

Submission to the Productivity Commission

Review of bilateral and regional trade agreements

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1..Overview

1.1 Australia's overriding interests

The Productivity Commission has established a global reputation for its capacity to evaluate policy options from an economy-wide point of view. The Commission has excelled in terms of encouraging policy decisions which put wider and longer-term interests ahead of short-term expediency.

In this Review of trading arrangements to promote economic integration, the Commission will need to extend its vision. As the global financial crisis has shown, Australia's prosperity depends heavily on the rest of the world. In an already highly integrated international economic environment, it is essential to assess the effects of Australian trade policy decisions on global **as well as** national welfare.

The GATT/WTO trading system is based on the fundamental international economic insight that products should be compared on the basis of price and quality, not on the ownership or location of suppliers.

For more than 60 years, this system has created the conditions for confident engagement of economies in the global marketplace for over 60 years. This stands in sharp contrast to the situation in the first half of the 20th century, when trade was distorted by trading blocs and undisciplined restrictions.

The international trading environment underpinned by the GATT/WTO has allowed East Asian economies to escape from poverty by '**opening to the outside world**', contributing greatly to Australia's rising prosperity. An open, **non-discriminatory** international economic environment remains essential for billions of other people to escape from poverty. Therefore, Australia's long-term security **as well as economic** interests are best served by policies which defend this system.

This overriding interest needs to be kept in mind when considering the further use of policies which are **consistent** with the letter, but not with the fundamental principles, of the WTO. Short-term benefits, for **particular** producers, or even to the economy as a whole, is only part of the overall balance of costs, risks and benefits.

Bilateral and regional trading agreements have proliferated in recent years. Most of them are preferential trade agreements (PTAs) which discriminate among products by the source of supply, thus threatening the integrity of the non-discriminatory trading system.

A close examination of recent PTAs indicates that they are not contributing significantly to lowering border barriers to trade: products which are heavily protected are routinely exempted from the coverage of agreements or protected from genuine new competition by rules of origin.

Therefore, the direct economic effects of individual agreements are not great. However, the cumulative effect of the proliferation of discriminatory agreements are very serious.

1.1 Costs and risks of preferential trade agreements

The effort to negotiate hundreds of PTAs is diverting attention from defending and strengthening the WTO-based **non-discriminatory trading system**. The **non-discriminatory trading system** needed to allow producers in all economies to create and capture markets in line with comparative advantage is being supplanted by a complex system of preferential deals.

The negotiation of marginal, reciprocal reductions of trade barriers is also reviving the perverse perception that unilateral liberalisation of trade is a cost, rather than a benefit to economies.

Rules of origin are becoming a significant part of trade policy, but they are cutting across the market-driven trend towards ever-finer specialisation in line with comparative advantage. Production networks and supply chains, made possible by falling costs of transport and communications are the fastest growing part of international commerce. It is becoming ever harder, and less meaningful, to attempt to assess where value is added to products. Therefore, rules of origin are leading to high transaction costs as well as to less efficient use of resources.

The prospect of hundreds of overlapping preferential arrangements is causing increasing concern, turning attention to attempts to link them to form ever-wider PTAs. Unfortunately, the design of PTAs to shield sensitive products from new competition makes them hard to link.

Governments are becoming increasingly aware of these costs and risks. But no government currently dares to stay aloof from negotiating more and more PTAs. They want to respond to the damage caused by other agreements and to capture some short-term gains by obtaining preferential treatment from significant trading partners, even at the expense of other economies.

Against this background, the Australian Government faces a difficult choice. The Australia Government needs to decide:

- to continue negotiating more PTAs for short-term reasons and compound longer-term systemic costs;
- or to use alternative ways to promote economic integration which are **consistent** with Australia's overriding interest in defending a global trading based on WTO.

This submission seeks to improve the prospect of the latter option, by explaining the limited utility of PTAs for facilitating economic integration in the 21st century and recommending more effective domestic, regional and multilateral policies.

1.2 New realities

Traditional border barriers to trade in some sensitive products remain costly, but affect a rapidly shrinking part of international commerce.

Today, it is more efficient to concentrate on:

- problems of communications and logistics, often linked to security concerns;
- lack of efficiency, transparency, needless divergence and sometimes arbitrary implementation of economic policies in different economies.

Cooperation to deal with these problems is a matter of encouraging gradually better policy-making, including policies for many areas which are well inside the borders of our economies.

The effective constraint on collective action to create a more commerce-friendly domestic **as well as** international environment is not political will. It is limited capacity to design and implement the necessary policy reforms. And capacity cannot be created by negotiation. For example, easier movement of business people cannot be achieved by negotiating statements of good intentions.

There are some dimensions of economic integration where perceptions of short-term political costs outweigh perceptions of economy-wide gains. In those cases negotiations will continue to be needed to make short-term progress. However, these **negotiations** should take place where they are most likely to be effective. Theory and **experience** indicate that the problems of liberalisation which are proving difficult in the WTO are even less likely to be resolved among smaller **groups of economies**.

As discussed in this submission (and in Annex 1), there are many opportunities to reduce impediments to economic integration without rushing into **negotiations**.

Consistent with basic game theory, voluntary cooperation can be effective where participants perceive potential benefits. Voluntary international economic cooperation is therefore the efficient means for seizing many opportunities to promote mutually beneficial economic integration.

1.3 APEC and open regionalism

APEC is a process designed to promote regional economic cooperation, including by lowering all impediments to all international commerce. APEC is not a PTA and should not become one.

Established in 1989, APEC has adopted voluntary and **non-discriminatory** principles of operation set out in the 1991 Seoul APEC Declaration. **Accordingly, APEC economies are reducing impediments to international commerce in ways which do not seek to divert economic activity away from any economy. That is the essence of open regionalism.**

This submission explains how APEC offers a more efficient means of promoting economic integration now and in future, setting positive examples to the rest of the world.

1.4 Recommendations

Australia has much to gain from continuing to reduce impediments to integration with all other economies. It should use all efficient options to do so. These options should be selected by objective analysis of:

- **experience** with alternative options to date;
- the evolving nature of international commerce; and
- the changing relative importance of obstacles to economic integration.

Domestic and international efforts

The most important way to improve Australia's capacity to promote and benefit from economic integration is to continue to reform domestic policies to enhance productivity and the efficient operation of domestic as well as international markets.

Domestic reforms can be **complemented by international cooperation**. Such cooperation does not always mean **negotiations**. As explained in this submission, there are many opportunities which can be seized through voluntary cooperation. Where negotiations are essential, Australia should use the institution which has comparative advantage for such negotiations.

Preferential trade agreements

This Review provides the Productivity Commission with the opportunity to do evaluate Australia's recent experience with PTAs.

Following a thorough assessment, it should be possible to explain that the marginal gains from pursuing more PTAs of limited quality do not justify the cost in terms of diverting scarce policy-making resources and systemic damage to the international trading system.

There is no need to continue to forego significant opportunities to facilitate trade and investment with major trading partners including China and Japan until and unless we can negotiate a PTA. As the agreement with the United States has shown, Australia cannot expect to negotiate significant new access to markets for sensitive products in large economies, except with the support of others in the WTO. But there is no need miss many other opportunities to reduce other impediments in ways which are already perceived to be of mutual benefit.

In order to pursue these more efficient options to promote economic integration, the time has come for Australia to declare a moratorium on negotiating further PTAs.

The World Trade Organisation

The WTO is one of the most successful institutions in economic history.

A trading system built on the **fundamental principles of transparency, non-discrimination and national treatment** principles has provided the confidence for economies to engage in global markets contributing to an unprecedented era of prosperity as economies made use of their comparative advantage. In recent years, the WTO has also become an effective means of settling disputes.

At the same time, the Doha Round is demonstrating that it is hard to make progress on residual border barriers to sensitive products. That is not a reason for turning away – there are many other issues which need multilateral solutions.

No matter how the Doha Round of trade negotiations is eventually concluded, there will be much unfinished business. Comprehensive negotiating Rounds leading to single undertakings may no longer be efficient. Australia should lead the way in exploring new ideas which are already being canvassed.

A new vision for APEC

APEC offers an already tested and available means of seizing many opportunity to reduce the cost and risks of international commerce in the many areas where **negotiations** are neither necessary, nor sufficient, to yield practical results.

2010 is an opportunity to look beyond preoccupation with border barriers and adopt a new long-term vision of a single market.

In doing so, Asia Pacific governments can learn from the European Union **experience which showed the world that eliminating border barriers is far less than adequate for genuine free trade and investment and efficient economic integration**. In a region which is not prepared to accept a supra-national authority, tackling across-the-border and behind-the-border obstacles to integration will need to be modeled on the voluntary approach of ASEAN.

APEC's work on essential ingredients of deep integration can help ASEAN to move towards its adopted objective of an ASEAN Economic Community by 2015. ASEAN economies can draw on such policy development to pioneer practical, cooperative arrangements.

Such a strategy can also set examples for other Asia Pacific economies and for the world. APEC can encourage any economy to join **mutually beneficial** cooperative arrangements among some Asia Pacific economies, as soon as they willing and able to do so.

2. *Economic integration in 21st century*

2.1 The changing nature of international commerce

In the 1940s, international commerce was dominated by trade in commodities and manufactured products which were usually made in a single factory. Trade was obstructed by high border barriers to trade in goods, such as tariffs or quotas (Feketekuty, 1992).

Successive rounds of GATT negotiations then achieved welcome reductions in border barriers. These negotiations were accompanied by extensive unilateral reforms as more and more governments recognised that 'opening to the outside world' was essential for sustained development.

By 1989, when APEC was established, trade in services had increased relative to trade in goods while international movements of capital and people were becoming increasingly important.

In the two decades since then, spectacular changes in information technology and the dramatic decline in communications costs have transformed the pattern of production and exchange. The marginal cost of electronic communication has fallen very close to zero. Along with steadily declining border barriers and lower real costs of transport, this has allowed ever-finer specialisation in line with evolving comparative advantage.

International commerce has become an intertwined flow of goods and services accompanied by international movement of capital (including direct foreign investment) and people. Information and communications technology has been transformed and international exchanges of information have become essential to all international commerce.

These days, economic integration means much more than 'free trade'. It encompasses all of the ways national economies are connected in international markets, including trade in goods, services ideas and information, along with essential and complementary international movements of people and capital and the coordination of public policies (Hummels, 2008).

Trade in services continues to grow more rapidly than trade in goods, while international investment is growing faster than trade in either goods or in services. Reflecting rapid growth in intra-industry and intra-firm trade, supply chains are becoming the main means of integrating economies (Fung, 2005 and World Bank, 2007).

Against this background, policy to promote **mutually beneficial** economic integration should not be based only on what is currently fashionable: namely negotiating PTAs. It should be based on a careful assessment of the relative importance of impediments to international commerce and look for the most efficient way to reduce these obstacles.

2.2 Impediments to international economic transactions

Progress towards a long-term vision of a single market needs to pay attention to the full range on impediments to all types of international transactions. These can be classified as follows:

BOX 1: Impediments to international economic transactions

1	Natural impediments;
A	physical (e.g. distance or infrastructure shortages);
B	intangible (differences in language or culture);
2	Policy-based impediments;
A	policy barriers to crossing borders, applied to: products (intermediate and final goods and services); or factors of production (labour, capital and information);
B	divergences of domestic policy, including: standards; administrative procedures; commercial legislation and regulation;
C	policy uncertainties caused by problems including: lack of transparency of regulations; arbitrary application of regulations; inadequate dispute settlement procedures.

As border policy barriers have come down and the nature of international commerce has evolved, it is essential to focus on all of these impediments to economic integration, including the many regulatory, institutional and policy measures that reduce the potential for trade and investment (Elek, 1992 and Drysdale, 2004).

Traditional border barriers to trade in some sensitive products remain costly, but affect only a rapidly shrinking part of international commerce. Today, it is more efficient to concentrate on problems of communications and logistics, combined with the lack of efficiency, transparency and sometimes arbitrary implementation, of economic policies in different economies.

The potential gains from policies to deal with logistic problems are enormous. For example:

- the ADB has cited potential to save up to 1 per cent of the value of traded products by reducing port clearance times by one day.
- the World Bank (2007) has estimated that bringing below average APEC members half way to the APEC average in terms of the efficiency of their

trade logistics would result in a 10 per cent increase in intra APEC trade, worth about 280 billion.

- APEC's new 2009 target to make it 25 percent cheaper, faster and easier to do business within APEC economies by 2015 is expected to reduce the average the cost of importing and exporting a container of goods by up to US\$450 (APEC, 2009).
- Wilson et al (2003) estimated that a 0.55per cent improvement in port efficiency or a 5.5 per cent improvement in customs efficiency would increase intra-APEC trade by US\$27 billion per year.¹

It is harder to estimate the benefits of improving the efficiency, transparency and compatibility of behind-the-border economic regulations. However, surveys show that people actually engaged in international commerce now consider these issues to be more important than remaining border barriers.

The change in the relative importance of impediments, away from traditional border barriers to new **across-the-border** and behind-the-border issues has become widely accepted. Indeed, their growing importance is often cited as the need for creating new bilateral and/or regional trading arrangements.

It has not proved easy to deal with such new issues in WTO negotiations. **One part of the problem is that it is neither easy, nor necessary for all the many members of the WTO to agree on how to deal with many of the new issues.**

But that does not imply that bilateral and/or regional negotiations are the effective ways to address these issues. Negotiations should not be needed to seize opportunities for international economic cooperation which yield benefits to all participants in such cooperation.

2.3 Economic integration and game theory

During the past 60 years, an **essentially non-discriminatory international trading system underpinned by the GATT and the WTO allowed economies to specialise in line with their comparative advantage.**

This has been especially important in East Asia and made Australia's rising prosperity possible. As Patrick (2005) explains:

East Asian economies have successfully implemented the standard model of climbing the development ladder from unskilled to more skilled labor, from simple technologies to more sophisticated technologies, and from less capital per worker to more capital per worker. This has occurred in essentially market environments within most of these economies, and in the context of a global economic system in which, if they could produce efficiently and competitively,

¹ Additional evidence of the economic gains from trade facilitation can be found in OECD (2005) and CIE (2009).

they could sell anywhere. The GATT multilateral system significantly benefited all the East Asian economies, first in their trade with the United States and Europe, then with Japan, and now with each other.

Productive engagement with other economies has led to an unprecedented increase in global trade and improved living standards. Consequently, governments interested in promoting development are keen to promote even closer economic integration.

Experience has also shown that it is sometimes efficient to promote integration with neighbouring economies and/or significant trading partners, since some issues are more easily addressed among smaller groups of economies.

These are the motives behind the rush towards **negotiations** of bilateral and regional arrangements to promote economic integration. Unfortunately, the instruments which have become fashionable are discriminatory PTAs. These arrangements not only threaten to undermine the efficiency of global commerce, but are also **inefficient** ways to deal with the realities of modern commerce as described above.

Game theory

Game theory explains that neither **negotiations, nor binding agreements** are needed where **participants** perceive that cooperation is a positive-sum game.

Since economic integration is seen to benefit economies, voluntary cooperation can be expected to work when governments perceive mutual benefit. As discussed below, there are many dimensions of economic integration where voluntary cooperation can be effective.

At the same time, there are some arrangements for closer integration where governments perceive the short-term political costs to outweigh the long-term economic and political benefits. In those cases, **negotiations** are needed to achieve short-term cooperation. **But negotiations** should be used only for issues where they are needed.

Where **negotiations** are needed, game theory warns that PTAs **are not the most efficient ways to proceed**. For example, it is not logical to refuse to cooperate on matters which lead to perceived short-term mutual benefits until other issues (which are not perceived to be positive-sum games) are resolved by negotiation. Other weaknesses of PTAs are discussed in Section 2.

Opportunities for voluntary cooperation

Among the impediments to economic integration summarised in [Box 1 above](#), traditional restrictions to products moving across borders are in Group 2A. These do include issues where short-term political considerations still outweigh economic logic.

As noted in Section 2.1, the relative importance of these issues has declined sharply in recent years. Moreover, the remaining significant border barriers are concentrated

in a few sensitive products, whose share in international commerce is also declining rapidly.

Most of the other impediments in the other listed in Box 1 can be reduced either by unilateral decisions of individual economies, or by voluntary cooperation among them.

Dealing with such problems, often related to logistics and regulation is a matter of encouraging gradually better policy-making, including policies for many areas which are well inside the borders of economies.

Reducing such impediments to economic integration are seen to benefit all economies. Therefore, the effective constraint on collective action to deal with these problems is not political will.

The real constraint is limited capacity to design and implement the necessary policy reform. Progress depends on capacity for **policy development as well as** the capacity of information and communications technology and economic infrastructure. Such constraints cannot be eased by negotiations. On the other hand, international cooperation can enhance the capacity for better policy-making by sharing relevant **information, experience, expertise and technology.**

The following examples demonstrate that **negotiations** are not **always needed**, and have limited utility, when dealing with many dimensions of economic integration.

Almost all governments are anxious to reduce the cost (including the cost of delays) involved in moving products to markets, including international markets. There is no significant resistance to facilitating commerce by improving logistics, so negotiations are unnecessary.

There are enormous economies of scope from implementing compatible systems for the management of **logistic facilities, especially by using compatible software and protocols for electronic exchange of information.** Both public and private efforts are taking advantage of opportunities to implement cooperative international arrangements without the need for **negotiations** between governments.

The APEC process has been able to promote such cooperation, including the design of cooperative arrangements among economies through voluntary cooperation which is already saving billions of dollars per year (APEC, 2005). APEC's contribution to dealing with practical **across-the-border** and behind-the-border issues has relied on consensus-building to design cooperative arrangements which can be adapted to the circumstances of different economies.

For example, the progressive adoption of the **APEC Business Travel Card** by all APEC governments was made possible by sharing compatible software to handle the electronic exchange of information about business travelers.

This example shows that **negotiations** are not always needed for practical cooperation; it also makes it clear that **negotiations** are neither relevant, not sufficient to achieve practical outcomes. Easier movement of business people cannot be achieved by

negotiating statements of good intentions. Real progress needs patient work to set up compatible information technology to allow movement of people consistent with security requirements.

Similarly, a negotiated undertaking, for example to enact legislation and regulations to promote competition in particular services is meaningless in the absence of the skills and institutions need to implement and enforce relevant legislation.

Such efforts to reduce impediments to international commerce can be implemented among pairs or small **groups of economies**. **There is a trade-off between capturing economies of scope or positive network effects by involving large groups and the increasing transaction costs of reaching consensus and implementation among large groups.**

The practical approach, adopted by APEC, is to design cooperative arrangements among economies as open clubs among self-selected 'pathfinders'. Other economies are then encouraged to join as soon as they perceive the benefit of doing so and has the capacity to implement the relevant policies.

Role of negotiations

Some opportunities for economic integration are not (or sometimes not yet) perceived to be positive-sum games. Where long-term gains are seen to be outweighed by short-term costs, voluntary cooperation cannot be expected to work. This problem makes it difficult to reduce the residual border barriers to some **sensitive goods**; it can also prevent agreements for mutual recognition of product standards and professional qualifications .

In such cases, negotiations may be needed. But negotiating PTAs is neither the only, nor the most efficient way to overcome these problems.

Theory and practice tells us unilateral decisions to promote competition, including international competition enhance global welfare, with the largest share of these benefits accruing to the economies which implement such reforms.

Several submissions to this review (including by Bosworth and Trewin, Carmichael et al and Stoeckel) recommend promoting domestic reforms as an important way to improve prospects for economic integration. This submission supports that recommendation.

In recent decades, there has been extensive unilateral reform by many economies, especially in East Asia, including substantial unilateral lowering of border barriers to trade and investment. These decisions were motivated by the evident success of those economies which were 'opening to the outside world' Unilateral trade liberalisation has been accelerated by the Bogor commitment of APEC leaders to try to eliminate all obstacle to trade, as described in detail in Garnaut (2005).

Perceptions will continue to change in the light of **experience which bears out economic theory**. It will become even clearer that **reducing obstacles to economic integration is a benefit, rather than a cost to economies**.

Efficient negotiations

The Australian Government and Australians can do more to help accelerate change in perceptions, creating more scope of beneficial economic integration with less and less need for **negotiations**. **On the other hand, negotiations based on the false assumption that lowering trade barriers is a 'concession' to others will delay changing political perceptions of the net benefit of reducing impediments to international economic transactions.**

It takes time to change perceptions of net costs and benefits of protecting sensitive products. For short-term results, trade **negotiations** can accelerate some liberalisation.

Experience is demonstrating that the same products which are proving hard to liberalise in the WTO or APEC, are proving just as hard to tackle among smaller groups of economies. As Findlay (2003) explain, it is harder to deal with sensitive sectors in PTAs among pairs, or small groups, of economies. Compared to multilateral negotiations, it is more difficult to overcome vested interests against reform.

Therefore, PTAs cannot be expected to add much value to what can be achieved by WTO **negotiations**. **The marginal gains in terms of liberalisation in PTAs are not, on evidence to date, sufficient to outweigh the opportunity cost of diverting effort away from potentially more efficient WTO negotiations.**

An important added advantage of WTO negotiations is that they deal with upper limits to border barriers (called tariff bindings). That means unilateral liberalisation does not reduce what governments can offer each other in WTO negotiations. Therefore, there is less danger of misperceiving liberalisation as a concession to others.

Economies like Australia whose trade is a small share of global trade cannot expect significant gains from attempts to negotiate PTAs. This is evident from recent **experience**.

3 *Preferential trade agreements*

Preferential trade agreements are typically based on a discriminatory arrangement for trade in goods and, in many recent cases, a discriminatory arrangement for trade in services. All recent PTAs include, or at least propose, some cooperative arrangements to facilitate trade and investment by dealing with some non-border issues.

As noted in the submission by Lloyd, not all arrangements to promote regional trade are PTAs. In particular, **APEC is not a PTA – it is a voluntary process of cooperation, which has its limitations, but does not lead to such cost and risks. The potential for APEC to promote Australia’s integration with other economies is discussed in Section 5.3.**

3.1 Weaknesses of PTAs

A frequent rationalisation of the need for PTAs is that the WTO appears to have lost its ability to reduce residual border barriers to trade. But this motive for diverting attention from multilateral **negotiations** begs the question whether **negotiations** among smaller groups is likely to be more effective.

Game theory explains that it is easier to overcome the resistance of those fearing new competition from imports if trade **negotiations** offer offsetting gains to exporters from potential new access to markets. As noted above, such gains are more likely in WTO **negotiations** than in **negotiations** among smaller groups.

This theory has been reflected in practice. PTAs are not leading to significant liberalisation on issues which are proving difficult in WTO **negotiations**.

Trade in goods

In 2010, most products do not face high tariffs or other policy barriers imposed at the border. There are very few quantitative restrictions and high tariffs are applied to a few highly protected products, mostly in agriculture and labour-intensive manufacturing.

Protection of domestic producers against international competition has shifted from transparent border barriers towards other less transparent policies, such as anti-dumping measures, subsidies and countervailing subsidies. Such measures to prevent what is ‘unfair’ competition are often applied in an arbitrary manner. They are becoming the new front line of **protectionism. Once again they are mostly used to protect agricultural and labour-intensive manufactures.**

As noted in other submissions to this Review (including by Ravenhill), recent PTAs have not been effective in terms of reducing high formal border barriers to trade. In some cases, products which are heavily protected due to strong domestic vested interests are excluded from the coverage of PTAs. Since these products account for a fast-shrinking share of trade among most economies, it is possible to meet the WTO requirement that PTAs cover ‘substantially all trade’ among **participants**.

In other cases, sensitive products may be included in the agreement but protected against any significant new international competition by rules of origin. For example, the North American Free Trade Agreement (NAFTA) has close to 2000 pages of rules of origin to ensure that United States producers do not face competition from labour-intensive products which have substantial value added in other economies.²

Except for the Closer Economic Relations (CER) agreement between Australia and New Zealand, PTAs do not place any significant restrictions on the use of contingent protectionism. Subsidies and other 'trade remedies' embodied in the domestic legislation (rather than in tariff schedules) of trading partners are seldom covered in PTAs.

PTAs do usually eliminate all the low tariffs on trade with new partners. That has made a useful, but limited, contribution to liberalisation among the many economies which have now negotiated such agreements. On the other hand, the same result could have been obtained with far lower transaction costs.

All the governments involved could have obtained the bulk of the gains from reducing low tariff rates to zero by unilateral decisions applying to all trading partners. This would not have affected their capacity to negotiate reductions in significant rates of protection on sensitive products. There is no evidence, or prospect, that a threat to retain low rates of protection would influence political **sensitive** decisions on protecting sensitive products.³

Trade in services

The effective constraints on trade in services often well behind the border. For example, professionals may be able to cross borders fairly easily, but may not be allowed to practice their skills. It is almost impossible to stop capital crossing borders, but direct foreign investment can be blocked by sector-specific regulations.

In many cases, the constraints on supplying services in other economies cannot be resolved by trade **negotiations**. Policy reforms to create competitive domestic markets will be more effective than seeking special provisions for international suppliers of services.

Negotiations can hope to eliminate some particularly restrictive regulations, for example to agree on mutual recognition of some professional qualifications. However, complex legislative changes, such as better competition policies cannot be enforced by negotiation.

The limited utility of **negotiations** applies to most of the so-called 'new issues' which are being appended to agreements focused on trade in goods. In many cases, the implementation of policies which are perceived to benefit all parties to trade

² The costs of rules of origin are discussed in Section 3.3.

³ As explained in Section 2.3, unilateral reduction of applied tariff rates does not reduce the capacity to negotiate lower upper limits on protection in the WTO.

agreements are actually delayed, or prevented, by linking them to attempts to liberalise trade in sensitive products.

Investment

Some PTAs, for example NAFTA, cover direct foreign investment, which is becoming an increasingly important complement to trade in goods and services.

Most governments are working hard to make themselves attractive to investors. Therefore, they are implementing policies to offer appropriate assurances and other policies considered to be important to promote investment. At the same time, almost all governments restrict direct foreign investment in some sectors considered to be of special national significance.

Very many pairs of economies have already entered into bilateral investment agreements (BITs) which guarantee investment-friendly policies. Amending them to cover new issues, including some provisions on some PTAs like NAFTA should not need to wait for an agreement on trade in goods if they are seen to be of mutual benefit.

At the same time, politically-motivated restrictions on investment in some sensitive sectors are unlikely to be included in investment agreements, whether they are BITs or parts of PTAs.

A far more efficient way to improve policies for direct foreign investment would be to implement investment-friendly policies which apply to all potential investors, domestic **as well as** international.

This is already happening. APEC's non-binding investment principles, agreed in 1994, have encouraged reforms of investment policy towards increasing **consistency with these principles (Davidson, 2003)**.

Looking ahead, these guidelines can be strengthened to deal with new issues as they are raised by the changing nature of both **trade and investment**. Governments can also be encouraged to set timetables for full national treatment of all investment, except in a short negative list of sectors.

Facilitating trade and investment

The design of PTAs has responded to the reality that border barriers are no longer the only, nor the most significant impediments to closer economic integration among economies. New PTAs routinely include clauses, or chapters, on matters including business mobility, customs facilitation, **electronic** data exchange, paperless trading and mutual recognition of standards.

An often cited reason for including such matters is that they are either not on the agenda of WTO **negotiations, or (as in the case of trade) that the WTO has not been able to deal with them sufficiently rapidly.**

As discussed above, cooperation on many of these issues is seen to be a positive-sum game leading to gains to all **participants**. Therefore **binding agreements are not necessary**. Nor is necessary or efficient to delay implement cooperative arrangements until a PTA, focused on trade liberalisation, is completed. There is no logic in making the resolution of positive-sum games conditional on resolving games which are not perceived to be positive-sum games

Cooperation on matters such as harmonising customs procedures, for example by adopting compatible data requirements and compatible software for **electronic** data exchange should not have to wait for **negotiations** on trade in sensitive products.

Nor are **negotiations** productive on issues such as improving trade logistics. The clauses on 'new issues' in recent PTAs are generally no more than statements of good intentions. These need to be backed by **policy development** to design and implement practical cooperative arrangements. Accepting that these cannot be achieved by further **negotiations**, **PTAs typically establish** committees or working groups to design and implement practical arrangements to reduce the costs or risks of trade or investment.

Such work is already taking place in APEC, so new working groups among smaller number of economies duplicates existing work. Moreover, there are significant economies of scope in dealing with these issues in a compatible way among all the economies which are interested in finding practical ways to facilitate **trade and investment**. There are significant positive network effects from designing compatible arrangements to be adopted by as many as possible.

This suggests cooperation to enhance the capacity to design and implement practical arrangements for matters such as paperless trading as soon as possible, involving all who are able and willing to adopt such cooperative arrangements. These arrangements can be designed to be genuinely open to new participants and their positive network effects can be maximised by encouraging additional participation. There is certainly no merit in admitting only those who have negotiated PTAs with other participants.

3.2 Assessing preferential trade agreements

The integration of economies continues to be influenced by market forces as economic agents respond to evolving comparative advantage. Some trade may be being created and diverted by preferential treatment of favoured trading partners, but it is hard to isolate the effects of these arrangements.

To date, the evidence available does not indicate the PTAs have had a significant influence on the pattern of trade and investment. For example, China has become an increasingly important of **trade and investment** for most trading partners although it does not have PTAs with most of them.⁴

⁴ China became a major trading partner for ASEAN economies well before the PTA with ASEAN.

The limited effect of PTAs is **consistent** with evidence about the use of preferential access. As discussed in Section 3.3 it is difficult to demonstrate that products satisfy complex and often overlapping rules of origin. The submission by Professor Ravenhill to this review notes that:

The combination of relatively low barriers to the operation of regional supply chains plus agreements that generate few advantages has led to business indifference towards the agreements. Various estimates suggest that the costs of compliance with rules of origin may be as much as 8% of the value of a shipment: the preferential tariff has to be substantial for business to take the trouble to complete the documentation required for compliance with the rules of origin (and there are also frequent reports that processing of this documentation is not swift in many countries in the region).

Modelling PTAs

One of the justifications of entering into **negotiations** for new PTAs are quantitative models to measure the expected gain in trade by eliminating border barriers to trade among prospective **participants**.

In view of the limitations of data and the limited effect of PTAs on trade in services, the models usually focus on trade in goods. They are usually claimed to be computable general equilibrium (CGE) models and typically assume that all border barriers will be eliminated by the proposed PTA.

However, the analyses are actually no more than partial equilibrium analyses, since most PTAs motivate other PTAs as those not included seek to defend themselves against the costs imposed on them.

As discussed in this submission the end-point of proliferation is unclear. But, in the meantime, it is not legitimate to model PTAs without taking account of its indirect effects, including PTAs formed in response.

Nor is it legitimate to forecast benefits by assuming the maximum potential reduction of border barriers. The **experience** of most PTAs indicates that some sensitive products are either exempted or only partially liberalised. Even if tariff barriers are eliminated, they are often replaced by the use of less transparent protectionist measures, like anti-dumping. Therefore, as suggested below, at least some scenarios should be based on the more realistic assumption of partial removal of border barriers. Moreover, the actual rate of utilisation of preferences needs to be taken into account.

The Productivity Commission review of PTAs should contain an assessment of the effect of PTAs to date, especially those negotiated by Australia. While acknowledging that it is hard to isolate their effect, the limited evidence that can be gathered should help to explain the gain from the significant resources expended in negotiating PTAs is quite marginal.

3.3 Cost and risks of preferential trade agreements

As already noted, any PTA generates defensive reactions against the diversion of **trade and investment** away from other economies. All governments have an incentive to obtain preferential access to important markets before others do.⁵

At the same time, **experience** has shown that it can be quite easy to negotiate agreements with many trading partners. **Difficult political decisions can be avoided by exempting sensitive products from the coverage of agreements or by protecting them with product-specific rules of origin.** Therefore, many PTA prove quite easy to conclude. The commitment of governments to trade policy is coming to be judged by the number of trade agreements negotiated irrespective of their quality or effect.

In these circumstances, it is hard for governments to stay aloof from the proliferation of PTAs, leading to the hundreds which have been negotiated and the many more which are expected.

The effects of individual PTAs are, in most cases, quite limited. Quoting Shakespeare, Garnaut (2005) asks whether they are “*sound and fury signifying nothing*”. But he goes on to set out the substantial cumulative cost and risks of many PTAs. Some of these are summarised below.

Damage to the non-discriminatory trading system

The remarkable improvement in global living standards since the 1940s has relied heavily on the non-discriminatory trading system based on the GATT, succeeded by the WTO.

Under these conditions most East Asian economies have been able to escape from deep poverty once they committed themselves to engagement in global markets, specialising in line with evolving comparative advantage.

That has been very good for Australia. But our future security depends on the rest of the world being able to follow in the footsteps of East Asia. That prospect is bleak if the world moves to a system where access to markets depends on the ability to negotiate preferential access to markets.

In the absence of a non-discriminatory system, governments can protect selected producers from new competition by discriminating against selected economies. In such circumstances, the East Asia's economic success would have been much harder to achieve.

Many economies, especially in Africa and the rest of Asia have yet to commit themselves to a viable internationally oriented strategy for **development**. **They are the most vulnerable to selective discrimination if, and when, they attempt to engage in global markets.**

⁵ Some examples of PTAs reducing opportunities for others are discussed in Section 4.

In principle, the poorest economies can seek their own preferential agreements with significant trading partners. As weak economies and latecomers, they are not likely to be able to obtain additional access and very unlikely to be able to impose any limits on selective contingent protection such as anti-dumping measures.

The time and policy resources devoted to negotiating hundreds of PTAs is diverting attention from work to defend and strengthen the WTO-based trading system. Once again, this diversion is particularly costly for small and poor economies, leaving them with negligible capacity to press their interests in the WTO which is the only trade forum in which they can hope to exercise collective influence.

Damage to the World Trade Organisation

The WTO is one of the most successful institutions in economic history.

A trading system built on the **fundamental principles of transparency, non-discrimination and national treatment** principles has provided the confidence for economies to engage in global markets contributing to an unprecedented era of prosperity as economies made use of their comparative advantage. In recent years, the WTO has also become an effective means of settling disputes.

The WTO has never set itself the goal of eliminating all impediments to trade – its primary purpose has been to impose **discipline on the way trade restrictions are implemented. Since the establishment of its predecessor, the GATT, the institution has encouraged adherence to its principles and, through** a series of negotiating rounds, the WTO has also contributed significantly to today's trading environment.

With a few notable exceptions, most products face no (or negligible) nominal border barriers. Most governments now use loopholes from the fundamental GATT/WTO principles when they seek to appease producer interests.

At the same time, the WTO is encountering serious problems. The difficulty of launching, then negotiating, the Doha Round has led to a misperception that the WTO has 'failed' because it is not able to make significant headway against residual border barriers, including contingent protectionism.

Progress is being held up by the difficulty of dealing with sensitive products like agriculture and labour-intensive manufactures. The Doha Round will, nevertheless, be concluded in due course. But that will leave many more issues to resolve. It is no longer possible to expect all dimensions of economic integration to be dealt with by WTO Rounds.

On one hand, the WTO negotiating agenda is already too wide; so achieving a single undertaking takes far too long. On the other hand, agenda is also too narrow; it is no longer able to cope with all the new dimensions of international economic transactions and the impediments to them.

These shortcomings of the WTO are accelerating the growing reliance on preferential trading arrangements (PTAs). Their proliferation will not end with the end of the Doha Round.

It is beyond the scope of this submission to discuss the nature of the exemptions from non-discrimination which make it possible to claim that PTAs are **consistent** with the letter of the GATT/WTO system, while ignoring its spirit. But it is worth noting the difficulty of agreeing on a strict interpretation of relevant GATT and GATS articles allowing PTAs, especially among developing economies to avoid any significant liberalisation for sensitive products.

A habit of abusing the intent of provisions allowing discriminatory trade in limited circumstances can lead to a habit of making maximum use of exemptions to the basic principles of transparency, non-discrimination and national treatment.⁶

Work towards defending the fundamentals of the GATT/WTO system is urgent and options for future work, looking beyond the Doha Round are discussed in Section 5. Unfortunately, this work is not likely to be given priority if PTAs are seen as an alternative to the WTO based system.

Entrenching false perceptions

Economic theory explains that '**opening to the outside world**' benefits economies. Reducing obstacles to international movement of goods, services, capital and ideas increases global welfare with the greatest share of benefits accruing to those implementing such reforms. This prediction has been amply confirmed by evidence. Economies which have adopted outward-looking **development** strategies have outperformed, by a spectacular margin, those which sought to shelter their economies from international competition.

Inter-governmental **negotiations** are based on the opposite premise. Obstacles to trade are regarded as an asset, to be given away only in return for reciprocal reduction of trade barriers by others.⁷

As cited in the submission by Carmichael et al, Milton Friedman explained this relationship between the domestic and international dimensions of trade reform in 1982 as follows:

The method we have tried to adopt is reciprocal negotiation of tariff reductions with other countries. This seems to me a wrong procedure. In the first place, it ensures a slow pace. He moves fastest who moves alone. In the second place, it fosters an erroneous view of the basic problem. It makes it appear as

⁶ Early in the first term of the G W Bush administration, the United States imposed restrictions on steel import. NAFTA partners were given preferential treatment. This **experience** indicates the way PTAs can lead to selective protection.

⁷ As discussed in Section 2.3, this problem is less severe in the context of WTO **negotiations** which deal with applied rates of protection, rather than upper limits on those rates.

if tariffs help the country imposing them but hurt other countries, as if when we reduce a tariff we give up something good and should get something in return in the form of a reduction in the tariffs imposed by other countries. In truth the situation is quite different. Our tariffs hurt us as well as other countries. We would be benefited by dispensing with our tariffs even if other countries did not. We would of course be benefited more if they reduced theirs but our benefiting does not require that they reduce theirs. Self-interests coincide and do not conflict.”

The false perception of trade liberalisation as a ‘concession to others’ discourages unilateral liberalisation, playing into the hands of vested interests in protecting their products against international competition.

Very large economies can claim that demanding reciprocity adds to global welfare by inducing liberalisation by others. That does not hold for a small economy like Australia with negligible leverage in such **negotiations**.

Trade **negotiations** which hinge on reducing border barriers impose a serious opportunity cost in terms of reducing other impediments to integration. Governments are delaying cooperation on matters where mutual benefit are available until **negotiations** of trade barriers are concluded. In many cases opportunities for **mutually beneficial** facilitation of **trade and investment** are foregone altogether since it is not always possible to agree on **trade liberalisation** with all economies.

Rules of origin

PTAs allow **participants** to set different tariffs for any product imported from non-**participants**. To avoid new competition from products trans-shipped through **participants** with lower trade barriers, members of PTAs apply rules of origin.

In many cases, these rules of origin are product specific – tailor-made to cater to the vested interests of selected producers in one or more PTA partners. In his excellent critique of PTAs, Bhagwati (2008) describes the growing tangle of overlapping rules of origin as a ‘spaghetti bowl’. He and Garnaut (2009) discuss, in some detail, the costs imposed by rules of origin in terms of transaction costs for business and in terms of welfare loss due to the misallocation of resources when trade and investment are diverted from the most efficient locations and directions.

Administering rules of origin is becoming costly and arbitrary. As discussed in Section 2.1, intra-industry and intra-firm trade are the most rapidly growing part in international trade. Value is often added in many locations as part of production networks or supply chains. The emergence of these networks creates the potential for ever-finer specialisation in line with comparative advantage. As Fung (2005) explains, they greatly benefit economies, such as Viet Nam, which are seeking to integrate with the international economy for the first time.⁸

⁸ Leung (2010) notes these problems in the context of Viet Nam’s engagement in supply chains.

PTAs which rely on preference to steer trade cut across this new development and, as discussed above, seriously damage to prospects for poor economies seeking to trade their way out of poverty.

By the early 1990s it was already evident that it is not possible to assess the origin of products either objectively or accurately (Pearson, 1993). This problem has become much greater with the rise of production networks.

As described in Section 2.1, trade in goods, which is a shrinking proportion of international commerce, has itself been transformed quite thoroughly. The most rapid growth is in intra-industry and intra-firm trade. Components, whose value is increasingly made up of intellectual property and information technology are being moved along supply chains involving several economies.

It is becoming less and less possible to ascertain where a product is made or who owns the firms which add value in different locations. Against this background, it is ironic that rules of origin are becoming a major tool of trade policy as preferential trading arrangements (PTAs) proliferate.

Garnaut (2005) and submissions to this Review by Lloyd and Ravenhill note that the costs of proving compliance with rules of origin are high. It is, therefore, not surprising that more and more producers are deciding it is less costly to ignore the potential availability of preferential access. For example, Baldwin (2006, page 9) notes that almost no one uses the preferences offered under the ASEAN Free Trade Area, citing relevant survey data.

Some of the costs could be reduced, but not eliminated by adopting relatively simple rules of origin. The recent P4 agreement among Brunei, Chile, New Zealand and Singapore have been praised for their simple rules of origin based on a single share of value added in partner economies. However, 18 pages are needed to explain them.

Moreover, a high proportion of PTAs use complex rules of origin tailored to protect specific products from genuine new competition. As already noted, the NAFTA relies on 2000 or so pages to set out rules of origin, largely designed to avoid East Asian competition to labour-intensive manufactures.

The problem of rules of origin could also be eased by linking PTAs to form larger ones.

Potential for linking PTAs

It would require tens of thousands of bilateral PTAs to link all economies. While no one expects that to happen, governments continue to enter into more bilateral PTAs, hoping that they can later be linked to form larger (subregional or regional) arrangements. PTAs can then be justified as potential building blocks for larger areas with few barriers to internal trade.

Unfortunately, the design of PTAs do not make them easy to link.

If PTAs among pairs, or small groups of economies were comprehensive, they could be linked to form wider regional arrangements, creating free trade in all products by abolishing all border barriers to trade among member economies. In that case, any other economy could join, as long as it was prepared to abolish all border barriers to trade with existing members. It would also be possible to link several comprehensive regional arrangements into a potentially global arrangement, which would no longer need to be preferential.

Unfortunately, there are very few comprehensive PTAs. The same products which are proving hard to liberalise in the WTO or APEC, are proving just as hard to tackle among smaller groups of economies. As Findlay et al (2003) explain, it is harder to deal with sensitive sectors in PTAs among pairs, or small groups, of economies. Compared to multilateral negotiations, it is more difficult to overcome vested interests against reform.

The recent pattern of PTAs has highlighted this problem of 'sensitive sectors'. In a growing number of examples, PTAs deal with relatively easy aspects of trade liberalisation, while dodging around the hardest ones. Recent agreements, including those between Japan and Singapore, Korea and Chile demonstrate that PTAs tend to exempt the products which are deemed to be the most sensitive. Even the agreement between two of the most vehement advocates of **trade liberalisation**, the United States and Australia, excludes some aspects of agriculture, or sets long lead times for even modest liberalisation.

Recent experience indicates that any economy, which is not yet ready to open some sectors to significant international competition can form PTAs only with those economies:

- which are willing to exclude these sectors from the agreement; or
- which do not offer serious competition in these sectors.

The Australia-United States PTA is an example of the first. The Australian Government was so eager to reach an agreement, that it was willing to conclude a deal which exempted some agricultural products, or offered very limited increases in quotas, without any changes in the heavy domestic subsidies to US producers. As noted in Section 4, some of these gains were at the expense of others.

Another way of avoiding hard issues is to include sensitive products in agreements which do not lead to significant new competition. For example, an agreement between Japan and Singapore may include the full liberalisation of rice imports from either partner, since neither is concerned about rice imports from the other. But such PTAs contain product-specific discriminatory rules of origin which prevent the re-export of rice from economies which would threaten existing producers. Efficient rice producers would not be able to join, without renegotiating the rules of origin, or exempting the sensitive product.

Professor Lloyd notes in his submission to the Review that agreements which are tailor-made to protect sensitive products in **participating economies create vested interests against further accession. He explains that:**

when bilateral regionals do succeed in opening up significantly important overseas markets, they create an incentive to preserve the preferences gained; witness the opposition of ACP countries in the current Doha Development Round negotiations to “preference erosion”.

Most PTAs contain a clause which, in principle, permit accession of new parties. In practice, accession is likely to be limited to those who do not create serious new competition for the interests protected within existing agreements (either by exemptions or rules of origin).

This limitation makes hard to make progress on new issues such as harmonisation of **customs procedures, mutual recognition of standards and many other opportunities to facilitate trade and investment. If progress on these issues is linked to PTAs, then these opportunities to promote mutual beneficial integration in all sectors will be missed with trading partners who threaten a few sensitive sectors.**

The potential for linking agreements could be increased if they were designed to be increasingly compatible, and to meet standards which exceed the very weak **disciplines** currently imposed by GATT/WTO articles including Article XXIV of the GATT.

In 2004, based partly on the criteria proposed by the Pacific Economic Cooperation Council (PECC), APEC leaders endorsed a paper which describes ‘best practice’ RTAs involving APEC economies. These are RTAs which, among other things:

- go beyond minimum WTO requirements;
- being comprehensive in scope, providing for liberalisation in all sectors;
- phase-out periods for liberalising of sensitive products to be kept to a minimum;
- are seen as first steps towards multilateral liberalisation at a later stage;
- have simple rules of origin;
- allow wider accession on negotiated terms and conditions.

RTAs which have these characteristics would, indeed, be relatively more likely to be building blocks towards APEC-wide free and open trade and investment.

Very few PTAs meet such criteria. Governments which have signed lower quality agreements are not likely to be willing to renegotiate them. Therefore, the prospects for formal (as against in principle) adoption of high standards for PTA are very slim, for the same reasons which have long made it impossible to impose tighter GATT/WTO **disciplines** on PTAs.

This submission supports the following remarks in the submission by Lloyd:

The Issues Paper refers to the possibility of adopting best practice principles, along the lines of those developed by APEC and the Asian Development Bank. In my view, this would be a futile exercise. The primary reason is that Australia is not in a position to impose its view of best practice terms and measures during negotiation of bilateral or regional agreements. Any terms must be mutually acceptable. Australia cannot dictate terms to potential partners such as China, Japan, Korea or the Trans-Pacific Partnership, all of which are much bigger traders than Australia and all of which have rather different views of bilateral/regional trade and different precedents.

Potential regional arrangements

Despite these problems, it has been possible to link some PTAs which have used relatively simple rules of origin. The P4 agreement, mentioned above, is frequently cited as a “high quality” subregional agreement. But as noted by Gao (2009) it has quite a few weak points.

Negotiations have commenced to form a Trans-Pacific Partnership of eight economies built on the P4, by adding Australia, Peru, United States and Viet Nam. These **negotiations** will test whether PTAs can be linked and rationalised. As discussed in Elek (2009) it may prove possible to negotiate a TPP if potential new partners are willing to accept limited gains. Even then, ratification by the United States Congress cannot be taken for granted. Several PTAs, some negotiated in 2005 have yet to be submitted to Congress, which can seek to renegotiate them in the absence of a negotiating authority leading to a simple yes/no vote.

An APEC-wide trade negotiation?⁹

If a TPP is negotiated and ratified, then attention will again turn to the prospects for an APEC-wide PTA.

This is not a new idea. Ever since 1968, there has been extensive discussion of whether the negotiation of an APEC-wide preferential trading arrangement (these days called an FTAAP) is necessary, desirable or feasible.

The region-wide preferential option has been rejected or deferred, repeatedly, for a wide range of reasons. On balance, these reasons remain valid in 2010.

A recent assessment by the Pacific Economic Cooperation Council (Morrison et al, 2007)) sets out arguments for and against attempting to negotiate such a PTA. The overview of the assessment notes that an FTAAP is not feasible in the foreseeable future and that APEC should continue to pursue other, more realistic priorities.

Any decision about attempting to negotiate a region-wide agreement should consider the nature of the outcome which could be realistically expected. APEC leaders should be encouraged consider the likely outcome of any attempt at negotiations, assessing not only the potential benefits to participants, but also the potential costs and risks.

⁹ This section draws on Elek (2007) a paper prepared for APEC senior officials.

It is not valid to assume that APEC-wide negotiations would lead to substantial liberalisation of remaining border barriers. As noted in Bergsten (2007), many of the agreements which have been negotiated in Asia are of low quality. He also notes that agreements between developed APEC economies have also tended to dodge some of the hardest issues, especially for sensitive agricultural products like sugar and rice.

The willingness for politically painful reform in the context of an APEC-wide negotiation should be assessed in a realistic way. The problems which are blocking progress elsewhere will not simply disappear during negotiations for an FTAAP. Actual experience, including the failure to conclude a Free Trade Area of the Americas and APEC's own failure to agree on the so-called Early Voluntary Sectoral Liberalisation (EVSL) in 1968 should not be ignored.

APEC governments could decide to avoid the hard issues which are limiting progress in other negotiations. In that case, they could contemplate a lowest common denominator agreement which did little more than reflect current practice, leaving sensitive issues untouched.

As experienced in the WTO and the attempted Free Trade Area of the Americas, many years are needed to make even marginal progress on liberalising sensitive products. Drawn-out negotiations on trade liberalisation divert attention from the many other opportunities for cooperation which are positive-sum games and do not need such negotiations.

An APEC-wide PTA is often advocated as a means of tidying up the problems which are being caused by the proliferation of bilateral and sub-regional PTAs. It is claimed that a region-wide trade deal would do away with the currently growing discrimination by some Asia Pacific economies against others and could also get rid of the tangled snake-pit of rules of origin, which are often product-specific and discriminatory.

However, dealing with discriminatory rules of origin would raise the hard issues which were avoided when they were negotiated. For example, the approval of the North American Free Trade Agreement (NAFTA) by the United States relied on rules of origin which were designed specifically to avoid competition to sensitive products, especially from East Asia. It is unrealistic to assume that an agreement which did away with such discrimination would be approved by the United States Congress.

There would be negative repercussions on economies not included, and on the future of the WTO-based international economic system. This needs to be considered carefully at a time when the global economy has to absorb the significant structural adjustments which will be needed to accommodate a rapidly growing Indian economy as well as China.

4 Australian experience with PTAs

This submission does not attempt to provide a full assessment of Australian **experience** with PTAs – it is limited to some examples as background to the recommendations in Section 5.

The Closer Economic Arrangement (CER) agreement evolved from a quite low quality earlier PTA between Australia and New Zealand to be a very high quality agreement. It covers trade all goods, with a small negative list for some trade in services. It also deals with many opportunities to facilitate **trade and investment** in other ways, including a path breaking agreement on competition policy which rules out anti-dumping actions among the two partners.

Clauses on facilitating trade, for example, by mutual recognition of standards have gone well beyond **negotiated statements of good intent**. **Extensive cooperative policy development has led to a remarkably high degree of integration among the two economies as described in Nottage (2009).**

Unfortunately, the more recent PTAs negotiated with other trading partners do not come close to meeting such high standards. Recent agreements are modelled on the low standards set by PTAs with the United States, with exemptions of sensitive products and lengthy, discriminatory product-specific rules of origin.¹⁰

This submission supports the following comments by Bosworth and Trewin in their submission regarding the:

“ many separate agreements to meet political ends (their basic rationale) rather than advancing Australia’s liberalisation. Trade policy should be about ensuring Australia uses its resources efficiently to maximize national economic welfare, and is far too important an economic instrument to be negotiated externally and become a political pawn in meeting foreign policy goals.

Moreover, in the few cases where some liberalisation has seemingly occurred, its significance is often over-stated and needs to be tempered by the discriminatory and associated impacts. For example, in the AUSFTA, by negotiating higher FDI screening limits for US investors, we now discriminate against non-US investors, which is impossible to justify economically, and there have been no moves to unilaterally extend these concessions on an MFN basis to all other foreign investors, or even it seems to offer these in the negotiations with other major investors, such as China and Japan. One of the authors of this submission, also recalls being told publicly at a conference in Bangkok by a Ford Motor executive a few years ago that an additional reason why Ford was arguing in Australia for the Government to maintain its relatively

¹⁰ The Productivity Commission has reviewed the lower-quality of rules of origin imposed on the CER to be more in line with product-specific provisions.

high MFN tariffs on imported cars was to preserve its tariff preferences to Australia from Thai exports under the Thailand-Australia FTA. This illustrates how PTAs can generate business opposition to unilateral MFN liberalisation to protect preferential positions and associated rents.

The recent PTA covering Australia, New Zealand and ASEAN economies has little resemblance to the CER. New issues are included, but amount to no more than statements of intentions. The new agreement contains a clause that the new agreement does not override any of the provisions of existing agreements involving the participants. Negotiations continue to conclude further bilateral PTAs among the economies involved, so the new 12-member agreement has had a limited effect in terms of rationalising the proliferation of agreements.

As for other economies, the capacity to conclude PTAs has depended on whether Australia and potential partners are:

- able to, or willing to exclude sensitive products from the agreement; or
- which do not offer serious competition to sensitive products and accept product-specific rules of origin.

The Australia-United States PTA is an example of the first. The Australian Government was so eager to reach an agreement, that it was willing to conclude a deal which exempted some agricultural products, or offered very limited increases in quotas, without any changes in the heavy domestic subsidies to US producers.

The deal with the United States has also demonstrated that short-term gains in market access can be at the clear expense of others. The United States refused to allow any additional access for Australia sugar exports, since they had just granted some marginally improved access to Central America. Australia did gain some additional access to the US lamb market. However, Australia did not achieve any change in United States policy to restrict lamb imports. Therefore such short-term gains were at the expense of other economies, including Australia's CER partner, New Zealand.

Australia has not been able to conclude PTAs with two of its most significant trading partners China and Japan, because it has so far not proved possible to negotiate what products would be exempted or protected in order to avoid politically difficult decisions by at least one of the governments involved.

Since Australia is a very small market for these partners, it is not realistic to expect them to make political difficult decisions to secure an agreement with Australia. The prospects for negotiating significant new market access have been greatly weakened by accepting an agreement with the United States which offered negligible new access.

With major trading partners it would be more productive to engage in cooperative **policy development** to help change perceptions of residual trade barriers, so that they are seen correctly as costs rather than benefits to the economies imposing them. It

is difficult to do so while attempting **negotiations with the same economies** based on an incorrect perceptions of Australia's few remaining border barriers.

Garnaut (2009, page 10, cited in the submission by Carmichael et al) explains that:

“The main way you get gains from other countries’ liberalisation is through their own processes. The most important thing we can do is to encourage those processes. The worst thing you can do is to engage them in bilateral discussions and have them thinking that their liberalisation is a concession to us”

The difficulty of negotiating PTAs with significant trading partners has a large opportunity cost. Agreements to implement cooperative arrangements to facilitate trade in many of the ways adopted in the CER are being delayed, or held hostage to drawn-out **negotiations** on border barriers on a few sensitive products affecting a shrinking share of trade.

It would be more efficient to separate potential positive-sum game from those which are misperceived as imposing costs. There is no need to forego opportunities due to a preoccupation with residual border barriers. The largest short-term benefits from closer integration with all our major trading partners would be cooperative **policy development** to reduce across-the-border and behind-the-border impediments to **trade and investment**.

Such work would be most efficient if it proceeds with **all trading partners willing to cooperate**. There are **significant economies of scope in terms of designing appropriate policy arrangement**. Moreover, there are **significant potential network effects from expanding the number of economies which adopt compatible arrangement to facilitate trade or investment**, for example by enhancing the security and efficiency of their trade logistics.

As discussed in the following Section, the APEC process is available as a convenient means of dealing with very many issues of growing importance to productive integration with many of Australia's significant trading partners.

5. *Efficient economic integration*

Australia has much to gain from continuing to reduce impediments to integration with all other economies. It should use all efficient options to do so, after an assessment of the nature of the challenge, recognising that the relative importance of impediments to integration has changed. While residual border barriers remain costly (including Australia's own) remain costly, they are of rapidly shrinking importance compared to opportunity to reduce **across-the-border** and behind-the-border impediments.

Australia can do much to promote economic integration by a combination of

- further domestic reforms;
- through reforms of, and **negotiations** in, the WTO;
- voluntary cooperation with other economies, including in the APEC process.

There is no need to divert resources away from these efforts by continuing to pursue PTAs.

5.1 **Domestic reform**

This submission supports, strongly, the submissions by Carmichael et al, Bosworth and Trewin and Stoeckel who urge Australia and others to reform domestic policies which limit capacity for economic integration and limit ability to compete in international markets.

As those submissions advocate, such reform is most likely to succeed if policy options are assessed in a transparent way, which takes account of economies as a whole. Moreover, in an already highly integrated global economic environment, it is essential to assess the global, as well the domestic effects of decisions. As stated at the outset, such a wider view should be taken by the Productivity Commission in this review of trading arrangements.

While domestic efforts are essential and have considerable potential, Australia can add value to its efforts to promote economic integration by cooperation with other economies. Such cooperation does not always mean **negotiations**. **There are many opportunities which can be seized through voluntary cooperation. And where negotiations are essential Australia should use the institution which has comparative advantage for such negotiations.**

5.2 **A moratorium on preferential trade agreements**

There has been sufficient **experience with PTAs to evaluate the experience thoroughly. This review provides the Productivity Commission with the opportunity to do so. An objective review is likely to reveal a significant difference between the CER with New Zealand and more recent PTAs.**

In the case of the CER, comprehensive liberalisation has been followed up by extensive cooperative policy development to design and implement arrangements to deal with across-the-border and behind-the-border impediments to closer integration.

By contrast, more recent PTAs have settled for much less. Analysis will reveal they have achieved only very marginal gains in market access. That is not surprising, since Australia has limited leverage in negotiations based on a false assumption that trade liberalisation is a concession to others. That false perception has also led to limited gains in terms of liberalising Australia's own barriers in the course of these negotiations.

Following a thorough assessment, it should be possible to explain that the marginal gains from pursuing PTAs of limited quality does not justify the cost in terms of diverting scarce policy-making resources and the systemic damage to the international trading system summarised in Section 3.3.

In particular, there is no need to continue to forego significant opportunities to facilitate trade and investment with major trading partners including China, Japan and the European Union (EU) until and unless we can negotiate a PTA.

As the experience with the United States has shown, Australia has no capacity to effect significant change in the domestic policies of much larger economies to protect sensitive products. On the other hand, it should be possible to make significant headway on many opportunities to reduce other impediments in ways which are perceived to benefit all economies involved.

In these cases, the constraint on progress is not political will, but the capacity to design and implement appropriate cooperative arrangements. Proceeding with voluntary cooperation to reduce some across-the-border and behind-the-border obstacles will not reduce Australia's capacity to seek lower border barriers to sensitive products in the WTO.

As discussed in Section 2, voluntary cooperation is the most efficient means of playing positive-sum games. Voluntary cooperation can be expected to lead to sustained progress on many non-traditional issues. The prospects for progress depend not on negotiating statements of good intentions, but on patient consensus-building and capacity-building.

On issues where lowering obstacles to integration is still seen as a cost, rather than as a benefit, **negotiations** will be needed for short-term progress. The WTO is the most efficient venue for such **negotiations, especially for an economy like Australia which cannot expect to have an effect on the policies of major trading partners in bilateral or regional negotiations.**

The time has come for Australia to declare a moratorium on negotiating further PTAs. This is essential if Australia is to devote its resources to more effective means to promote economic integration. It can also help others to think about their priorities, including the

over-riding interests of all economies in defending and, where possible, strengthening the WTO.

5.3 The future of the World Trade Organisation

Progress in WTO negotiations will not be easy, as demonstrated by the Doha Round. Nevertheless, that Round will be completed at some time and the Australian Government can help look to reviving the WTO by changing the approach used to strengthen the multilateral trading system.

As noted in Section 3.3, the WTO negotiating agenda has become very wide; so achieving a single undertaking takes far too long. On the other hand, agenda is also too narrow; it is no longer able to cope with all the new dimensions of international economic transactions and the impediments to them.

No matter how the Doha Round of trade negotiations is eventually concluded, there will be much unfinished business. More work will be needed to reduce the extensive scope for potential trade restrictions which are compatible with formal WTO disciplines.

Options include:

- narrowing the gaps between applied and bound tariffs.
- avoiding the emergence of new sensitive products which become heavily protected, by building imaginatively on the WTO's information technology agreement precedent: all new products can be immunised against protectionists (Elek, 2008).
- agreeing on WTO disciplines on any trade measures linked to climate change.

The Doha Round is maybe the last we see which is so comprehensive. The future is more likely to be a series of connected, but limited, sets of negotiations. Harbison (2009) has explained that an ongoing sequence of permanent, manageable, non-comprehensive negotiations, with subjects linked together less formally than in the current 'round' format. In such a 'repeated game' environment, outcomes of a successive negotiations on separate issues could provide the prospect of an acceptable balance of perceived long-term gains compared to short-term sacrifices.

The time has come to explore such imaginative options, rather than to shift attention from the WTO to less efficient venues for negotiation.

5.4 A new vision for APEC

Australia can take pride in having launched the APEC process in 1989 and for its ongoing efforts to use it to promote economic integration in the Asia Pacific region.

The reasons behind the nature of APEC as defined in the 1991 Seoul APEC declaration are set out in Drysdale et al (1998). In a region with strong global, rather than just regional economic interests, it is desirable to reduce impediments to international commerce in the region without seeking to divert economic activity away

from the rest of the world. In a region which will not accept a strong supra-national authority, voluntary cooperation is the only viable option. It is neither feasible, desirable, nor necessary to negotiate a regional trading bloc.

It is more efficient to seize many available opportunities for voluntary cooperation by means of consensus-building and capacity-building. At the same time, Asia Pacific global interests can be pursued through the newly created G20 forum and through collective efforts to defend and strengthen the WTO to deal with matters where **negotiations** are needed to reduce obstacles to international commerce.

The prospects for using APEC in this way are set out in Elek (2010) which is Annex 1 to this submission.

That paper explains that APEC leaders can take pride in progress towards free and open trade. At the same time, there will always be more to do to integrate Asia Pacific economies. 2010 is the time to look beyond border barriers to trade and adopt a new post-Bogor vision of a single market.

As noted in this submission, traditional border barriers to trade in some sensitive products remain costly, but affect only a rapidly shrinking part of international commerce. Today, it is more efficient to concentrate on problems of communications and logistics, combined with the lack of efficiency, transparency and sometimes arbitrary implementation, of economic policies in different economies.

The effective constraint on collective action to deal with these problems is not political will. It is limited capacity to design and implement the necessary policy reform. Creating the necessary capacity needs a unifying vision to deal with all obstacles to genuine economic integration, that is, to build a single market.

In doing so, Asia Pacific governments can learn from the European Union **experience**. **But they need to promote ever-deeper economic integration without relying on a supra-national authority.**

Like free and open trade, a single market is a vision which can only be approached, rather than reached by any deadline – it is a point of reference for the many things that need to be done to integrate Asia Pacific economies in a meaningful way.

Asia Pacific governments should be encouraged to set their own medium-term targets for progress towards well-defined ingredients of a single market. Strict selection criteria should be used to identify options for cooperation which build on what APEC is already doing and which are in line with the priorities of most member economies. An ambitious program to enhance the efficiency of supply chains could set a successful **example and generate the confidence to do more.**

Work on practical dimensions of economic integration such as more efficient ports, airports and customs procedures and comprehensive mutual recognition of product standards would complement ASEAN economic cooperation.

APEC's work on essential ingredients of deep integration should help ASEAN to move towards its objective. ASEAN economies can draw on such policy development as well as the experience of other economies to pioneer practical, cooperative arrangements.

Such an Asia Pacific strategy to promote progress towards a single market will allow APEC leaders to point to measurable gains from their economic cooperation, year after year.

Such a strategy can also set examples for the rest of the world. Just as ASEAN economic can be pathfinders for ways to deal with **across-the-border** and behind-the-border impediments to integration, APEC can encourage any economy to join **mutually beneficial** cooperative arrangements among some Asia Pacific economies as soon as they willing and able to do so.

In this way, APEC can demonstrate that regional cooperation need not be to the detriment of any other economy and pave the way for the G20 to set its own practical agenda for voluntary cooperation to promote world-wide economic integration which looks beyond traditional border barriers to address the needs or the 21st century.

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