade and people who disagree with how the WTO works. Some people protest that the greater freedom to trade — in effect globalisation — simply leads to a ‘race to the bottom’ with adverse impacts on wages, jobs and the environment. These arguments are, of course, false and have been rejected most recently by the WTO-commissioned Sutherland report[8].

Another benefit of multilateral liberalisation is that the WTO can help reduce domestic political opposition to reform through an agreed international process and reciprocal liberalisation.

Although the World Bank reports that 25 per cent of the total tariff reduction between 1983 and 2003 was as a result of multilateral agreements, other studies have questioned the empirical evidence that the WTO multilateral process as a mechanism has achieved significant reductions in barriers to trade[9]. Some of the major events for GATT/WTO are outlined in chart 5.

The problem is that the WTO-sponsored multilateral trade talks are progressing too slowly. The main reason the WTO has not been able to build on its past achievements and gain more liberalisation is the difficulty of getting a consensus between the 148 member economies (called ‘contracting parties’). Unilateral and regional liberalisation are appealing because they bypass this problem.

8 Sutherland, P. 2004, *The Future of the WTO, Addressing Institutional Challenges in the New Millennium, Report by the Consultative Board to the Director-General Supachai Panitchpakdi*, World Trade Organization, Switzerland.

9 Rose, A. K. 2002, ‘Do we really know that the WTO increases trade?’ Centre for Economic Policy Research, *Discussion Paper Series No. 3538*, London, pp. 1–8.

5 Major events in GATT/WTO

1 January 1948	Following negotiations between 23 countries, the General Agreement on Tariffs and Trade (GATT) comes into force.
1950	China withdraws from GATT
1986–1994	Uruguay round of trade talks
1 January 1995	The World Trade Organisation (WTO) comes into force as a replacement for GATT
1999	Ministerial meeting in Seattle fails to launch new round
2001–present	Doha round of trade talks (ongoing)

Regional/preferential agreements

The third approach to removing trade restrictions is by joining bilateral or regional agreements to reduce trade restrictions for member countries. By definition, this approach is preferential rather than free, as it discriminates against countries that are not members of the agreement — consequently, regional and bilateral agreements can be referred to as preferential trade agreements (PTAs)[10].

The different types of PTAs are explored in more detail in the following chapter. As this book deals with all different types of regional and bilateral agreements and they all involve trading on a preferential basis it is appropriate to use the more inclusive term PTA.

PTAs are easier to negotiate than WTO liberalisation because there are fewer participants, and they may arouse

10 The Asia–Pacific Economic Cooperation (APEC) is not included as a PTA because it is not discriminatory. For more on open regionalism, see Bergsten, C.F. 1997, *Open Regionalism*, Working Paper 97-3, Institute for International Economics, http://207.238.152.36/publications/wp/1997/97-3.htm. Accessed 22 December 2003.

less domestic political opposition. However, as will be shown in the following chapters, in some situations PTAs may not actually provide a net benefit to member countries. Unlike unilateral and multilateral liberalisation, it is possible for regional and bilateral trade agreements to make countries worse off. Also, while the number of PTAs has increased significantly in the past 20 years, the contribution of PTAs to total tariff reductions has been only 10 per cent.

The future of trade policy and the topic of this book

The fundamental question for the future of trade policy is no longer *whether* trade should be liberalised – but rather *how*. Central to this debate is whether the different approaches are substitutes or complements.

The growth in the number of PTAs in recent years has brought this debate to the fore. There is an ongoing debate among economists and trade experts about whether PTAs cause more harm than good. While many economists strongly support the proliferation of PTAs, another group (led by free trade advocate Professor Jagdish Bhagwati[11]) rejects PTAs as counterproductive and a distraction.

Differences of opinion centre on a number of issues. There is a long-running debate about whether PTAs result in more positive *trade creation* or negative *trade diversion* (chapter 3). Economists also disagree about whether PTAs (and trade more generally) can lead to an additional *competition benefit* (chapter 4). In recent years there has been a shift in PTAs to include more *non-trade issues* — such as investment and intellectual property — and there is uncertainty about the impact of these measures (chapter 5). Finally, there is an

[11] Bhagwati, J. D. 2000, *The Wind of the Hundred Days*: *How Washington Mismanaged Globalization*, MIT Press, Cambridge, London and London, England, pp. 227–264.

ongoing debate about the *political economy* effects of PTAs and whether they help or hinder multilateral and unilateral liberalisation (chapter 6).

The increasing popularity of regional trade agreements and their ambiguous impact on welfare require that these agreements be closely assessed. As the World Bank notes, 'the interesting policy question then is not whether [PTAs] are categorically good or bad, but what determines their success?'[12] This book attempts to help people interested in regional agreements to understand the different elements of an agreement and to recognise features that contribute to a good agreement.

[12] World Bank 2005, *Global Economic Prospects: Trade, Regionalism and Development 2005*, The World Bank, Washington DC.

2 PREFERENTIAL TRADE AGREEMENTS — WHAT AND WHY?

Preferential trade agreements are becoming an important yet controversial part of the international trade policy landscape. The different types of PTAs are discussed below — but the one common feature of all PTAs is that they are preferential. They all offer advantages to one country or set of countries inside the agreement that do not apply to other countries outside the agreement.

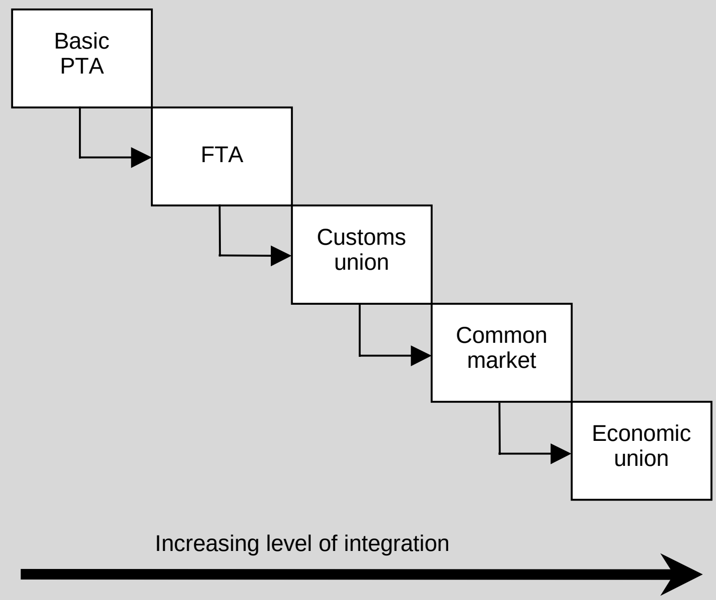
Types of preferential agreements

While most PTAs are commonly referred to as free trade agreements (FTAs), FTAs are only one of several different types of PTAs, which range in comprehensiveness and the degree of economic integration of members (see chart 6). Also, PTAs often encompass more than just trade issues, affecting the competitive environment, investment flows and domestic regulations.

Basic preferential trade agreements

The most basic sort of PTA involves a tariff discount for member countries. However, the tariffs against member countries are not abolished and there is no further coordination or cooperation between the member countries.

6 Types of PTAs



Free trade agreements

FTAs go further than the basic PTA by removing 'substantially all' protection between two (or more) countries. The definition of an FTA is taken from Article XXIV of the WTO. The Australia–New Zealand Closer Economic Relations (CER) agreement is sufficiently comprehensive to be considered an FTA. But it is still preferential in that it excludes all other countries from the favourable access extended between Australia and New Zealand.

Customs union

A customs union between two (or more) countries involves an FTA between those countries as well as a common external tariff. For example, the countries of South Africa, Botswana, Lesotho, Namibia and Swaziland form the South African Customs Union.

Common market

A common market involves a customs union as well as the free flow of labour and capital between the member countries. In 1992 the European Community moved from a customs union to a common market.

Economic union

The most comprehensive regional agreement is to form an economic union. This involves a common market as well as coordinated fiscal and monetary policy. The most obvious example of this is the forming of federations, such as exist between states in the United States and in Australia. The European Union is another example of the progression from a common market to an economic union with the formation of the common currency and coordination of macroeconomic policy among the Euro area.

More PTAs but less preferential trade

In recent years there has been an explosion in the number of PTAs. The WTO records regional agreements; chart 7 shows the growth in the number of agreements since 1958. These numbers underestimate the total number of PTAs as many trade agreements are reported after they come into force. The average delay in reporting a PTA to the WTO is 354 days, and in some instances the delay is over six years[13].

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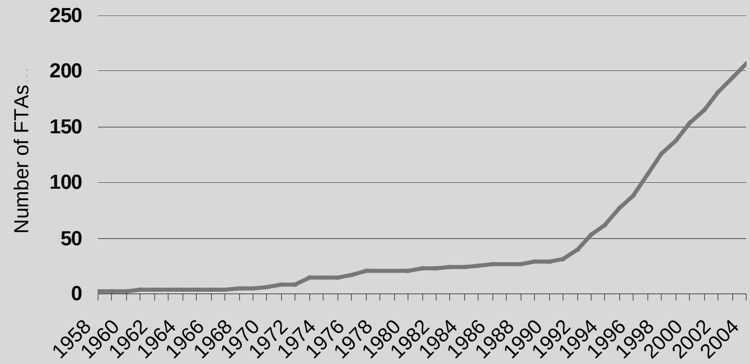
[13] World Bank 2005, *Global Economic Prospects: Trade, Regionalism and Development 2005*, The World Bank, Washington DC, p. 30.

7 PTAs reported as FTAs to the WTO



Source: World Trade Organisation

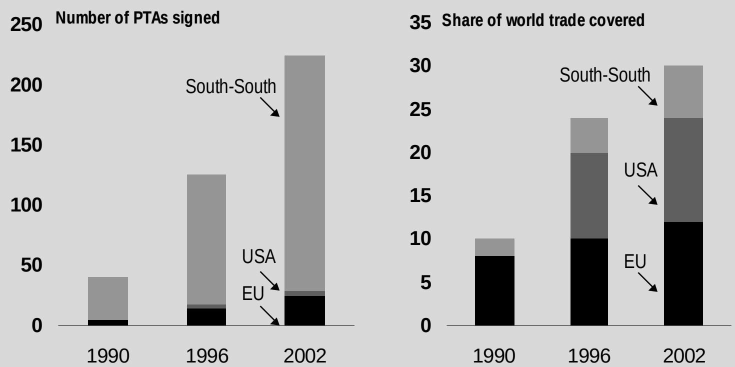
Over 80 per cent of countries now belong to at least one PTA, with most belonging to more than one.

However, the number of PTAs overstates the amount of preferential trade. Most PTAs are South–South agreements such as AFTA (ASEAN Free Trade Area), COMESA (Common Market for Eastern and Southern Africa) or MERCOSUR (Common Market for South America). But the European Union and United States dominate PTA trade by value (chart 8). The World Bank explains this is because many South–South agreements overlap with other agreements.

Also, the World Bank finds that the total trade flow between PTA partners overstates the amount of preferential trade[14]. The reason is that tariff schedules of many PTA members contain duty-free most-favoured-nation (MFN) rates at which no preference can be given.

[14] World Bank 2005, *Global Economic Prospects*, Washington, p. 41.

8 Trade with PTAs



Source: World Bank 2005, *Global Economic Prospects*.

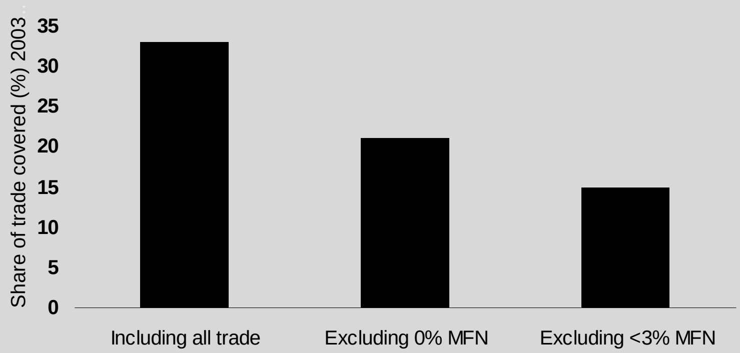
Excluding trade at zero MFN rates, PTAs account for only about 21 per cent of world trade, or only 15 per cent if MFN rates of less than 3 per cent are excluded — see chart 9.

Why are PTAs so popular?

The increasing number of PTAs raises questions about the economics and politics of trade — including *why* PTAs are growing in popularity. There are several possible reasons.

- Domestic political sentiment is against multilateral and unilateral trade reform.
- Countries wish to pick and choose which products are included to avoid making difficult decisions.
- The slow pace of liberalisation through the WTO is forcing countries to reform trade by other means.
- Countries fear of being left behind as others enter into trade agreements.

9 PTAs provide less new market access than it might appear



Source: World Bank 2005, *Global Economic Prospects*.

Domestic political sentiment

Trade reform often creates difficult domestic political issues. People in protected industries fear that new competition will expose their inefficiency and they will lose market share. These protected industries are able to conduct influential political campaigns that turn opinion away from free trade.

Another reason that domestic political opinion can be hostile to unilateral and multilateral trade, but less hostile to regional trade deals, is the view that reciprocity in regional trade deals looks 'fairer' and therefore more acceptable[15]. There is a view that trade can only produce a benefit when 'concessions' have been negotiated with a trade partner. The fallacy of this argument is that it assumes that trade is a zero–sum game (where the benefit to one country must come at the expense of another).

[15] While multilateral liberalisation also involves reciprocity, the reciprocity involved in regional agreements is more explicit.

Although multilateral and unilateral liberalisation generally promises greater benefits than regional trade liberalisation — ironically, public opinion seems to be the exact opposite. In Australia, while only 20 per cent of people support trade liberalisation — over 50 per cent indicated their support for the Australia–United States FTA[16]. Politicians are forced to respond to the concerns of their constituents and so are drawn towards the less politically sensitive bilateral deals.

Picking and choosing

To avoid sensitive political areas, some countries prefer to pursue a more moderate ‘free trade light’ option of arranging small trade deals with countries that do not threaten their sensitive markets. For example, Japan is highly sensitive to lowering agricultural trade barriers and has consistently argued that it should be able to keep high levels of protection for its farmers. By negotiating an FTA with Singapore (which has no agricultural exports), Japan was able to pursue trade liberalisation without having to address the sensitive issue of reducing agricultural protection.

The fallacy of this selective approach is that the greatest benefits of free trade result from the very thing that is being prevented. By excluding industries in which it has a comparative disadvantage, Japan is preventing the specialisation and trade that lead to welfare gains. Japan would gain significantly more from a trade agreement that included agriculture.

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[16] Norton, A. 2004. ‘The Politics of Protection: Public Opinion Can Favour Liberalising Trade’, *Policy*, Centre for Independent Studies, Sydney, pp. 10–15.

Troubles with the WTO

The growth of PTAs has often been blamed for stalling the momentum of WTO reform[17]. This is considered in chapter 6. However, the causation may be the other way round.

It is equally possible that the progress of the WTO impacts on a country's desire to pursue bilateral and regional trade agreements. If the WTO offers little progress towards free trade, then countries that want greater liberalisation will turn to other approaches — such as PTAs.

As with all sensitive political negotiations, the easier decisions tend to be made earlier. As WTO negotiations continue and the membership of the WTO continues to grow — the potential for significant and speedy reform diminishes. While the state of the WTO is not the topic of this book[18], it is reasonable to note that many countries would like to see some areas of trade negotiation be pursued more vigorously.

For countries that are impatient to reform trade, PTAs offer a way forward. While they cannot achieve the potential gains of complete multilateral liberalisation, they have the advantage of being easier to negotiate, more politically acceptable and they allow pro-trade countries to take significant steps towards liberalisation, albeit on a preferential basis.

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[17] See Bhagwati, J. 2002, *Free Trade Today*, Princeton University Press, USA and Garnaut, R. 2003, Requiem for Uldorama: A plain but useful life, Paper presented at the Committee for Economic Development of Australia (CEDA) Trade Forum, 'New Horizons in Trade: The WTO Round and Australia's Free Trade Negotiations in Post-Iraq 2003', Adelaide, 5 June.

[18] For a book that directly considers this issue, see Stoeckel, A. 2004, *Termites in the Basement*: *To Free Up Trade, Fix the WTO's Foundations*, Rural Industries Research and Development Corporation, Canberra, Publication number 03/092.

Fear of being left behind

To some degree, the growth of PTAs is a self-perpetuating phenomenon. Parties excluded from PTAs are often made worse off by the PTA, and so will seek entry into current groups (a kind of ‘trade peer pressure’). Furthermore, by recognising the possibility of other countries forming PTAs, there is an incentive to beat other countries to the punch in a ‘race for PTAs’.

While it makes sense for each country to join this race out of self-interest, the consequence of this behaviour may lead to the fallacy of composition. If other countries begin to form PTAs, then it is in the interest of a country to follow the trend. However, it may have been better for all countries if the trend had never started. A commonly used example of the fallacy of composition is the behaviour of spectators as a sporting event. If the person in front of you stands up, then you are forced to stand up also – in your own self-interest. This leads to the person behind you standing up and so on until the entire stadium is on its feet. While entering into PTAs may look to be in a nation’s self-interest, they might be better off if no PTAs were formed.

PTAs and the WTO

The most-favoured nation (MFN) principle is one of the core foundations of the WTO system. The principle requires that members of the WTO treat all other members of the WTO the same. This principle was embedded in the first Article of the General Agreement on Tariffs and Trade (GATT) back in 1948 and is the cornerstone of multilateral liberalisation efforts.

By definition, all PTAs violate the MFN principle. PTAs involve different treatment of different countries and so the formation of PTAs is in violation of Article I of the GATT.

However, another rule — GATT Article XXIV[19] — of the WTO allows countries to form PTAs that are 'significant in scope and scale'. In other words, regional agreements are consistent with WTO rules so long as they are more comprehensive than the first type of integration as discussed above — a basic PTA.

While many countries have taken advantage of GATT Article XXIV, it is not clear whether all such agreements have conformed to the requirement of a comprehensive PTA. Box 10 considers the requirement of 'substantially all' trade.

When notified of a new PTA, the provisions of the agreement are subject to review by the WTO. However, the WTO has never issued a final report on any trade agreement and none have received formal endorsement.

A second method for avoiding WTO restrictions on trade agreements is to not report them at all and instead record them as 'closer economic cooperation agreements' or 'industry cooperation agreements'. These may also be in violation of WTO rules. However, as these agreements have not yet been challenged to the WTO they have not been ruled illegal.

Although regional trade agreements violate one of the principles of the multilateral trading system, the WTO has not imposed any effective barrier to their formation. GATT Article XXIV explicitly allows for comprehensive PTAs and the rules that do apply have not been enforced as no trade agreement has ever been challenged.

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[19] There are other exclusions from the MFN principle. However, Article XXIV is the most important for developed countries.

10 What is 'substantially all' trade?

There is no formal definition for the WTO requirement that PTAs include 'substantially all' trade. Nations are therefore able to interpret the term in the most convenient way for their purposes.

For the sake of ensuring that PTAs are as comprehensive as possible it is necessary to develop an agreed definition of 'substantially all' that means what it says.

One interpretation of the term has been that substantially all products should be included. The problem with this is that a country could continue to protect the most inefficient industries and only liberalise in those areas that are relatively unimportant. Such a PTA could be far from comprehensive.

Another interpretation is that barriers have been reduced with regards to products that currently make up substantially all trade. Schiff and Winter[20] suggest a criterion of 95 per cent of the value of trade after 10 years, rising to 98 per cent after 15 years. The problem with this is that it ignores those industries that are currently so highly protected that there is no trade.

A more robust interpretation is that a country should liberalise trade so that the amount of trade under the PTA is substantially equal to all of the trade that would occur under free trade, determined through the use of independent economic modelling. The Schiff and Winter criteria of 95/98 per cent could be applied.

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20 Schiff, M. and Winter, L.A. 2003, *Regional Integration and Development*, co-publication of the World Bank and Oxford University Press, Washington DC.

3 TRADE EFFECTS OF PTAS

The trade effects of a PTA can make a country better off or worse off. Given the benefits of trade (as described in chapter 1), this can seem counter-intuitive. If free trade is good, then surely a free trade agreement must be good also? Not necessarily.

The reason that PTAs can be positive or negative is that they are both trade liberalising (for those inside the agreement) and trade restricting (for those left out). In addition to this, there are limits to what a PTA is able to achieve.

The consequences of trade liberalisation are many and varied, with any change in one area of the economy impacting on other areas of the economy. It is therefore necessary to consider trade policy in any economy-wide framework. A useful tool in this regard is general equilibrium modelling, which tracks the impact of a change in one area of the economy through to all the other areas of an economy.

In addition to changing the way we allocate resources, the change in market rules and competition can lead to dynamic changes in a firm's level of innovation and imitation. This 'competition' impact of trade will be discussed further in chapter 4.

What PTAs can and cannot do

Preferential Trade Agreements never result in free trade. They are limited to trade between those countries participating in the agreement. But even within that constraint, PTAs do not achieve free trade between member countries due to some common exclusions, safeguards and rules of origin.

Domestic subsidies

Trade reform under PTAs is preferential, which means that it applies to some countries but not to others. While it is possible to apply tariffs and quotas discriminately against specific foreign countries, this is generally not the case for subsidies.

Subsidies are provided directly to a domestic producer, which artificially increases their relative competitiveness against all foreigners equally. It is not easy to provide a general subsidy that discriminates against some foreign competitors, but not others. Because of this, subsidies are often considered to be a multilateral issue and subsidy reform is excluded from PTA negotiations.

The importance of this exclusion on subsidies depends on the situation. In some instances, the primary sources of trade restriction are tariffs and quotas, and so a PTA can be effective in achieving significant liberalisation. However, in some other cases subsidies can play a large role in distorting trade. The most famous example of this are the farm subsidies provided predominantly by developed countries, such as the Common Agricultural Policy in Europe or the Farm Bill in the United States[21].

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[21] In the OECD, approximately 30 per cent of the total income of farmers comes from government protection (OECD, 2002). For a review of the economic and environmental costs of agricultural subsidies, see Humphreys, J., Van Bueren, M. and Stoeckel, A. 2003, *Greening Farm Subsidies: The next step in removing perverse*

Exclusions & Safeguards

It is not necessary for PTAs to have exclusions or safeguards. However, these are common elements of most PTAs that further reduces the liberalising effects of PTAs.

Exclusions generally cover politically sensitive products. The World Bank[22] notes that one key facet of American PTAs seems to be the 'exclusion or delayed liberalisation of sensitive products, commonly including agricultural products such as dairy products, cotton, ethyl alcohol, peanuts and peanut butter, sugar, and tobacco'.

Safeguards allow a country to re-introduce protection if certain things happen.

If exclusions and safeguards are included in a PTA, they should have a sunset clause.

Rules of Origin

Rules of Origin (RoO) require that the product being traded come from a member country. RoO are necessary in any regional agreement that does not have a common external tariff[23]. Their purpose is to prevent non-member countries exporting goods into a low-tariff member country and then using the PTA to re-export the same product on

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farm subsidies, RIRDC Publication No: 03/040, Canberra and Myers, N. and Kent, J. 1998, *Perverse Subsidies: Tax $s Undercutting Our Economies and Environments Alike*, International Institute for Sustainable Development, Canada.

[22] World Bank 2005, *Global Economic Prospects: Trade, Regionalism and Development 2005*, The World Bank, Washington DC, p. 33.

[23] Garay, L.J. and Cornejo, R. 2002, *Rules of Origin and Trade Preferences*, in Hoekman, B., Mattoo, A. and English, P. 2002 Development, Trade, and the WTO: A handbook, World Bank, Washington also argue that rules of origin 'should not be used when the differences between FTA members' third-country tariffs are minimal or when their tariff levels are low', p. 121.

to a high-tariff member country without paying the high tariff.

To combat this, RoO require that a product is only included in the PTA if it comes predominantly from a member country. There are several different ways of making this determination (see box 11).

The existence of RoO restricts trade in two ways. First, the production process of many goods is being increasingly globalised, so it is becoming more difficult for many products to meet RoO requirements. Second, complying with RoO requirements raises compliance and administration costs, which discourages trade.

Rules of origin are effectively barriers to trade. They can increase the cost of production and reduce trade. In addition, RoO create an additional distortion in the production process by encouraging producers to change their behaviour to comply with RoO requirements[24].

The impact of RoO depends on the rules used and the nature of the PTA. In some regional agreements, a significant amount of trade is undertaken at the preferential rate — indicating that the costs of RoO are low. For example, 64 per cent of NAFTA trade takes place at the preferential rate.[25] In other trading blocs, very little trade occurs at the preferential rate. One report suggests that the only 5 per cent of trade under the ASEAN PTA takes place

[24] This creates trade diversion in inputs as producers shift their consumption towards higher cost input producers at the expense of least cost producers.

[25] Estevadeordal, A. and Suominen, K. 2004, Rules of Origin: A World Map and Trade Effects. In *The Origin of Goods: Rules of Origin in Preferential Trade Agreements*, eds. Estevadeordal, A., Cadot, O., Suwa-Eisenmann, A., and Verdier, T., DC: Inter-American Development Bank.

11 Rules of Origin

There are several different ways that the rules of origin (ROO) can be set. Garay and Cornejo (2003) outline the three basic categories.

- *A change in tariff classification.* This requires that the tariff classification of the final good is different from the tariff classification of the materials used.
- *Minimum value added threshold.* This system requires that a minimum percentage of the value of the final product come from the member country.
- *Specific manufacturing requirements.* Use of a specific technical process or of certain components in manufacturing a product.

at the preferential rate.[26] Estevadeordal and Suominen offer a measure of restrictiveness of RoO and they conclude that more restrictive product-specific RoO undermine trade.

Evaluating the best RoO for a PTA is a difficult exercise. As Inama[27]notes in his review of rules of origin, 'it is impossible to determine the best rules of origin or the best proposal without being product-, country-, and industry-specific'. What is clear is that the RoO should strive to be

[26] The measure of trade undertaken at the preferential rate can be a misleading figure. For example, only 30 per cent of trade between Australia and New Zealand takes place at the preferential rate under CER, Adams, R., Dee, P., Gali, J. and McGuire, G. 2003, *The Trade and Investment Effects of Preferential Trading Arrangements — Old and New Evidence,* Productivity Commission Staff Working Paper, Canberra, May, p. 20. However, this is largely because Australia and New Zealand have low or zero external tariff rates. Indeed, the Australian government reports that 99 per cent of imports from New Zealand to Australia are duty free.

[27] Inama, S. 2002, 'Nonpreferential Rules of Origin and the WTO Harmonization Program', in Hoekman, B., Mattoo, A. and English, P. 2002, *Development, Trade, and the WTO: A Handbook,* World Bank, Washington p. 126.

as simple and consistent as possible in an attempt to minimise the administrative and compliance burden.

First round effects

While PTAs may be an imperfect way of encouraging more trade, they generally do succeed in increasing trade between member countries. However, because PTAs are biased towards member countries, trade with non-member countries may decrease.

The net impact on welfare from these two effects can be positive or negative, depending on the exact nature of the trade agreement. A substantial body of literature has been developed to consider the trade impacts of PTAs in all it’s complexity[28]. The following discussion presents a simple overview of the general conclusions.

Trade creation and diversion

The increase in trade with a PTA partner country can come from two sources. Either the trade is new trade (referred to as *trade creation)* or the trade is displacing trade with non-member countries (referred to as *trade diversion*).

Trade creation and diversion arise when both countries preferentially reduce their tariffs. A country will be impacted both due to its own liberalisation (allowing more imports) and its partner country’s liberalisation (resulting in an increase in exports). The various welfare impacts of a PTA are summarised below in table 12.

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[28] Started by Viner, J 1950, *The Customs Union Issue*. NY: Carnegie Endowment for International Peace. A good review of the literature is Panagariya, A 2000, ‘Preferential Trade Liberalization: The Traditional Theory and New Developments’, *Journal of Economic Literature*, Vol. XXXVIII (June 2000) pp 287-331.

12 Trade impact of PTA on country A

	Trade creation	*Trade diversion*
Country A liberalisation	Good	Bad
Country B liberalisation	Good	Good

Both countries in a PTA benefit from the preferential tariff rate offered by the other country. The preferences result in increased exports, which is unambiguously positive for the exporting country.

The distinction between trade creation and trade diversion is only relevant for the importing country.

As discussed in chapter 1, unilateral and multilateral liberalisation provides unambiguous benefits both to exporting and importing countries. This is not necessarily the case with PTAs. The welfare consequence from increased imports depends on the relative amount of trade creation and trade diversion.

Trade creation increases welfare for the same reason as explained by standard trade theory (see chapter 1). In contrast, trade diversion decreases welfare. Trade diversion does not represent a net increase in welfare, but simply a change in suppliers to a less efficient producer.

The concept of trade diversion is often misunderstood. Some people find it hard to accept that being able to buy something at a lower price can ever have a negative impact on total welfare. It is true that trade diversion offers a benefit to the consumer (who can now purchase their imports at a lower cost). However, from the nation's point of view there is an additional loss of economic rents (normally tariff revenue). Trade diversion occurs when the benefit to consumers is exceeded by the lost economic rents. Box 13 shows an example of trade diversion.

13 Example of trade diversion

Consider a hypothetical world with three countries (A,B,C) that all have a fixed 10 per cent tariff on imports. Country A and B then enter into a PTA.

Before the introduction of a PTA, country A imports cars from country C because their cars are $1000 cheaper than from country B. If a car is imported for $20,000 then the tariff revenue from importing a car is $2000 and the sale price is $22,000.

Following the introduction of the PTA, country A can import cars from country B for $21,000. Consumers switch to the new cars because they save $1000. This is a real consumer benefit.

However, the government has now lost $2000 in tariff revenue. The consumer benefit ($1000) is less than the loss of tariff revenue ($2000). If we assume that the government does not waste the tariff revenue, then the above example shows how country A can lose $1000 per car from trade diversion.

There are two important situations in which trade diversion is not negative. If a country is receiving no economic rent from a trade restriction, then they cannot lose that economic rent. This may occur if a country has a quota or other restrictions instead of a tariff.

A second exception occurs when trade is already diverted due to previous distortions, and a new PTA diverts trade back to the efficient producer.

Studies of trade creation and diversion

The total welfare impact from the first round trade effect of PTAs is ambiguous and depends on the exact nature of the PTA[29]. If there is significant trade creation and only

[29] Further, distribution of the benefits from a PTA also depend critically on the nature of the agreement. For example, even if a PTA creates a welfare reduction in member countries, one member country may benefit while the other loses.

minimal trade diversion, then a PTA is more likely to give a net benefit to member countries. If trade creation is zero or near zero, then the trade effects of a PTA are likely to reduce welfare in member countries. Because of the importance of trade creation and trade diversion in determining the trade benefits of PTAs, many econometric studies have been conducted to determine how trade flows change due to PTAs.

A recent report by Adams et al[30] included a comprehensive review of various econometric studies that have been conducted on trade creation and diversion, as well as providing new estimates. Most studies have shown that PTAs tend to produce both trade creation and trade diversion, with ambiguous results. According the modelling done by Adams et al, most PTAs (including AFTA, the EU, NAFTA, ANZCER and many others) have produced no significant trade creation.

The World Bank[31] conducted a meta-analysis of PTA studies. Of the 19 PTAs assessed, 10 had an average net trade diversion. For the overall trade impact of all assessed PTAs, 42 per cent of results were negative and significant, 34 per cent were positive and significant and 24 did not provide significant results. The World Bank concludes that ‘there can be no presumption that a preferential trade agreement will be trade creating’.

While econometric studies have the advantage of dealing with known facts, they do not allow for strict conclusions on the welfare effects of PTAs. While higher net trade

[30] Adams, R., Dee, P., Gali, J. and McGuire, G. 2003, *The Trade and Investment Effects of Preferential Trading Arrangements — Old and New Evidence*, Productivity Commission Staff Working Paper, Canberra. May.

[31] World Bank 2004, *Global Economic Prospects: Trade, Regionalism, and Development 2005*, World Bank, Washington, p. 62.

creation is likely to lead to greater benefits, there is not an automatic link between trade and welfare.

Second round effects

The welfare consequence of a change in trade depends on a number of factors, including the sensitivity of supply and demand in different industries. In addition, changes in one area of an economy inevitably have impacts on other areas in the economy. There is a range of second-round effects that need to be taken into consideration.

In an attempt to determine the total welfare consequence of trade changes, economists can use General Equilibrium (GE) modelling.

There are benefits and costs to using a GE model to review PTAs. The cost is that such models must rely on simplifying assumptions and estimates of unknown variables. In addition, the report by Adams et al notes that *ex-ante* modelling often assumes complete liberalisation and underplays the importance of exclusions, safeguards and rules of origin. The benefits of using GE modelling is that such models are able to consider the second-round effects of trade changes as well as the impact on welfare.

Some of the second-round effects that are considered in GE analysis include changed consumption and production, changed investment behaviour and the impact on taxes.

Production & consumption

The interaction between different elements of the economy is too complex to be done justice in just a few pages. That is why complex economic models are developed. However, it is possible to consider some of the general changes that will result from trade reform.

To the degree that there is trade creation, this will impact on the composition of domestic production. Inefficient industries and firms will decrease in size and resources (land, labour and capital) will shift into more efficient industries and firms.

The impact of these changes will depend on which industries expand and which industries contract. For example, if more resources go into industries that compete with imports, then this may result in *less* trade with some countries. What is produced and where trade takes place will depend critically on the flexibility of capital markets, the cost of structural adjustment and changes in the exchange rate.

It is possible that a PTA may result in trade creation, and yet trade may decrease with some countries (making the situation look like trade diversion). This is one reason why trade flows do not necessarily give a good guide to the welfare impact of a PTA and why GE models can add value to PTA analysis.

A second reason that domestic production may change following a PTA is that some industries may benefit from the lower cost of imports. A change to a tariff of an imported input changes the effective rate of protection for an industry (see box 14), which may result in resources being shifted into that industry.

If the resources are shifted into more efficient industries, then this will increase welfare. However, if the resources are shifted into inefficient protected industries and this new production replaces imports, then the effect will be the same as trade diversion (that is, the cost of lost tariff revenue will be lower than the benefit to the producer).

14 Effective rate of protection

The effective rate of protection (ERP) measures the total impact that trade barriers have on an industry, including the impact of trade barriers on industry inputs.

Trade barriers on an industry’s output will help that industry by decreasing the competition. However, trade barriers on an industry’s inputs will hurt that industry because their inputs will be more expensive. The net impact of all trade barriers is measured through the ERP. If a trade barrier on an industry’s inputs is removed, then their ERP is increased.

The ERP is defined as $(V – V^*) / V^*$, usually expressed as a percentage.

In this formula, V is the domestic value added (including tariffs on the inputs and the output) and V* is the value added under free trade. Value added is defined as the gross value of output minus the cost of inputs other than labour.

In addition to changes in production, a PTA can cause a change in consumption behaviour. Changes in disposable income will impact both on the amount and composition of domestic consumption, as well as the level of domestic savings. Changes in consumption patterns could lead to a change in trade relationships with different countries.

For example, if American consumers were made wealthier through a PTA, they may buy fewer Nissans (from Japan) and more Mercedes (from Germany). This could appear to be trade diversion, but in reality the change simply reflects the change in consumer preferences.

In addition, the introduction of a PTA could change the relative price of different products. Depending on the nature of the markets and trade relationships involved, the welfare impact from consumption changes may not be related to the trade impact. This is another reason why analysing trade data before and after the formation of a

PTA cannot be used to make conclusions about changes in welfare.

Investment

Changes to trade also have a flow-on effects on investment. This impact should not be confused with direct reform of investment rules — which will also effect investment. Direct investment reform is considered in chapter 5. This section considers only investment changes that result from trade reform.

Depending on the nature of a PTA, it is possible that the price of capital equipment could increase or decrease compared with the price of consumption goods. Also, as noted above, some industries may grow or contract as a result of the PTA and they will require a different level of investment.

These changes will impact on the demand and supply for capital, which will impact on the capital markets, domestic savings and foreign investment.

For example, if capital equipment became relatively cheaper then investment would be expected to increase. Some of the new investments could be financed through foreign investment, which would lead to financial flows in and out of the country.

Changes to the capital account (foreign investment) are related to the current account (trade balance) through changes in the exchange rate. This is another reason that trade data cannot be used to determine the welfare consequences of a PTA.

One example of the interaction between the capital account and the trade balance is what happened in Mexico after the introduction of NAFTA. When NAFTA was introduced, there was some expectation that Mexico would see a significant increase in its net exports. Instead, Mexico’s net exports actually decreased. The reason for this is that NAFTA encouraged investment into Mexico and that increased the value of the Mexican peso. The strength of the Mexican currency resulted in higher imports (which were relatively cheaper) and consequently Mexico reported a reduction in net exports.

Tax effect

All of the above changes will impact on the amount of revenue going to the government. The most obvious change will be a change in tariff revenue due to the removal or reduction of tariffs with partner countries. The reduction of a high tariff can increase or decrease tariff revenue[32], while the removal of tariffs will unambiguously reduce tariff revenue. As Ebrill, Stotsky and Gropp note[33], ‘the impact of trade liberalisation on revenues is generally ambiguous and depends on the reforms undertaken’.

In addition, if income, production, investment, trade and/or consumption change then this can impact on other tax revenue.

If a PTA results in less revenue for the government, then the government may be forced to increase other taxes to meet their current spending goals. While the existence of a tax is not itself a welfare loss (it is a transfer), there is an efficiency cost of taxation, which is a welfare loss. This cost

[32] Reducing a high tariff can increase revenue if there is a sufficient increase in the quantity of imports

[33] Ebrill, L., Stotsky, J. and Gropp, R. 2002, Fiscal Dimensions of Trade Liberalization, in Hoekman, B., Mattoo, A. and English, P. 2002 Development, Trade, and the WTO: A handbook, World Bank, Washington, p. 24.

has been estimated to be between 20 and 40 per cent of the tax revenue raised.[34]

In contrast, if a PTA results in more revenue for the government, then the government may be able to offer tax relief and still meet their spending goals. In this case there would be a reduction in the efficiency cost of taxation. The ultimate impact of the tax effect will depend on the nature of the PTA.

Conclusion

It is possible for a PTA to increase or decrease welfare. Determining whether a PTA is good or not is an empirical matter and there is no substitute for case-by-case analysis of each agreement.

The first round effect of a regional trade agreement is likely to result in both trade creation and trade diversion. Studies show that many PTAs have produced a significant amount of trade diversion. Second round effects on production, consumption, investment and tax also impact on trade and welfare (and sometimes in different directions). It is not possible to determine the welfare impacts of a trade deal by observing the changes in trade flows.

Instead, to gain an understanding for the full consequence of a PTA it is necessary to use a economywide model to estimate the outcome of the complex set of relationships

[34] In Canada, Fortin, B. and Larcroix, G. 1994, 'Labour supply, tax evasion and the marginal cost of public funds: an empirical study', *Journal of Public Economics*, vol. 55, pp. 407-31, estimate the 'excess burden' of a dollar tax to be between 39 and 53 cents. In New Zealand, Diewert, W. and Lawrence, D. 1995, 'Excess burden of taxation in New Zealand', *Economic Record*, vol. 71, pp. 121-31, estimate the cost to be 18 cents. In the United States, Jorgenson, D. W. and Yun, K. Y. 1990, *The Excess Burden of Taxation in the US*, Discussion Paper No. 1528, Harvard Institute of Economic Research estimate 38 cents. In Australia, Campbell, H. F and Bond, K. A. 1997, 'The cost of public funds in Australia', *Economic Record*, vol. 73, no. 220, pp. 22-34, estimate between 19 and 24 cents.

that exist between different sectors of the economy. Economywide models have their own problems in that they rely on simplifying assumptions and sometimes underestimate the impact of rules of origin, exclusions and safeguards. Despite these concerns, such models remain the best way to evaluate the total impact of PTAs on welfare.

4 COMPETITIVE EFFECT OF PTAS

Standard trade policy analysis ends with the content of chapter 3. However there is a growing amount of evidence that suggests there is an additional way that trade impacts on economic activity. Trade liberalisation results in increased competition and this can increase innovation and therefore productivity growth. This chapter will consider the theory and evidence that links trade to higher economic growth via increased competition.

Benefits from competition

In one sense, the links between trade, competition and innovation seem obvious. A 1997 poll of Australian attitudes towards trade showed that 52 per cent of respondents agreed that lowering tariffs would encourage industries to become more competitive.[35] This is despite the fact that most Australians are instinctively hostile towards free trade.

While the links between competition and growth may seem obvious to many, the standard theory of competition does not result in growth and the standard growth theory does not rely on competition. Because of this, neo-classical economics can tell us little about the dynamic links between the competitive process and innovation and economic

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[35] Norton, A. 2004. 'The Politics of Protection: Public Opinion Can Favour Liberalising Trade', *Policy*, Centre for Independent Studies, Sydney.

growth. To fully appreciate such relationships it is necessary to look outside of traditional competition theory.

Some schools of economics[36] have taken a keen interest in observing the complex competitive process and how it impacts on innovation. Whereas standard competition theory assumes a convergence towards a static competitive (or monopolistic) equilibrium — dynamic competition is actually a process of constant change and market evolution. When a market approaches the competitive equilibrium there is an incentive to innovate and gain monopoly profits. However, high monopoly profits encourages new firms to imitate and innovate themselves to cut into that profit.

The existence of a robust competitive process encourages businesses to use better technology and business practices either through innovation or quicker adoption of new ideas. In reviewing the recent history of economic reform in Australia, Banks[37] explains that trade and competition reform forced managers to devote more attention to improving business performance. He notes that productivity performance 'generally appears to have been much greater in particular industries … where trade pressure increased most'.

As trade barriers are effectively barriers to competition — then removing trade barriers will increase competition. Increased competition leads to more innovation, and therefore leads to higher levels of productivity growth. This benefit has been referred to in several different ways — the X-factor, dynamic benefits — but will here be referred to as the competitive effect of trade.

[36] Such as Austrian and evolutionary economics.

[37] Banks, G. 2003, *Australia's economic 'miracle'*, address to Forum on Postgraduate Economics, National Institute of Economics and Business, ANU, Canberra, 1 August 2003, p. 7.

Evidence for competitive benefits of trade

The case for believing in competitive benefits from trade is not universally accepted. John Quiggin has claimed that 'there is no basis in economic theory for an assumption that competition promotes technical progress. Empirical evidence on this issue is limited'.[38]

It is reasonable to consider what evidence does exist to support a competition-innovation links. Recent years have seen a growth in our knowledge of the links between trade, competition and productivity. Evidence includes econometric studies, anecdotal evidence from around the world and lessons learned from previous modelling mistakes. Each of these pieces of evidence is considered below.

Evidence: econometric studies

One method of testing the competition-growth theory is to measure the relationship between protection in an industry and output in that industry.

If there is no benefit from increased competition, then less protection should lead to less output. However, if the decrease in protection leads to benefits from more competition, then productivity in that industry will increase and output may actually rise.

In several studies conducted in the late 1990s, Chand has estimated the productivity and output consequence of reduced protection for the Australian manufacturing industry. He concludes that a 1 per cent reduction in protection is

[38] Quiggin, J. 1998, 'Micro gains from micro reform', http://eprint.uq.edu.au/archive/00000565/01/Microgains98.htm. Accessed 10 November 2004.

consistent with an increase in total factor productivity of between 0.18 and 0.5 per cent.[39]

Another source of econometric evidence comes from measuring causes of economic growth. Dean Parham tells us that the 'empirical literature also points to the importance of openness, trade orientation and competition as factors driving productivity growth' and he cites several studies in support of this comment.[40]

In assessing the trading performance of Mexico, Schiff and Wang[41] found that trade with their NAFTA partners (Canada and America) had a large and positive impact on productivity. They estimate that Mexican manufacturing productivity increased by between 5.5 and 7.5 per cent due to NAFTA and they suggest that one cause is the closer contact and more information exchanges between NAFTA countries.

Evidence: some examples

While there is growing empirical evidence of a relationship between trade, competition and productivity — it is difficult for econometric studies to reveal the exact causal relationship. Perhaps the most convincing evidence for the existence of the competition benefits of trade are the many real world examples.

In the early 1980s, the New Zealand agricultural sector was highly protected. Around 40 per cent of sheep and beef

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[39] Chand, S 1999, 'Trade Liberalization and Productivity Growth: Time-Series Evidence from Australian Manufacturing', *The Economic Record*, Volume 75 No. 228 pp 28-36.

[40] Parham, D. 1998, response to Quiggin in Productivity Commission Report on *The Gains from Microeconomic Reforms*, p. 109.

[41] Schiff, M. and Wang, Y. 2003, *Regional Integration and Technology Diffusion: The case of the North America Free Trade Agreement.* Policy Research Working Paper 3132, World Bank, Washington D.C.

farmers' income came from the government.[42] Farm protection accounted for 14 per cent of the government budget and 6 per cent of New Zealand's entire gross national product.

Then the government decided to drastically reduce protection for the farm sector. This reform coincided with the appreciation of the New Zealand dollar, falling commodity prices, increasing farm costs as well as high inflation and high interest rates. Standard trade theory suggests that the farm sector should have shrunk and resources should have shifted into other more efficient areas. Official predictions were that 10 per cent of farms would fail.

What happened next is one of global trade's good news stories. Since 1986 the size of the agricultural sector (in constant dollar terms) has increased by 40 per cent. Farming output as a percentage of GDP has increased since protection was removed because growth in the agricultural sector has outpaced growth in the New Zealand economy as a whole. The number of full-time farm workers has increased. Agricultural productivity has increased from 1 per cent a year to an average of 5.9 per cent a year. In short, since the removal of protection, the New Zealand farming sector has seen considerable increases in productivity and output.

While New Zealand represents an outstanding example of the link between trade, competition and productivity, there are many other examples.

In Japan, the moderate liberalisation of trade in beef did not result in the expected reduction in Japanese beef production. In the late 1980s, subsidies made up 44 per cent of the incomes of Japanese cattle farmers. Following

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[42] Statistics for New Zealand are taken from Humphreys, J., Van Bueren, M. and Stoeckel, A. 2003, *Greening Farm Subsidies: The next step in removing perverse farm subsidies*, RIRDC Publication No: 03/040, Canberra.

import liberalisation in 1991 this has since reduced to 32 per cent.

In response to lower protection, Japanese producers innovated and, through product differentiation and an increase in average herd size, were able to maintain their market share. Beef cattle numbers increased from 2.6 million in 1985 up to 3 million by 1995 and have remained fairly constant since then.[43]

Another piece of anecdotal evidence comes directly from preferential trade deals. The World Bank reports that some regional trade deals (such as AFTA, NAFTA and MERCOSUR among others) appear to result in higher exports to non-member countries, despite the existence of some trade diversion. Increased exports to non-member countries imply an improvement in domestic productivity.

The World Bank suggests a link between PTAs and productivity when they state that larger markets 'permit wider competition, larger scales, and greater specialization, all of which increase productivity and growth'.[44]

Evidence: modelling mistakes

Economists have been using economy-wide models to predict the consequences of trade reform for many years. While these models rely on assumptions and generalisations that are abstractions from reality, they remain the best tools available for understanding the consequence of trade on wellbeing.

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[43] Statistics for Japan come from Centre for International Economics 2003, *The Political Economy of Beef Liberalisation: A Collection of International Papers*, a study prepared for the Five Nations Beef Group, Canberra.

[44] World Bank 2005, *Global Economic Prospects: Trade, Regionalism and Development 2005*, The World Bank, Washington DC, p. 64.

These economy-wide models can be accurate. However, they can also perform poorly when reality refuses to align with the predictions of the model. Timothy Kehoe[45] compared the outcomes of the North American Free Trade Agreement (NAFTA) with some predictions made using economy-wide models (which did not consider productivity benefits from competition), and found that the models did not produce accurate predictions.

Kehoe points out that it was productivity changes, and not trade changes, that explained the macroeconomic fluctuations following the introduction of NAFTA. He suggests the possibility that 'the biggest effect of liberalisation of trade and capital flows is the effect on productivity — through changing the distribution of firms and encouraging technology adoption — rather than the effects emphasised by the models used to analyse the impact of NAFTA'.[46]

Conclusion

Most of the attention given to trade analysis concerns the trade effects outlined in chapter 3. However, there is a growing amount of evidence to suggest that the trade effects are only half of the story and that the competition effects of trade can be just as important, if not more important.

At this point, it is difficult to determine the size of the competition benefits of trade. This has resulted in trade analysis concentrating on what is well understood to the detriment of other effects. Such an approach has been likened to a person looking for their lost keys under the

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[45] Kehoe, T. J. 2003, 'An evaluation of the performance of applied general equilibrium models of the impact of NAFTA', Federal Reserve Bank of Minneapolis, Research Department Staff Report 320, August.

[46] Kehoe, p. 25.

streetlight because that's where the light is, despite the fact that they dropped them on the other side of the road.

If the competition effect of trade is significant then this can significantly change the way PTAs are viewed. It becomes possible that PTAs can increase welfare even if trade diversion outweighs trade creation as discussed in chapter 3. A second conclusion is that the benefits of a trade agreement will be higher when trade barriers are reduced in inefficient industries in which there is currently little competitive pressure. While these industries are often the loudest to oppose trade reform, they may actually end up gaining from the reform.

5 NON-TRADE ISSUES INVOLVED WITH PTAS

Trade agreements typically cover more issues than simply trade. Indeed, some recent evidence suggests that non-trade issues may actually be more important than the trade aspects of PTAs.

One of the most important non-trade issues that has been included in regional trade agreements is the impact on investment.

The impacts of trade changes on investment were discussed in chapter 3. There are two additional ways that investment can be affected by an PTA — commitments to liberalise investment (and services) rules and changes in the country risk premium. The three different impacts on investment are contrasted in box 15.

Investment liberalisation

Foreign investment policy is in some ways the other side of the trade policy coin. Countries can either trade goods and services across borders (trade) or can transfer money (foreign investment) — with similar results.

Access to foreign investment increases the total supply of credit in a country, which results in more investment, more production and more jobs. While some of the benefits

15 Different PTA impacts on investment

1) Trade liberalisation can result in changes to investment via changes in return on capital invested in industries with price changes (see chapter 3)

2) Changes to investment regulations can result in changes to investment via lower transaction costs of investing (see section on Investment liberalisation)

3) Changes to the risk premium can result in changes to investment via lower overall cost of capital due to reduced country risk for the partner country (see section on reduced political risk)

from foreign investment flow back to the international investor, some of the benefits remain in the recipient country through wages, taxes, rent etc.

Issues of foreign investment rules and regulations regarding international service providers are becoming increasingly important in the construction of PTAs. Their inclusion has been referred to as marking the 'third wave'[47] of trade agreements that fundamentally change the way that such agreements should be judged.

Analysis of the impact of bilateral investment liberalisation differs from bilateral trade liberalisation for a number of reasons. Investment liberalisation does not result in diversion because barriers to investment do not provide any tariff revenue (or any other sort of economic rent).

However, there are some concerns about the impact of foreign investment. Countries with thin markets and

[47] This terminology is used by Adams, R., Dee, P., Gali, J. and McGuire, G. 2003, *The Trade and Investment Effects of Preferential Trading Arrangements — Old and New Evidence*, Productivity Commission Staff Working Paper, Canberra. May, in their review of preferential trade agreements.

unsophisticated domestic players may be susceptible to potentially damaging speculative investments. This is less of a concern for countries with deep equity and financial markets. Also, changed investment rules may result in an increase in the number of mergers and acquisitions. It is uncertain what impact this would ultimately have on an economy. These concerns notwithstanding, the benefits of foreign investment are generally accepted.

Reducing political risk

Potentially the most important non-trade issue associated with trade deals is the least well-understood — political risk. Political risk is the chance that government behaviour will affect the profits of a business, for example by changing the right to withdraw capital. Many parts of a trade agreement may impact on political risk, with potentially significant consequences for total investment and national welfare.

To understand how PTAs affect political risk, it is necessary to understand the importance of the country risk premium.

The country risk premium is the extra return foreign investors require over that of a riskless investment (usually taken to be the US long term bond rate) to compensate them for the extra risk they take on when investing in a country. This risk can be from political risk, exchange rate risk, market risk or some other. Political risk — usually that the country is unstable or the laws may change unpredictably — is often a large risk. If it were possible to decrease the risk premium, investors would be more willing to supply capital at a lower rate of return. If a PTA is able to lower political risk, this could increase the supply of capital from external sources and increase investment.

There are several ways a PTA could impact on political risk. One common element of trade agreements is to introduce or lower a 'bound tariff rate', which cannot be exceeded. This rate may not be the same as the applied tariff rate. For instance, it is possible for a bound tariff to be 20 per cent while the applied rate is 10 per cent. To affect trade, it is necessary to lower the applied rate. Lowering the bound rate down to 10 per cent would not, of itself, change trade. But it would reduce the political risk by removing the possibility that tariffs will be increased, which would encourage greater investment and therefore trade. The effects of bound tariff rates are not typically measured in economy-wide PTA analyses.

Investment and services rules can also affect political risk. Government policies that prevent or hinder investment activities have a direct impact on investment (as discussed above). They also affect perceptions of political risk, as anti-investment policies act as a signal that foreign investment is a politically sensitive issue and that the government may interfere in the future.

In effect, political risk is determined by market perceptions about the likelihood that the government will change the rules of trade and investment. A binding trade agreement helps to bolster confidence in the trading and investing processes and can help prevent nations from backsliding during difficult economic or political times.

The potential consequences from a change in the risk premium are significant. One modelling estimate for an Australia–United States FTA, for example, suggested that a change as small as 5 basis points (0.05 per cent) in the country risk premium could lead to between 0.25 and 0.36 per cent change in real GDP[48].

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[48] Based on G-Cubed modelling, as described in Centre for International Economics, 1994, *Mauritius: Looking beyond the region*, Canberra, October.

Intellectual property

Trade agreements may include rules regarding intellectual property. Intellectual property rights (IPR) are monopoly rights over a certain idea. They are granted by the government for a set period of time and given to the person who first patents the idea.

The reason for IPR is to protect the benefit that people get for coming up with new ideas. New technology and innovation are drivers of economic growth. However, innovative ideas (unlike real property) are easy to steal, but costly to produce. If new innovations can be easily 'stolen' the innovator receives little advantage over other people who steal their idea. By giving an innovator the monopoly use of their idea for a set period of time, IPR increases the incentive to innovate and therefore invest in research and development. There is more innovation and society is better off.

The cost of IPR is the same as the cost of any monopoly business. Competition drives down prices and can lead to a more efficient allocation of resources. In addition, competition can itself be a driver of innovation and economic growth (as discussed in chapter 4). By granting monopoly rights to the innovator, the benefits of competition are delayed until the expiry of the patent.

While most economists agree that IPRs are necessary, there is no consensus on how long they should last. This makes it difficult to assess the consequences of a change to the IPR system. Further, if IPR reforms only change the treatment of IPR several decades in the future, then the present value of that change is likely to be insignificant.

However, a second effect of IPR reform has an immediate, measurable and potentially significant impact. If IPR recognition is changed and this applies retrospectively, a country will benefit if it is a net exporter of patented and copyrighted materials and will lose if it is are a net importer of patented and copyrighted materials. Including IPR in a PTA can lead to net benefits or net costs and the issue has to be assessed on a case-by-case basis.

Other

In recent years there has been increased pressure for trade agreements to explicitly include a greater range of domestic issues such as competition policy, environmental issues and labour issues. The consequence of including such issues will depend on the exact nature of the changes being proposed and should be evaluated on their merits.

While competition policy is not trade distorting per se, competition policy provisions are sometimes included in trade agreements.

Likewise, while environmental and labour issues are not directly related to trade policy, provisions relating to these issues are increasingly being included in trade agreements.

Irrespective of the merit of domestic policy reform in these areas, their inclusion in PTA negotiations raises the possibility of ‘new protectionism’. This term generally refers to rich countries that refuse to trade with poor countries because of concerns about labour and environmental standards.

It is important to recognise that poor countries cannot necessarily afford high labour and environmental standards. If these countries are excluded from international trade, this will reduce their opportunities to develop and so their labour and environmental standards are unlikely to improve.

If countries want to develop common policies on competition, the environment and labour law, then these policies could be pursued separately to the benefit of all countries involved. A separate agreement could be negotiated in tandem with a trade agreement. However, by ensuring that the trade agreement is not linked to or dependent on agreements regarding other domestic policy, 'new protectionism' can be avoided. Here the saying applies: 'it is not possible to kill two birds with one stone'. To encourage trade, restrictive trade policies should be removed. To encourage better environmental or labour outcomes, better environmental or labour policies should be used. First-best policy would be free trade combined with appropriate domestic environmental or labour policies. These issues are best left out of free trade agreements.

Conclusion

Non-trade issues can be important in PTAs. The gain from investment liberalisation and the reduction in political risk can outweigh the trade effects as usually measured by economy-wide models. The effects of including intellectual property aspects in PTAs depends on whether the country is a net importer or exporter of intellectual property and needs to be assessed on a case-by-case basis. Environmental and labour issues are best excluded from PTAs altogether and addressed by appropriate domestic environmental and labour policies.

6 POLITICAL ECONOMY OF PTAS

Economists have sometimes been accused of developing theories and policy suggestions without a realistic grasp on the nature of the world around them. In reality, things are not always as easy or simple as they appear in the textbooks.

One response to this accusation has been the development of public choice theory. This growing branch of economics recognises that politics is an important part of the real world, and that politicians and bureaucrats are not always perfectly knowledgable or benevolent.

For complete analysis of preferential trade agreements it is necessary to consider how reform changes governments' behaviour.

Domestic political impacts

A PTA can result in a number of changes (both positive and negative) in the domestic political environment. It is difficult to predict this impact. The range of outcomes can include changing sentiment towards trade, encouraging rent seeking and exerting pressure for sound economic and political management.

Changing sentiment towards trade

Just as public opinion influences trade policy, trade policy can influence public opinion. One of the reasons PTAs are preferred to multilateral and unilateral liberalisation is that the level of public support is highest for PTAs. Despite the importance of public opinion, it is nearly impossible to predict how a PTA will sway public opinion.

As a worst-case scenario, a disappointing PTA could reduce support for free trade. In their review of the North American Free Trade Agreement (NAFTA), Smith and Lindblad note that, despite the many NAFTA successes, a negative impression of NAFTA has spawned an anti-trade attitude among many Latin Americans. One reason cited for this is that ‘the deal was oversold by its sponsors as a cure-all’[49].

All trade reforms involve adjustment costs. They are likely to hurt some people, and so inflame anti-trade sentiment. It is an inevitable risk of reform that must be taken. However, these risks may be reduced through transparent government processes and a sober analysis of benefits and costs.

Rent seeking

Rent seeking is an inevitable cost of all government policy, including trade agreements. Instead of concentrating their resources on production, some stakeholders will divert resources towards political lobbying. The problem with this is twofold.

While rent seeking makes sense for individual lobbyists (who may benefit from a change in policy), the time and money spent lobbying government is a waste for society.

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[49] Smith, G. and Lindblad, C. 2003, ‘Mexico: Was NAFTA Worth It?, *BusinessWeek*, December 22, p. 37.

This waste of resources from rent seeking is in addition to the cost to society already counted when government policy is shifted away from optimal public policy. Protected industries often argue against any sort of trade liberalisation, whether it is unilateral, multilateral or preferential. The achievement of liberalisation generally reduces the power of the lobby group. However, this is not necessarily true with PTAs.

One potential problem with PTAs is that an industry may be able to gain an exclusion from PTA liberalisation. This may entrench their protection and make it more difficult to reform the industry in the future.

Potentially more harmful is that PTAs can actually turn some industry groups against unilateral and multilateral trade liberalisation. This is considered later in this chapter.

Impact on other policies

Governments do not pass legislation in a policy vacuum. PTAs can cause governments to pass other policies not directly related to the trade agreements. For example, Australia increased compensation payments to its sugar farmers following the exclusion of sugar from the Australian trade deal with the United States.

Even though such policies are not directly related to trade agreements, if they only exist because of the trade agreement then their effects — which may be either positive or negative — need to be considered.

Pressure for good economic management

One argument sometimes advanced for PTAs is that they increase the incentive for good economic and political management.

Producers in the traded sectors (exporters and those who compete against imports) are forced to compete against producers from many other countries. This group is particularly sensitive to policy changes that will make them less competitive. In addition, they are aware of good policy in other countries that improves efficiency and productivity. If a PTA increases the number of producers in traded sectors, these producers could increase pressure on their governments to introduce high quality public policy.

Economic liberalisation has also been linked to democratic reform. Some commentators have noted Mexico's shift from a single-party state to a multi-party democracy since the introduction of NAFTA, which required increased government transparency. These impacts are difficult to prove and even harder to measure.

Impact on the international trading environment

The growth of PTAs is an important change in the international trading environment. This, in turn, has implications for the other types of liberalisation — multilateral and unilateral. The impact of PTAs on the WTO and unilateral liberalisation has been described as being either a 'building block' (positively re-enforcing trade liberalisation) or a 'stumbling block' (preventing multilateral and unilateral liberalisation)[50].

50 For an example of the building block argument see Griswold, D. 2003, 'Free-trade agreements: Steppingstones to a more open world', CATO Institute, July and for an example of a stumbling block argument see Limao, N. 2003, *Preferential trade agreements as stumbling blocks for multilateral trade: Liberalization: Evidence for the US*, University of Maryland, November.

PTAs and the WTO: complement or substitute?

Some people who oppose PTAs argue that we have a choice between PTAs and the WTO process, and that the WTO process is preferable. This argument suggests that PTAs and the WTO are substitutes between which we must choose and that the growth of PTAs will harm the WTO.

This fear is supported by evidence from the United States that reveals that multilateral tariff reductions in the Uruguay round of WTO negotiations were lower on goods that were subject to preferential treatment[51].

Countries that benefit from preferences have an incentive to argue against multilateral liberalisation, because they would lose their competitive advantage. For example, under NAFTA, Mexico receives preferential access for sugar into America’s market. Mexico’s sugar production and exports to the United States have risen. But global sugar reform would remove this preference. Mexico now has an incentive to block global sugar reform[52].

Another reason that PTAs could harm the WTO process is simply that they may divert limited resources away from multilateral negotiations.

If PTAs create more obstacles to WTO progress, the WTO may lose its relevance and international trade liberalisation could stall. This political economy cost could outweigh any potential economic benefit from individual PTAs.

However, the impact of PTAs on the WTO could be reversed. Instead of diverting attention away from the WTO, PTAs could increase the total amount of attention and resources being dedicated towards trade issues and

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51 Limao, 2003.

52 Stoeckel, A. 2004, *Termites in the Basement: To Free Up Trade, Fix the WTO’s Foundations*, RIRDC Publication No. 03/092, Canberra.

could help to build important networks between trade bureaucrats in different countries.

In addition, some argue PTAs serve as an experimental laboratory for cooperation on issues that have not yet been addressed multilaterally and this can help WTO negotiations[53].

PTAs may also help the WTO by raising the stakes of WTO negotiations. This involves the high-risk strategy of encouraging progress in the WTO with the threat of an alternative trading environment based on regional trade agreements. Those countries being excluded from important regional agreements will have an increased incentive to argue forcefully for successful multilateral reform.

PTAs and unilateral free trade: help or hindrance?

Regardless of their effect on the WTO, PTAs could have either a positive impact on unilateral reforms towards free trade or could result in competing and hostile trade blocs.

On the positive side, PTAs can help to dilute the power of special interest groups opposed to trade. By exposing protected industries to small increases in competition, a PTA might allow an industry to partially adjust and therefore reduce its opposition to future trade reform.

One example of this is the Closer Economic Relations (CER) agreement, the PTA between Australia and New Zealand. This agreement has added momentum to the internationalisation of both economies. Evidence can be

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53 It should be noted that not all aspects of PTAs are in the interests of all countries. For example, developing countries have argued strongly against the inclusion of competition policy provisions in WTO negotiations. See for example Hoeckman, B. and Kostecki, M. 2001, *The Political Economy of the World Trading System*, 2nd edition, Oxford University Press, New York.

seen in the dairy industry. Bilateral liberalisation was one of the drivers of adjustment for the Australian dairy industry. As the Australian dairy industry became more competitive, it became easier to shift towards unilateral liberalisation[54].

The growing number of PTAs may result in a positive cycle of bidding wars, with an increasing number of countries entering into agreements with a wide network of their trading partners. For countries that are already party to an PTA, each additional PTA results in less trade diversion and so increases the likelihood of positive impact on welfare. This increases the incentive of a country to search for additional PTAs. In addition, excluded countries also have an incentive to search for PTAs to avoid being excluded from potential markets. This process could end up as a 'race towards free trade', as countries out-bid each other in offering more and more liberalisation until the remaining barriers are insignificant.

On the negative side, the growth of PTAs could create several large and potentially hostile trading blocs.

A third possibility is that countries may develop a complex network of trading agreements based on preferences and aid but not free trade. This bad outcome existed in the early twentieth century and the high cost of this system was the reason that countries turned to multilateral liberalisation in the first place. One way to prevent this outcome is to ensure that PTAs only take place if they are comprehensive. This highlights the importance of making sure that PTAs

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54 Stoeckel, A. 2004, *Termites in the Basement: To Free Up Trade, Fix the WTO's Foundations*, RIRDC Publication No. 03/092, Canberra. See also Harris, D. and Rae, A. 2004, 'Agricultural Policy Reform and Industry Adjustment in Australia and New Zealand', paper prepared for International Agricultural Trade Research Consortium Summer Symposium, Adjusting to Domestic and International Agricultural Policy Reform in Industrial Countries, June 6–7 2004, Philadelphia, Pennsylvania.

are as comprehensive as possible, as required by GATT Article XXIV.

Impact on international relations

Trade forms a vital part of relationships between countries. A close trade relationship means that many people have a strong interest in the success and stability of their trading partners. This fosters cultural exchange, increased understanding and lowers the probability of conflict.

In addition to building relationships between citizens, trade agreements can help to build ties between administrations. Negotiations can build important relationships, and linking two economies more closely together increases the importance of good political relationships.

Finally, trade agreements can be used to 'reward' friendly countries or 'encourage' countries to pursue more economically liberal policies. This option is noted by Griswold[55] in his discussion of possible American PTAs. He supports a trade agreement with some Central American economies because it 'would recognize and reward [their] progress' and a trade agreement with Morocco would 'help to build a core of Arab nations [along with Jordan] that would support trade liberalisation and economic integration with the global economy'[56]. Likewise, an agreement with the South African Customs Union might 'encourage economic reform and institutional development in a region of the world where both have been rare and fragile'[57].

Like all of the political economy impacts of trade agreements, the impact on international relations is difficult

[55] Griswold, D. 2003, 'Free-trade agreements: Steppingstones to a more open world', CATO Institute, July.

[56] Griswold, p. 12.

[57] Griswold, p. 14.

to prove and harder to measure. Just as a trade agreement can be either trade creating or trade diverting depending on how it is pursued, it is also possible for a trade agreement to harm or hinder a country’s broader trade and foreign policy agenda.

Conclusion

There are several valid PTA issues countries should consider besides the more easily measured trade effects. But while these other effects can be important, they are often difficult, if not impossible, to quantify.

While it may not be possible to draw a strong conclusion about the desirability of PTAs, the discussion of the past four chapters does allow us to identify features that increase the benefits of a trade agreement. These are discussed in the next chapter.

7 FEATURES OF A 'GOOD' PTA

The previous four chapters have considered different elements of PTAs — trade effects, competition effects, non-trade issues and political economy effects. It is not possible to draw a definitive conclusion about the desirability of PTAs, and it will always be necessary to evaluate each PTA on its merits.

However, there are some clear indicators as to what makes a PTA better. Building on the discussion so far, this chapter will suggest ten lessons regarding PTAs that will encourage benefits to be realised and potential costs to be minimised. These lessons then are summarised in a checklist for evaluating PTAs in box 16.

1. Ensure that prices are reduced

A PTA's trade impacts can be quite complex. The simple rule to remember is that the greater the price reduction, the higher the benefits and the lower the costs of the PTA. If there is little or no price reduction from a PTA then most of the trade impact is likely to be *trade diversion* rather than *trade creation* (see chapter 3).

The more efficient and larger the PTA partner and the greater the barriers being removed, the more likely prices will be reduced.

16 PTA lessons & checklist rules

Lesson	*Checklist rule*
Trade benefits are maximised when the price change is maximised	Is the price reduction maximised?
Increased competitive pressures can lead to additional benefits, especially for ‘problem’ industries	Are ‘problem’ industries included in the PTA?
Comprehensive PTAs create fewer distortions and lower administration and compliance costs	Is the PTA comprehensive, including substantially all trade that would have occurred under free trade?
Complex and inflexible rules of origin increase the costs of PTAs	Are the rules of origin simple, consistent and flexible?
Significant benefits can be gained through increasing the certainty of the trade and investment environment	Does the PTA increase certainty for trade and investment?
PTAs can achieve investment liberalisation to the benefit of both countries	Does the PTA also liberalise investment rules?
Although important, domestic issues should be excluded from PTAs as they can prevent trade liberalisation and provide questionable benefit	Is the PTA free of any ‘new protectionist’ measures, such as unnecessary environment, labour market or competition law requirements?
PTA negotiations should be as transparent and inclusive as possible and detailed independent analysis of the costs and benefits should be published	Are the details and consequences of the PTA well understood following a transparent process and independent analysis?
Member countries of PTAs should reinforce their commitment to successful multilateral liberalisation	Have PTA countries reinforced their commitment to the WTO and is there a sunset clause to multilateralise the PTA?
PTAs should extend beyond regional agreements and PTA members should be open to expanding membership and merging PTA groupings	Does the PTA allow for expansion with new members and potential integration with other PTAs?

Because the trade benefit comes from the price change, another way to improve the benefits of a PTA is to link it to a general reduction in tariffs. For example, if a country had an average tariff level of 20 per cent, they could link the introduction of a PTA (zero tariffs with the PTA partner) with a general reduction in their tariff level to, say, 18 per cent. This would guarantee a reduction in prices and would decrease the probability of trade diversion, while retaining the preferential nature of the agreement.

2. Don’t exclude ‘problem’ industries

It can be tempting for political decision-makers to avoid difficult decisions. Reducing protection for highly protected industries can be a hard political decision because of the pressure from special interest groups. However, reform in these industries can also often be the most beneficial.

Reforming those industries with high levels of protection can often result in significant price reductions, which increases the trade benefits. In addition, tariff reductions can increase competition in the protected domestic industry and encourage new innovation and quicker adoption of best-practice production and management techniques.

One of the benefits of PTAs is that they can be a gentle way of exposing highly protected industries to some of the rigours of international competition without exposing them to full international competition. This can help to reduce political economy impediments to multilateral and unilateral reform and gives highly protected industries more time to adjust before they face full international competition. This benefit is lost if highly protected industries are exempt from the trade agreement. This benefit can be strengthened if the country is committed to further unilateral or multilateral liberalisation in the future.

A potential cost of PTAs is that they may entrench the protection of special interest groups through exclusions, making it more difficult to reform those industries in the future. This cost can be avoided by making sure ‘problem’ industries are included in the PTA.

3. Make PTAs comprehensive

Ideally, PTAs should completely remove all tariffs and quotas between two countries. While the timeline to achieve this outcome may be negotiable, the goal should not. Safeguards are a restriction on trade, and if included they should be phased out over time.

Exempting an industry or sector from a PTA creates additional distortions. An incomplete PTA has two sources of distortion — it discriminates between countries and also between products. This increases the potential for trade diversion and increases the costs of preferential liberalisation. In addition, the potential trade and competition benefits are lost in the exempt industries. The lower benefits and higher costs from exclusions can make the difference between a good and a bad PTA.

Just as importantly, if some products are exempt or some tariffs do not reduce to zero, then this will increase the complexity of such a PTA. This increases administration and compliance costs and also can result in a complex mix of inconsistent deals struck with different nations. This would make it harder for PTAs to evolve into free trade and may result in a ‘spaghetti bowl’ outcome that could be worse than higher, but consistent, protection.

This lack of comprehensiveness is a legitimate fear expressed by many critics of PTAs and is the motivation behind the requirement in GATT Article XXIV that PTAs cover ‘substantially all’ trade. For this requirement to be effective, 'substantially all' should be interpreted as trade amounting to a fixed per cent (perhaps 95 per cent) of the amount of trade that would occur with zero protection.

4. Make rules of origin simple and consistent

One of the costs of PTAs is the rules of origin (RoO)[58]. The size of this cost depends on the type of rules and the nature of the PTA. Rules that are more restrictive and rules with high compliance costs will drive up the costs of PTAs and can potentially make the difference between a good and bad agreement.

Having different RoO in different PTAs will increase administration and compliance costs and should be avoided if possible.

One important principle for RoO is that the rules should be removed wherever possible. For example, when both member countries have similar levels of external tariffs, they should remove all RoO.

Both member countries should also remove RoO if they have overlapping PTAs with a third country. This suggestion extends the cumulation principle of RoO. Cumulation is an instrument that allows producers to import materials from other countries within a PTA without undermining the origin of the final product.

The cumulation principle should be extended to include imports from any country that has a separate PTA with both member countries. For example, both Australia and Singapore have a PTA with the United States. If a product is made in either Australia or Singapore it can freely enter

[58] Rules of origin are not relevant for a customs union, common market or economic union as all countries have the same level of external protection.

the US. However, if a product is made jointly by Australians and Singaporeans, then inflexible RoO may deny the product access to the US. Extended cumulation can avoid this problem.

Extended cumulation makes for smarter rules of origin. Without these rules, the growing number of PTAs are more likely to result in a costly and complex set of overlapping agreements — the ‘spaghetti bowl’ analogy. Extended cumulation and evolving RoO help to reduce this risk.

5. Maximise certainty

Risk is an inescapable feature of all economic systems. A government cannot totally remove risk, but it can decrease political risk by making the economic and trading environment more certain.

Political risk is reduced when there is consistency of rules and when trade and investment restrictions are low. The existence of anti-trade and anti-investment rules are an indicator that trade and investment may not be welcome and that there may be a risk of future political action that harms the interests of traders and/or investors. Conversely, the existence of bound tariff rates and political agreements to reduce barriers can decrease the perception of political risk and therefore increase willingness to trade and invest in a country.

6. Investment liberalisation

Trade and foreign investment are two sides of the same coin and should be considered together. As discussed in chapter 5, many recent PTAs have expanded into areas other than trade. Some reports suggest that investment liberalisation may actually outweigh trade liberalisation as a source of benefits[59].

Investment liberalisation is key to effective trade in services, as services can require physical operations to shift into the partner country.

7. Avoid 'new protectionism'

Recent PTAs have expanded into several areas other than trade. While the inclusion of investment liberalisation and trade-related regulations are an improvement over previous PTAs, some other inclusions have more questionable consequences and can be used to restrict trade.

Policies regarding intellectual property, competition laws, labour market regulations and the environment are all vital to the long term prosperity and sustainability of a nation's economy. However, there is significant disagreement about exactly how these issues should be managed and there may not be a universally applicable set of rules and regulations. For example, it may be inappropriate and counter-productive to hold developing countries to the same intellectual property, environmental or competition laws that exist in developed countries.

As these issues are only tangentially related to trade policy, it is not worth risking the potential benefits of freer trade (and investment) liberalisation by including these complex issues in PTAs. Indeed, some groups promote the inclusion of these non-trade issues with precisely the intention of preventing trade liberalisation. This is called 'new protectionism' and should be avoided.

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59 Adams, R., Dee, P., Gali, J. and McGuire, G. 2003, *The Trade and Investment Effects of Preferential Trading Arrangements — Old and New Evidence*, Productivity Commission Staff Working Paper, Canberra. May.

If domestic issues are included in a PTA, then the benefits and costs of these changes should be carefully assessed and included in the overall analysis of the PTA.

8. Transparent process, consultation and detailed analysis

There are two important reasons to make sure that the PTA negotiation process is transparent, independent, detailed and public. The first reason is that the political motivation may not align with the economic benefits and costs of a PTA and public scrutiny can help to ensure that agreements are determined according to an objective value of national welfare.

Secondly, by providing public analysis and thorough community consultation the public is likely to become more aware of the potential gains and losses that may eventuate. This can help to decrease unrealistic expectations or fears, increase public confidence in the decision-making process and provide greater certainty as to the ultimate trading environment. If the PTA does not increase national welfare, the analysis can prevent a bad decision from being made and also focus debate on why the PTA offers no net gain. Most likely it will be due to a few ‘problem’ industries, where there should be public debate about the costs and benefits of unilaterally reducing protection — with or without a PTA.

The World Bank has identified improving transparency as the most useful and immediate step the WTO can take to improve PTAs. This could be done by the Committee on Regional Trade Agreements. International analysis of PTAs should be supplemented by comprehensive assessments at the national level for each trade partner[60].

9. Continue commitment to WTO

Whether PTAs and the WTO are complements or substitutes depends on the approaches of the countries involved. Ultimately, it is in the interests of every country to pursue the goal of total free trade and participants in any PTA should re-affirm their commitment to a new and more comprehensive round of WTO negotiations. In effect, PTA members should commit to a WTO agenda that will make the PTA redundant at some point in the future — preferably as soon as possible.

One way to ensure that PTAs are more consistent with the goal of free trade is to introduce a sunset clause. The basic idea is for PTA member countries to commit to multilateralise their trade agreement at some specific time in the future. In this way, PTAs contribute directly to non-preferential trade liberalisation. The downside to this option is that it may be politically unacceptable.

A weaker version of the sunset clause is to commit to removing the preference at a specific time in the future. While this option will not result in non-preferential free trade, it would provide a strong incentive for countries to achieve multilateral reforms before their preferential trade deals end. Producers and consumers that benefited from higher trade under a PTA would form a lobby group in favour of greater multilateral liberalisation.

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[60] More on the critical role of transparency in securing better outcomes for trade policy can be found in 'The path to world agricultural trade reform', paper for a workshop prior to the Annual Conference of the Australian Agricultural and Resource Economics Society, on Trade Policy Reform and Agriculture, Coffs Harbour, 8 February 2005 and Stoeckel, A. 2004 *Termites in the Basement: To Free Up Trade, Fix the WTO's Foundations*, RIRDC Project No. CIE-13A, Canberra.

10. Pursue evolutionary PTAs

Proponents of PTAs argue that they can potentially evolve into universal free trade as countries race to enter into agreements with all other nations. One way to increase this possibility is to have less strict rules about joining PTAs.

Trade agreements that are open to new entrants and extend beyond a single region are more likely to promote trade liberalisation and less likely to result in hostile trading blocs or a ‘spaghetti bowl’ of costly and complex overlapping agreements.

This could be achieved either through merging existing PTAs or the using open-ended PTAs that set rules and have an open invitation for new countries to join so long as they comply with the trade (and perhaps investment) requirements.

Feulner et al[61] propose a similar suggestion: a ‘global free trade alliance’ between the United States and any other nation that meets the basic requirements of a commitment to free trade and investment, minimal regulation, and property rights. This free trade alliance would not be regionally based and would be open to any country that meets the joining criteria.

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[61] Feulner, E. J., Husman, J. C. and Schaefer, B. D. 2004, ‘Free trade by any means: How the global free trade alliance enhances America’s overall trading strategy’, *Backgrounder*, No. 1786, August.

8 WHERE TO FROM HERE?

Former U.S. Trade Representative, Clayton Yeutter[62], points out that there are three options for global trade negotiations. Either we can stop negotiating, turn increasingly towards regional and bilateral negotiations, or get the WTO system back on track.

Some trade advocates suggest that the WTO is the only way forward and that PTAs are an unwelcome distraction from the main game. However, whether we like it or not PTAs are becoming a more important part of the modern trading environment. If the WTO continues to falter in its pursuit of liberalisation, PTAs may be effectively the only game in town. It is fundamental that serious attention is paid to the structure and future of PTAs with the goal of maximising their benefits and reducing their costs.

The next step for the WTO

There are a number of ways the WTO can help to manage PTAs. First and foremost, PTAs would not be relevant in a world with complete multilateral free trade. The success of the WTO would make PTAs redundant.

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62 Yeutter, Clayton 2003, 'Towards Relaunching the Doha Round in 2005' *Getting the WTO Negotiations Back on Track*, papers for a Trade Policy Roundtable at Arnold & Porter, Washington, DC, 25 November, pp. 38–44.

If multilateral free trade is not achieved soon, the WTO can still play an effective role in improving PTAs. Article XXIV of the GATT, which requires that PTAs cover ‘substantially all’ trade, should be clarified to mean PTAs must result in substantially all (perhaps 95 per cent) of the zero-protection level of trade. The WTO can also monitor PTAs and improve transparency regarding the benefits and costs of different PTAs.

The WTO could also give countries guidance on preparing better PTAs, perhaps by offering an ‘off-the-shelf’ PTA template for member nations to use as a starting point for negotiations. Such a template could make use of the ten-point checklist and offer suggestions about rules of origin, sunset clauses that multilateralise PTAs and how to manage open-ended PTAs.

The next step for trading nations

Irrespective of the WTO’s actions, trading nations are going to have to come to terms with PTAs. At an individual level, few countries will be able to change the momentum towards PTAs, but all will have to live with the consequences.

The ten-point checklist developed in chapter 7 offers a range of points for a nation to consider when negotiating a PTA. Each nation should have a pre-existing coordinated strategy for dealing with PTA negotiations so that agreements are complementary and as consistent as possible.

The World Bank stresses the need to adopt ‘the widest possible product coverage and greatest market access expansion. This means that agricultural trade policies should be included in PTAs. Excluding agriculture from

PTAs — the dominant practice at present — does not promote development'[63].

PTAs may yet save or destroy the movement towards free trade. Much depends on the decisions of trading nations and the WTO in the coming decade. With a good understanding of the four elements of PTAs and guidelines for better PTAs, countries should be in a better position to make the right decisions.

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63 World Bank, 2005, *Global Economic Prospects: Trade, Regionalism and Development 2005*, The World Bank, Washington DC, p. 145.

\`Free\` Trade Agreements:
Making them better

RIRDC Publication No. 05/035

Australia's agricultural prosperity depends on exports. Global trade liberalisation is crucial for Australian farmers.

There are two ways of reducing agricultural trade barriers. First, the ponderous multilateral Doha round of trade negotiations. Second, bilateral trade agreements, which are currently growing rapidly. In this study, we evaluate bilateral trade agreements as a route to more liberal trade.

Bilateral trade agreements are controversial, a controversy that cannot be resolved easily. So, we pose the question: what can be done to ensure bilateral agreements — which are sure to take place anyway — are more likely to be beneficial? In answer, we provide a checklist of ten actions to enhance the good aspects of bilateral trade agreements and minimise the bad.

This publication is one in a series on trade issue published by the Rural Industries Research and Development Corporation (RIRDC) as part of their Global Competitiveness R&D program. Previous reports in this series and additional copies of this publication may be obtained from RIRDC by visiting their website (www.rirdc.gov.au).

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