



**ITS Global**

Consultants on Global Issues

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**Developing trade and  
investment policy  
settings for Australian  
business**

**Submission to the Government Review of  
Export Policies and Programs**

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## **Executive Summary and Recommendations**

### **The role of trade and investment policy**

The BCA supports trade and investment policy for Australia which underpins the working of free, open and efficient global markets.

This is best secured through multilateral liberalisation under the WTO, supported by other means. This includes FTAs which are consistent with Australia's trade rules and long term goal of global free trade. Trade policy must be complemented with and reinforce international efforts by governments to encourage structural reform in foreign markets aimed at facilitating pro-competitive regulatory environments for business, such as those in APEC.

### **Drivers of liberalisation**

Prospects for further global liberalisation in the WTO Doha Round, although continuing, are uncertain. While it is hoped the main elements of a Doha outcome can be agreed by the conclusion of 2008, further liberalization in the short term is more likely to occur as a result of unilateral, bilateral or plurilateral liberalisation and market developments.

Although business will need to ensure it can respond commercially, it will also require a policy environment which encourages appropriate responses in both the short and long term.

Australia's trade policy settings must serve to well place business to take advantage of developments in international trade and investment and secure the benefits of further meaningful liberalisation at the multilateral, regional and bilateral level. Policy must support broader efforts for structural reform of "beyond the border" impediments and foster regulatory environments which are conducive to open trade and investment.

### **Future liberalisation in the WTO**

In the longer term the WTO still offers a robust framework capable of delivering significant reform of global trade which is of commercial benefit to business.

Australia's trade policy approach should be to continue to actively participate and support a liberalising outcome from the Doha round which deliver tangible benefits to business, particularly in services.

At the same time it must seriously consider next steps for securing liberalisation, which are consistent with this, post Doha, taking into account the current global trade and investment environment.

### **Making the WTO more effective**

It is essential that Australia act to preserve the authority and integrity of the WTO system.

The Australian Government should review how the process of trade liberalization is undertaken in the WTO, including whether free standing negotiations in specific sectors should be formally pursued.

A special standing body should be set up in the WTO to address liberalization of agriculture. The WTO dispute settlement system should be reviewed with a view to minimizing the risk that it will usurp the legislative function of the WTO's executive organs.

### **The benefits of Australia's FTAs**

The BCA considers that Australia's current FTAs have generally been beneficial for business.

By and large, they have promoted open markets and removal of barriers to trade and investment as basic factors to promote growth. Most have delivered liberalisation outcomes which are comprehensive and which build on multilateral achievements, although the scope and degree of liberalisation varies across agreements.

FTAs have also delivered benefits to business by addressing 'beyond the border' impediments to trade and investment in priority areas in both foreign markets and Australia and more comprehensively than would otherwise be the case in the WTO. While they have been helpful in effecting some changes and facilitating dialogue and cooperative efforts, far-reaching policy changes affecting the business environment remain a matter of broader economic policy and structural reform.

Closer economic integration achieved among FTA parties has been commercially beneficial for business in some areas. Long term benefits are expected from those agreements which align Australian business more closely with international best practice standards in international commerce and globally integrated supply chains.

### **Improving Australia's FTAs**

Australia's current and prospective FTAs would offer greater benefits to business if they were improved in a number of ways.

They should build on the APEC Principles for best practice RTAs and FTAs to ensure consistency of liberalisation among agreements and with both APEC goals and the WTO on a non discriminatory basis.

Liberalisation of goods, services and investment across agreements should be deepened to extend beyond WTO commitments and to counter liberalisation achieved by competitors in third party FTAs. Improvements in the regulatory framework in some areas should be more targeted.

Agreements must support structural reform efforts in FTA markets to address beyond the border barriers and encourage pro-competitive regulatory frameworks; including in areas not currently addressed.

Measures and mechanisms to support closer economic integration between FTA partners must be tailored to and respond and adapt to changing economic conditions.

## **Reconciling FTAs with the WTO**

The basic concern about clashes between or inconsistency among measures in FTAs and provision of WTO agreements is that because FTAs liberalize on a discriminatory basis, they will deliver less economically liberal and potentially sub-optimal results than if liberalization were delivered through the multilateral disciplines of the WTO.

Although more political than economic, there is also a concern that the rise of FTAs carries a prospective threat to the authority and thereby the effectiveness of WTO multilateral trading system.

The BCA proposes that Australia continue to support activity in the WTO to highlight the importance of WTO principles that seek to encourage FTAs and regional agreements that do not create trade diversion that outweighs trade creation.

Measures to improve FTAs set out elsewhere must also serve to ensure that WTO principles and measures continue to be treated as the reference points for related measures in FTAs.

## **Advancing regional integration**

The BCA considers that a number of actions could be taken to advance regional integration. Australia should actively promote open market economic integration in the Asian Pacific region, in particular encouraging active US engagement in that process. It should formally support all models of regional integration being proposed in the Asian Pacific region, but set a strategic goal of building an effective APEC based FTA.

Australia can work with other open, like-minded economically liberal economies to build regional economic integration models that could lay down precedents for an APEC wide FTA in the long run. To this end, Australia should consider building small regional agreements out of existing bilateral agreements.

Australia should actively support development of the Economic Structural Change program launched in APEC Sydney Summit to take the historic focus on trade liberalization to another plane to promote regional economic integration by focusing on domestic economic reform in APEC economies.

## **Addressing the impacts of climate change regimes on international trade rules**

Measures to abate emissions of greenhouse gases which significantly increase the cost of power in Australia will make Australian industry uncompetitive in global markets until there is a globally agreed cap to underpin a global price on greenhouse gases.

Global agreement on a global emissions trading scheme is unlikely in the foreseeable future.

Preserving the competitiveness of Australian industry and ensuring there is not the risk of carbon leakage, should be the leading criteria for the successful introduction of an emissions trading scheme which includes a cap on emissions. Other criteria should be equal or subordinate to that, not superior.

Australian policy should recognize that in general Australian industry is a price taker in the global market, not a price setter.

Australia should “move with the pack” on measures to abate, not seek to be ahead of the pack to ensure Australian business is not made uncompetitive in global markets.

The core principles of the open multilateral trading system created by WTO agreements must remain inviolate. Australia should not adopt measures on the presumption that core values of the WTO system need accommodation.

In the first iteration of the emissions trading system, Australia should set a low cap so any risks of loss of competitiveness and carbon leakage will be small.

The early years of the ETS should be recognized as an introductory phase with an opportunity to test what will work in the longer run. A review date should be included in the introduction of the ETS so the effectiveness and efficacy of this measure can be assessed before a long term commitment is made to make them a permanent feature of Australian measures to mitigate greenhouse gas emissions.

Flexibility should be a guiding principle. Trade exposed emissions intensive industries should be relieved from competitive pressures with granting of free permits to emit, or being subject to other tools where increased charges for reducing carbon can be rebated from exports. Measures to restrain emissions other than an ETS should be considered if they are the only practicable option at this stage.

### **Allocation of government resources**

To cope with the expanded agenda of economic integration issues, DFAT should increase the technical expertise and knowledge of officials in DFAT handling these matters

## 1. What is the role of Australia's trade and investment policy?

### *Trade and investment policy*

Trade and investment policy provides the basic governing framework for the conduct of international commerce. It involves laws and regulations which regulate the conditions of competition in markets between domestic and foreign operators. These form part of broader national economic policies. They are also the subject of international treaties and arrangements including the WTO, bilateral FTAs and regional forums like APEC.

Trade and investment policy is primarily focused on ensuring that international trade and investment is liberalised; it is geared to promoting competition, not providing protection. It is about securing access to international markets for business through the removal and reduction of impediments affecting cross border operations; particularly where these discriminate among operators. They include impediments at the border (such as tariffs barriers for goods) as well as those which extend to operations behind the border (such as restrictions on services transactions and investment establishment).

The basic premise underlying trade policy, including that of Australia's, is that trade openness, economic performance and living standards are strongly interlinked.<sup>1</sup> The economic welfare of the economy is improved through open and efficient markets which maximise benefits to consumers and minimise distortions to business. These provide a strong foundation for sustained growth in trade and investment over the medium to long term.

The role of the government is to not only set domestic trade and investment policy settings but also to help shape the international trade policy framework which has a direct bearing on the international competitiveness of Australian business. The latter is achieved through trade negotiations resulting in development of legal rules in treaties and agreements, as well as political and economic cooperation involving non-regulatory measures. It is pursued through a combined multilateral, regional, and bilateral approach.

### *Structural reform*

While trade and investment policy is important for business, global commerce today is affected by a much broader range of economic activity. As global impediments to trade have been progressively reduced over the last 40 years, the conditions of competition in international markets, including those which extend beyond national borders, (such as overly burdensome regulatory systems, lack of transparency, measures which inhibit competition and poor governance), have become more important.

Addressing "beyond border barriers" is more about structural reform for improving economic efficiency and the business environment in domestic markets rather than about trade and investment liberalisation per se.

Structural reform encompasses much broader economic activity undertaken by governments than just trade and investment. It includes economic and financial

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<sup>1</sup> WTO (2007) *Trade Policy Review of Australia*, (WT/TPR/S/178/Rev.1), p 18.

reforms designed to strengthen those arrangements that enable or support well-functioning markets. It is focused on creating new markets and introducing competition into those markets<sup>2</sup>; and ensuring that existing market forces function properly. This includes facilitating investment in productive activities, regulating natural monopolies, building stronger businesses and letting new businesses enter and inefficient businesses exit a market through the removal of barriers.

The ultimate aim, like trade liberalisation, is to derive the economic welfare from well-functioning and competitive markets which encourage innovation and productivity gains and, ultimately, sustainable economic growth.<sup>3</sup> Just as international trade promotes competition in domestic markets, domestic structural policies influence the ability of domestic firms to compete internationally. These domestic policies directly affect the preparedness of economies to open up markets to more international trade connections and enhance the benefits from trade.<sup>4</sup>

Governments are limited in the extent to which they can achieve better functioning markets through traditional trade policy instruments, such as trade agreements. While trade and investment policy can erect broad principles or disciplines to facilitate this, it is much more effectively dealt with at the international level through cooperative efforts for improved structural reform.

This was recognised and emphasised by APEC Economic Leaders last year, who in Sydney agreed to give greater attention to beyond the border issues by endorsing a strong mandate for structural reform. A detailed work program was agreed to implement and progress structural reform in five key areas – regulatory reform, competition policy, corporate governance, public sector governance and strengthening of economic and legal infrastructure, to be implemented between 2007 and 2010.<sup>5</sup> Also newly agreed were efforts by APEC specifically dedicated to helping strengthen existing institutions that promote and implement structural reform.<sup>6</sup> Australia committed to convene a Ministerial-level meeting on structural reform in 2008, the first wholly dedicated to that.

### ***Key deliverables for BCA from Australia's trade and investment policy***

The BCA supports trade and investment policy for Australia which;

- Underpins the working of free and open and efficient global markets;
- Is consistent with 21<sup>st</sup> century business interests and current developments in the global economy;

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<sup>2</sup> This includes altering the market structure so that service providers operate, as far as practicable, on a commercial basis and in a competitive environment. See APEC Structural Reform “About APEC Structural Reform” at <http://www.srmm2008.apec.org>

<sup>3</sup> APEC Structural Reform “About APEC Structural Reform” at <http://www.srmm2008.apec.org>

<sup>4</sup> APEC (2008) APEC Structural Reform, “How does Structural Reform fit in the APEC Agenda?” at <http://www.apec.org>

<sup>5</sup> The work program builds on the APEC Leaders Agenda to Implement Structural Reform.

<sup>6</sup> See (2007) 19<sup>th</sup> APEC Ministerial Meeting, Sydney Australia 5 – 6 September 2007, Joint Statement at <http://www.apec.org>

- Improves competition in the economy, in particular in productivity, innovation, services and investment growth;
- Addresses to some extent domestic regulations and beyond border barriers that hold the key to new investment and business development opportunities, and;
- Balances the need to encourage global investment and the protection of private investors.

The BCA considers that open and efficient markets are best secured through preservation, deepening and improvement of the multilateral, open trading system created by the provisions of the instruments of the WTO. This also includes FTAs if they also support to that broad goal as well as the narrower goal of improvements in trade and investment on bilateral and regional bases. Important benefits can be secured for Australia from bilateral and regional measures. The value is greater if they also directly support the global system of open trade and investment.

## **2. What factors are driving international trade and investment liberalisation?**

### *The uncertainty of Doha developments*

Prospects for further global liberalisation in the WTO Doha Round, although continuing, are uncertain. Negotiations which commenced in 2001 have become focused on difficult issues where protectionist forces and political sensitivities are strong. Progress has been slow.

While it is hoped the main elements of a Doha outcome can be agreed by the conclusion of 2008, further liberalization in the short term is more likely to occur as a result of unilateral, bilateral or plurilateral liberalisation and market developments.

This does not diminish the importance of the WTO as a driver of global liberalisation, but reinforces the need for ongoing efforts by government to ensure the Round delivers gains for business operating in international markets, including Australia

Due to the success of previous rounds of WTO and the Uruguay Round, barriers to trade in goods in most areas have been significantly reduced. High levels of protection remain, mainly in agriculture, in both developed and developing countries, and across manufacturing products, mostly in developing countries. The original level of ambition in the Doha Round was to go much deeper and accomplish real market openings on a wide front in terms of tariffs and subsidy cuts.

Agriculture has been a major sticking point, with developing countries demanding from the US and the EU priority needs such as cuts in developed country tariffs and domestic subsidies and allowances for protection of products for “development needs” and the EU and US for their part seeking from developing countries greater reduction in protection across the board, including in services and manufacturing, to balance the commitments they have already made. Market access is controversial and still to be negotiated.

The resulting deal is either likely to be less ambitious, or take several more years to get right. The EU for example, will not formally look at reforming its common agricultural policy until 2013. On the other hand, the loss of trade promotion authority in the US<sup>7</sup> will make it difficult for a less ambitious deal to pass through the Congress. Developing countries have not indicated a readiness to further liberalise services or industrial products any time soon.

Prospects for liberalisation under the WTO are discussed in greater detail in the following section.

### *The rise of bilateral and regional FTAs*

The proliferation of the negotiations of bilateral and regional free trade agreements, apparent in recent years, is likely to continue. The trend is toward an increasingly

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<sup>7</sup> Trade promotion authority (TPA) is the legislative authority which allows the Administration to pass international trade agreements through the Congress as negotiated.

complex set of trade arrangements that differ in the degree and scope of liberalisation achieved, often described as “a patchwork of bilateral hub and spoke FTAs.”<sup>8</sup>

This has the potential to drive greater liberalisation and regulatory reform than the WTO. By creating discrimination in trade however, it also poses risks of diverting more trade than it creates, and undermining that process. It underscores the need for the negotiations of FTAs which are consistent in reducing barriers to trade comprehensively across goods, services and investment.

Bilateral agreements in the Asia Pacific region have proliferated in the last five years, spearheaded by the US and followed by Korea, Japan, China and ASEAN nations. More recently, the EU and India have joined the fray. There are now 17 FTAs in force and about 60 in the pipeline in China, India and South East Asia alone. Bilateral FTAs are most in evidence, but there are plurilateral negotiations too, especially those involving ASEAN collectively. An ASEAN Plus Three (China, Japan, Korea) FTA has been proposed, as has an East Asia Economic Community (bringing in Australia and New Zealand).<sup>9</sup> There is even talk of an Asian Economic Community (involving India and other South-Asian countries) and of a Free Trade Area of the Asia Pacific (FTAAP) comprising of all APEC member economies.

More agreements will be negotiated in future. The EU and US have already begun transatlantic efforts to ease trade and investment flows between them in certain sectors, including financial services. The EU is currently concluding deals with Korea and ASEAN countries. If the Korea/US FTA eventually passes through the Congress, this will give added impetus for Japan to seek an FTA with the US.

The extent of liberalisation achieved in FTAs has not been uniform; it varies considerably in both degree and scope. While those negotiated by the US, Australia, New Zealand and Singapore for example have tended to be comprehensive in their coverage of goods, services and investment liberalisation, as well as beyond the border barriers, those negotiated by many of Australia's Asian trading partners have been far more “trade lite” agreements, delivering weak and partial liberalisation. Often politically sensitive products are carved out from liberalisation; rules of origin can be restrictive; services and investment liberalisation minimal or non-existent.

All FTAs however extend preferential market access to enterprises from FTA partner countries, and with this have introduced discrimination in markets of FTA partner's vis-à-vis competitors from third countries. FTAs between Australia's major trading partners and competitors, such as the US and Korea for example, could potentially disadvantage Australian business.

To ensure Australia is not excluded from important bilateral deals between important trading partners in the future, the continued negotiation of FTAs by Australia is warranted. At the same time, it underscores the need for a consistent approach to FTAs.

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<sup>8</sup> Razeen Sally (2007) “Trade Policy in Asia - Where next with a crippled WTO and weak FTAs?” ECIPE Policy Brief No 01/2007, at [www.ecipe.org](http://www.ecipe.org), p 5.

<sup>9</sup> *Ibid*, p 5.

## *China growing, emergence of India*

Economic growth in China and India is transforming global trade and investment patterns. Trade policy responses are changing the dynamics of the international framework. China's accession to the WTO in 2001 and the subsequent role it plays in multilateral trade negotiations will have profound impacts on future global liberalisation. FTAs by both countries responses will increasingly set the scene for Asian economic and political integration.

Australia's trade policy settings must serve to well place business to take advantage of growth in trade and investment in the region and secure the benefits of further liberalisation in growth markets at all levels - multilateral, regional and bilateral.

Economic growth in China, and increasingly India, are changing global trade and investment patterns. Although for the last half century, Japan and the "Asian tigers" such as South Korea, Taiwan, Hong Kong and Singapore, have dominated Asian economic activity, (Japan still accounts for over 50 percent of East and South Asian combined GDP at market prices) China is fast catching up.<sup>10</sup> It is already more globally integrated than Japan in terms of trade and FDI penetration and has recently displaced Japan as the world's third largest trading nation.<sup>11</sup> It has recently displaced Japan as Australia's largest trading partner.<sup>12</sup>

India's global integration pales in comparison, but it has come far in recent years and has the potential in future, given its huge pool of cheap labour and unworked resources, to become a labour-intensive, FDI-driven expanding powerhouse in industrial goods and a budding exporter of labour intensive agricultural products.<sup>13</sup> It is Australia's fastest growing major export market.<sup>14</sup>

Both countries will alter the international trade and investment landscape. China's accession to the WTO in 2001 is perhaps the most significant policy development. In a short time China has swung from extreme protectionism to rather liberal trade policies, particularly by developing country standards. This has not only opened up a huge market to the world, but it has also given China a strong stake in the rules based multilateral trading system.

More than any other developing country, China has internalised the classic logic of the GATT/WTO as an instrument of defence against arbitrary protection of other powerful countries, a lever to expand access to export markets and a framework of rules to buttress domestic market reforms and integration into the global economy.<sup>15</sup> It has at the same time however, demonstrated mercantilism in investment and trade

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<sup>10</sup> *Ibid*, p 2.

<sup>11</sup> Trade in goods is 63 percent of GDP, FDI stands at 35 percent of GDP and multinational enterprises account for and astonishing 60 percent of merchandise trade. See Sally (2007).

<sup>12</sup> Australia's two-way trade (exports and imports) with China in the year to March 2007 reached a combined total of \$52.7billion, eclipsing two-way trade with Japan of \$50.6billion.

<sup>13</sup> Razeen Sally (2007) "Trade Policy in Asia - Where next with a crippled WTO and weak FTAs?" ECIPE Policy Brief No 01/2007, at [www.ecipe.org](http://www.ecipe.org), p 2.

<sup>14</sup> Goods and services exports increased by an annual average of over 34 per cent over the last five years. Two-way trade in goods and services in 2006-07 totalled \$13.6 billion making India Australia's ninth largest trading partner. See [www.dfat.gov.au](http://www.dfat.gov.au)

<sup>15</sup> *Ibid*, p 4.

policy and sought to negotiate relatively weak FTAs with trading partners in East and South Asia. This also reflects a political strategy to ensure its dominance in the region.

India continues to liberalize its economy, but in the WTO, its commitments to liberalize are weak and it leads other developing countries to take defensive positions in the Doha Round. It has started to negotiate FTAs in South Asia and elsewhere, in part in reaction to activity by China, but they are generally 'trade lite'

The path China takes in future will have significant broader impacts for the economic and political setting. Although to date China has been a cautious and non-confrontational player in the Doha Round, it can be expected to remain pragmatic on key issues.<sup>16</sup> On the FTA front, more FTAs which extend beyond WTO commitments will prove difficult to negotiate. India will continue to influence developing country positions in the Doha Round unless or until China takes an active role. This does not bode well for further liberalisation prospects both at the multilateral and bilateral level.

### *The importance of developing country trade*

Trade among and by major developing countries is increasingly driving global trade and investment. This has occurred as developing countries such as China, India and Brazil have become more politically and economically integrated through manufacturing supply chains and economic agreements. Much of this economic activity however, remains constrained by trade and investment barriers and restrictions.

Many of these countries are important trading partners of Australia. It provides a strong case for pursuing further liberalisation in developing country markets and policy settings at the international level which support this.

Trade among developing countries is expanding, albeit from a small base.<sup>17</sup> Most is probably accounted for by China's economic growth. Other major developing countries, particularly Brazil, are increasing their share and dominance in world trade.

Despite this, barriers to trade and investment among developing country markets still remain high by developed country standards. Major traders such as India for example, maintain high level of protection across both agriculture and manufacturing. Korea maintains relatively high tariff barriers on agricultural products. ASEAN nations, with the possible exception of Singapore, continue to apply a range of restrictions across all sectors of the economy. Although some of these areas have been liberalised through FTAs, overall the drive towards liberalisation has been slow and piecemeal. Few countries have demonstrated a willingness to further liberalise in the Doha Round.

Many of these markets, including China and particularly in South East Asia are becoming increasingly important to Australian business. Australia stands to gain both

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<sup>16</sup> Razeen Sally (2007) "Trade Policy in Asia - Where next with a crippled WTO and weak FTAs?" ECIPE Policy Brief No 01/2007, at [www.ecipe.org](http://www.ecipe.org), p 4.

<sup>17</sup> Merchandise trade among developing countries has expanded considerably in the past 20 years; it now makes up around 6 percent of world trade, compared with 3 percent in 1985. Over that period, it grew on average at the impressive rate of 12.5 percent a year, compared with 7 percent for trade among developed countries and 9.8 percent for merchandise trade among developed and developing countries. See OECD (2006) *South-South Trade: Vital for Development* (Policy Brief, August 2006).

from further liberalisation in key areas of trade and investment and also from greater regional and international integration which drives this.

### ***Timing of US and EU policy reforms***

Policy reforms in both the US and EU will remain important to the future path for global trade and investment liberalisation. They are of relevance to Australia for their broader influence in both driving the pace of multilateral liberalisation and utility of the WTO for delivering this. They must be considered by the government in its approaches towards that.

The US domestic setting has been and continues to be vital for the path of multilateral reform under the WTO. The loss of trade promotion authority in 2007 will make passage of any final Doha deal difficult. This is overlaid with a Congress that is increasingly hostile to free trade, including bilateral trade deals, and continually reluctant to give up billions of dollars in farm assistance to its own agriculture sector as demanded by developing countries. A new Administration will take office in 2009. It is difficult to gauge accurately the true approach of any Administration to trade liberalisation until it is in place. Current expectations are that the next Congress may be even more antipathetic to trade liberalization than the current Congress. A Democratic Administration would seek to use trade policy to advance environmental and social goals.

The US position is closely linked to that of the EU, whose reform of agriculture also faces domestic political constraints. Agricultural producing members such as France have continued to oppose agricultural reform. The CAP will not be formally reviewed until 2013. Problems with EU enlargement and the entry of new agricultural producers such as Poland have exacerbated the problem. It is unlikely there will be significant cuts in tariffs or reductions in subsidies for the next 5 years.

### ***Policy responses to commodity price rises***

Commodity prices have risen rapidly in the last year and are forecast to remain so for some time. These price rises are significant not only in terms of their cost impacts for the profitability of trade in certain products, but also for the broader policy responses they have and are likely to elicit at the international level.

Although business will need to ensure it can respond in the commercial environment, it will also require a complementary business and policy environment which encourages appropriate policy responses in both the short and long term.

Prices for agricultural products and minerals have risen substantially in recent times. They are forecast to keep rising for some time yet. Prices have risen as a result of demand exceeding supply for the different products. In the case of feed grains and oilseeds and meat, for example, increased corn demand for ethanol in the US has been a factor in driving up prices for corn and hence for soybeans which are both used as feed for meat animals and dairy production. Wheat prices have been affected by lower production caused by weather conditions, including drought in Australia. On the demand side, strong economic and income growth globally and especially in developing countries (China and India for example) has stimulated demand for

agricultural products, as consumers switch from carbohydrate-based diets to those more protein rich.

Price rises have been associated with increasing food shortages, and followed by trade restrictions on exports in some countries. Major producer countries as Argentina, Kazakhstan, India and Vietnam have stopped farmers from selling crops abroad and taxed exports heavily in order to keep local markets well supplied. While reducing exports in the short term, ultimately the result is to hinder investment and supply growth as farmers cut back acreage unable to take advantage of higher prices.

This can be expected to exacerbate rather than control structural imbalances in global agriculture, largely due to strong demand growth in recent years. In the short term, while import tariffs will likely come down, food subsidies can be expected to rise and shift to essential food commodities. Export taxes will likely increase. Over the longer term, other major factors affecting both supply and demand will play a role in policy responses. These include technological improvements, subsidisation practices of producing countries and population and income growth in both developed and developing countries.

### ***The rise of “beyond the border barriers”***

Global services trade and investment is rapidly expanding. It is increasingly driving economic growth in both developed and developing countries, including Australia. As a result, removal of barriers and restrictions which operate beyond the border in many economies is becoming more important for successful global markets.

It is imperative for business that approaches to liberalisation, both at the multilateral and bilateral level, seek to address these impediments to business and foster regulatory and policy environments which are conducive to open trade and investment.

Services trade has grown faster than trade in goods in recent years. The services sector is increasingly the engine of economic growth, accounting for well over half of GDP in most developed countries, including Australia, where it contributes over 70 percent. Global flows of foreign direct investment have also expanded rapidly in recent years. Australia’s total investment in APEC for example has risen markedly in the last 15 years as has APEC members’ investment in Australia. At the same time Australia’s services exports to the region have also grown.<sup>18</sup> The two are closely linked.

This growth has brought with it greater recognition that barriers to conducting business across borders are now less related to border restrictions such as tariffs, and more closely interlinked with the operating regulatory and policy framework in foreign markets. This applies not only to services and investment policy frameworks, but also broader policy impacting on business operations such as intellectual property rights, competition policy and government procurement.

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<sup>18</sup> Australia’s investment in the region rose from A\$110 billion in 1989 to \$548 billion in 2006 and APEC members’ investment in Australia rose from \$42.4 billion to \$508 billion. Australia’s services exports to the region grew by an average of 8.4 per cent per annum to reach \$26.2 billion in 2006 from \$5.9 billion in 1989 (15 per cent of total exports).

As business becomes more globally integrated, the operating environment in markets becomes more important. Governments can play a key role in facilitating services trade and investment flows by driving policy settings and legal arrangements at the international level which are consistent with an open and transparent business environment.

### **3. What are the prospects for multilateral liberalisation in the WTO?**

#### ***Prospects for future liberalisation***

Prospects for future multilateral liberalisation under the Doha Round currently are uncertain. In the short term, significant liberalisation is more likely to occur as a result of market growth and bilateral or region liberalisation through FTAs. In the longer term, however, the WTO still offers a robust framework capable of delivering significant reform of global trade which is of commercial benefit to business.

Australia's trade policy must be attuned to the reality of the multilateral setting. It must also be cognisant of the broader economic and political impacts this presents for the future of Australian business operating within it.

Serious consideration must be given by government about the role of the WTO in securing liberalisation; the maintenance of the integrity and authority of the multilateral rules-based system and for ensuring that liberalisation which is pursued elsewhere remains consistent with and complementary WTO.

#### ***Possible outcomes***

The current status of negotiations means it is very unlikely that a result which delivers the full level of ambition all players are seeking can be delivered this year. This leaves several possibilities: the conclusion of a less ambitious deal being in 2008; continued drifting and delay of negotiations indefinitely; a decision to take more time to conclude a more ambitious deal.

A less ambitious deal would effectively draw the Doha round to conclusion and while perhaps second best in terms of global liberalisation, could prove a valuable saving of face for the WTO.

This is perhaps the greatest risk for the WTO, should negotiations be allowed to seemingly continue to stall. While little will be achieved through this process, members will likely pursue bilateral and regional liberalisation where progress is politically more easily attainable and not always as economically difficult, depending on the level sought.

A decision to extend the Round for a reasonable time period to allow for a more significant result would be another option, but it is difficult to see any one party taking this lead. A reasonable time period for the US would need to allow for the presidential election to pass and see a new Administration settled in. It would also require significant movement from the EU. This is unlikely until it reforms its Common Agricultural Policy (CAP) which is not due until 2013. Many developing countries also need more time to build the case for liberalisation at home.

In several years, China may be more willing to offer liberalisation beyond its accession commitments, the US may have trade promotion authority returned and the EU may be more willing to reform its agricultural policy. All of these factors would help contribute to a more significant liberalisation outcome.

### ***Implications for Australian business***

A less ambitious deal risks delivering little trade reform in areas of commercial significance for Australian business when compared with the more ambitious levels currently sought. This applies particularly for services, where perhaps the largest gains are to be made, especially from improved commitments by developing countries. Given the potential of the WTO to drive greater multilateral and non-discriminatory liberalisation in services growth areas, this would be a significant opportunity cost.

On the other hand, reaching any result would at least bring the Round to conclusion, which would at least permit governments to focus on what the next steps might be. (See next section on how to make the WTO more effective). It would give the WTO the credibility of a result, albeit not the optimum one.

Allowing negotiations to drift without a result seemingly in prospect is likely to be more damaging than allowing a longer time period for the political negotiating reality to improve. Reaching agreement on issues where protectionist forces and political sensitivities are strong will remain difficult – experience with other Rounds shows that this takes time. While at present the WTO may be struggling to manage this process, it is not necessarily so that it will always be the case. There are long term benefits for business in maintaining the integrity of the legal framework which is underpinned by trade rules, regardless of the outcome of ongoing or future negotiations.

Perhaps the greatest risk for business and indeed for the prospect for further multilateral liberalisation in the WTO are that it fades into irrelevance; as domestic economic and political pressures increase; as negotiations stall and as major players resort to bilateral and regional liberalisation. This would not only forfeit the opportunity to derive the benefits of further multilateral liberalisation and its associated welfare benefits, but also potentially undermine it through the rise of discriminatory and partial approaches to liberalisation.

### ***The approach to take***

Australia's trade policy approach should be to continue to actively participate and support a liberalising outcome from the Doha round which deliver tangible benefits to business, particularly in services.

At the same time it must seriously consider next steps for securing liberalisation, which are consistent with this, post Doha, taking into account the current global trade and investment environment.

Should the round linger on for some time with little result, the government must now begin to consider ways in which liberalising results can be achieved more effectively within the current framework and play a key role in efforts to pursue them.

## 4. How can the WTO be made more effective?

### *Problems with the WTO multilateral trade negotiating process*

It is widely accepted that there is a problem with the WTO's system of multilateral trade liberalization, as evidenced by the difficulty of making progress in the Doha Round.

Efforts are currently being made to complete a package of results by the end of 2008. If that succeeds, the liberalization will be moderate and will certainly not meet the ambitions at the end of the Uruguay Round to have a round which would substantially advance the global reduction of barriers to agriculture and services. While the Uruguay Round was of historic importance because it aligned rules on trade in agriculture with WTO rules and principles, it did not reduce the overall level of protection of global markets for agricultural trade.

The key problem is agriculture. Most major economies are unwilling to commit to substantial reductions in protection. The political blame is laid at the feet of the EU and US. It should also include Japan. However Brazil, India and China – all large agricultural producers – are also unwilling to reduce protection.

It is politically convenient to blame the EU and the US for not taking the lead and setting the example. If they did, it would make a difference. But it is also patently obvious that most the 160 odd members of the WTO do not attach priority to trade liberalization.

This is a dismal situation, a dramatic demonstration of the failure of countries, which also happen to have the highest incidence of poverty, to act in their economic self-interest. These developing countries constitute the majority of members of the WTO and have on average the highest trade barriers.

It is in their self interest to use the WTO system to reduce their trade barriers. Newly acceding members, most spectacularly China and to a lesser extent Vietnam, have used the process of accession to unilaterally open their markets. Existing members, such as India and most nations in Africa and Latin America, however show no inclination to use the WTO system, either as part of the process of multilateral trade negotiations or independently (as they could at any time), to reduce trade barriers and lock them in as legally binding commitments through WTO procedures.

There is another irony. While the Doha Round struggles on, negotiation of bilateral and regional FTAs has flourished. Many are negotiated for political reasons. But many deliver real liberalization in areas where no progress is possible in the WTO, such as on agriculture and services and in areas which WTO does not cover, such as investment, competition policy, de-regulation and other “beyond the border” issues.

Because the politics of the trade round have now been built around achieving liberalization of trade in agriculture, a situation Australia played a leading role in creating during the Uruguay Round, liberalization in other areas, such as industrial products and services is also blocked. As well, efforts to extend the scope of liberalization to reflect today's global structure of trade and business, in particular by addressing barriers to investment, have been blocked.

There has also been a trend to load the WTO up with peripheral activities, mostly to meet political demands from developing countries to show greater regard for the “development dimension”. This has been encouraged by the major economies in part to try to demonstrate preparedness to take some action in the absence of tangible progress in negotiating reduction of trade barriers.

The multilateral negotiating process, which has produced a steady global reduction of trade barriers since 1948, seems no longer capable of producing a result. Why is this?

Views vary. Some argue the WTO is too big - now 136 members with a large number for whom trade is not important enough. The WTO is now more like the UN, where the large majority of small countries determine proceedings.

The General Agreement on Tariffs and Trade (GATT) states that one aim is to enable parties to reciprocally enjoy the benefits of collective trade liberalization. It worked for the original 23 parties, the dominant members then were from Europe and the US. They achieved significant reductions in barriers to trade in manufactures in the fifties and sixties. The mutual benefits their producers secured from the greater access to each other’s markets were manifest.

While reciprocal benefit has been criticized by some free traders as fostering mercantilism, it serves the political economy of trade liberalization well: few governments successfully sell the economic benefits of unilateral liberalization; demonstrating that other things are gained and others share the pain is the political reason trade agreements exist.

It is difficult to see how a broad deal which would deliver identifiable reciprocal gains from trade liberalization can be constructed in the WTO today between the rich and the poor countries. For example, most of the small economies, such as the 50 odd African economies, already have access to the open markets of the big economies. As well, those economies are too small today to offer significant markets to businesses in large economies by opening their own markets.

The principles guiding the multilateral negotiating process (which set the rules for the “Rounds” of trade negotiations) also seem at fault, in particular the requirement that no package of results can be adopted in any area without concurrence to results in all areas of the negotiations – no result on agriculture, no result on services. Any sizeable group of nations can hold the entire process of negotiation hostage.

If the multilateral trade processes are not working, this does not mean the WTO has lost its value. They are not necessarily its most important features.

### ***The fundamental importance of the WTO***

The WTO system of rules is possibly the most important institution of the post war period. It provides a legal right for States to build prosperity by trading on the comparative advantage of their economies. It has created the foundation on which has been built the greatest increase in prosperity and reduction of poverty in world history.

It still provides that platform to lift the remainder of the world’s poor out of poverty. By promoting global prosperity it generates an economic interdependence that fosters

collaboration and militates against resort to conflict. It reduces significantly the capacity of nations to use trade as a tool of coercion. It has infinitely greater capacity to support the removal of subsisting poverty than any aid program or any multiple of them.

In view of China's dramatic economic reform and growth as a world trader, the WTO's greatest importance during the first quarter of this century, at least, is China's acceptance of its rules as an external standard to guide its continuing transition to a market economy.

Nothing can provide greater assurance that China will use its continuously increasing market power to build a presence in the global economy based on market principles, not sheer economic weight, than its obligations under WTO Agreements.

A number of other important economies are also in a position to benefit from WTO accession, in particular Russia and other former satellites of the USSR. All are making the transition to market economies and all would benefit from the external discipline WTO obligations provide to stay the path.

The process of accession, as China showed, is in itself an act of trade liberalization. It is likely that the accessions of major economies to the WTO over the past two decades have generated as much, if not more trade liberalization than commitments negotiated in the multilateral trade rounds (the Uruguay Round and prospectively, the Doha Round).

The WTO also provides a common set of rules by which the largest nations can resolve trade disputes. It is the world court for trade for the EU, the US, Japan and increasingly China. If the WTO never presided over another process of global trade liberalization, maintenance of the existing set of rules and the dispute settlement system which ensures compliance with them would justify preservation of the WTO system for the contribution it makes to preserve the multilateral trading system.

In fact the focus on trying to make the Doha Round a success has resulted in some neglect of developments in the dispute settlement system. As important as it is, there are some ominous trends emerging which deserve attention.

The system is showing systems of acquiring a legislative function. Some rulings are being made by the Appellate Body which would not in all probability be adopted by the members of the WTO operating in their executive capacity as rule makers. The risk of this was always significant when the existing system was adopted after the Uruguay Round. It is time for a major review of the dispute settlement system with the specific mandate of ensuring that the process of judicial review does not supplant the executive responsibility of the executive organs of the WTO.

### ***Action to consider***

It is essential that Australia act to preserve the authority and integrity of the WTO system.

As outlined above, Australia should actively participate and support a liberalising outcome from the Doha round which deliver tangible benefits to business, particularly in services.

Australia should work with leading WTO Members on next steps for securing liberalisation, post Doha, taking into account the current global trade and investment environment.

The Australian Government should review how the process of trade liberalization is undertaken in the WTO.

The review process should consider whether free standing negotiations in individual sectors should be formally pursued, such as liberalization under the services agreement. The concept of negotiation of “plurilateral commitments” should be considered in negotiating further commitments under the GATS negotiations. This would enable groups of parties who wish to commit collectively to a more advanced set of liberalization measures to do so. Others GATS parties would be free to join those agreements later. By this means, those who are interested in advancing liberalization of services on more global bases can do so and not be held up by a minority of countries with little interest in services.

A special standing body should be set up in the WTO to address liberalization of agriculture. This would be necessary to keep pressure up in the WTO on this issue. It should envisage that negotiations on agriculture would resume as a sectoral exercise when major parties are ready to liberalize further.

The WTO dispute settlement system should be reviewed with a view to minimizing the risk that it will usurp the legislative function of the WTO’s executive organs.

## 5. Have FTAs been beneficial for Australian business?

### *Measuring the benefits to business*

To date Australia has concluded FTAs with New Zealand, the US, Singapore and Thailand. There is as yet no systematic methodology for measuring their impact. It is too early to accurately assess trade and investment trends.

Econometric modelling done on the prospective effects of FTAs has produced results which, although roughly estimate the benefits from liberalising trade in goods and to a degree services, understate the dynamic long term value of the agreements. Positive and negative results of modelling are of limited value for measuring the long term benefits to business of FTAs.

Trade and investment statistics can provide some indication of trade flows over the period since implementation, but are limited for assessing trends. This is both due to the lag in collection of data and the time it takes for exporters to adjust to new trading conditions. Many changes in trade patterns will take several years to emerge as exporters adjust to new trading rules and as barriers fall progressively (for example, access for beef under AUSFTA will take 18 years to eventuate).

As such, the benefits for business of Australia's FTAs are best assessed qualitatively in terms of the extent to which they have met key business interests and needs.

For the BCA, the benefits of FTAs are measured by the extent to which they:

- Promote open markets and removal of barriers to trade and investment as basic factors to promote growth;
- Deepen liberalisation commitments made at the multilateral level under the WTO; or broaden liberalisation disciplines for economic activity in areas which are increasingly important to business but are not covered by multilateral disciplines, particularly investment;
- Address impediments and constraints to trade and investment which are important between the parties, including, to the extent practicable, beyond the border barriers such as competition policy and regulatory transparency;
- Facilitate closer economic integration among FTA parties which supports the business environment; such as through temporary movement of personnel, recognition of professional qualifications and financial services integration;
- Align Australian business more closely with 21st century business practices and needs, including globally integrated supply chains.

FTAs are currently being negotiated by Australia with China, ASEAN (jointly with New Zealand), Malaysia, Japan, the GCC and, most recently, Chile. Bilateral agreements with Korea, Indonesia and India are being considered.

## ***Have Australia's FTAs been beneficial for Australian business?***

### *Deepening liberalisation beyond WTO*

FTAs deliver benefits for Australian business where they provide for liberalisation which extends beyond that achieved at the multilateral level in the WTO. This applies for both goods, services and intellectual property, which are the subject of WTO rules.

FTAs also deliver benefits for business where they broaden disciplines for economic activity in areas which are economically important to business but are not covered by multilateral disciplines. This is particularly so for investment liberalisation.

The benefits derived for business are greatest where the degree of liberalisation achieved across agreements is comprehensive and is consistent among agreements and with the WTO. From a practical point of view, consistency in agreements avoids compliance costs associated with overlapping and differing commitments across markets. From a policy point of view comprehensive and consistent agreements limit the degree of discrimination arising from preferential liberalisation.

Generally, most of Australia's FTAs have delivered liberalisation outcomes which are comprehensive and which build on multilateral achievements, although the scope and degree of liberalisation varies across agreements.

### Liberalisation of merchandise trade

In the case of goods, market access gains were made in each of the FTAs across a number of products in markets of importance to Australian business. For example, (almost) completely free trade in goods achieved in ANZCERTA has benefited Trans-Tasman trade. Liberalisation of merchandise trade under AUSFTA eliminates nearly all tariffs either immediately or gradually over time, as set out in schedules to the Agreement - the phasing out of the US import quota on Australian beef for example, will over time produce significant access for Australian beef and dairy exports.

While liberalisation of merchandise trade under almost all of the FTAs has been comprehensive and "WTO plus", some restrictions do remain in areas of importance for Australian business. Greater restrictions apply in the case of Thailand where liberalisation has not been undertaken or will progress more slowly.

### Liberalisation of services trade

In services, some but not all of Australia's FTAs build on liberalisation achieved under the GATS, providing greater access for Australian service suppliers in FTA partners by granting access to foreign services suppliers in the Australian market. AUSFTA and SAFTA provide for deeper liberalisation in important and growing areas of trade such as financial services and telecommunications.

AUSFTA delivers the most liberalising outcome for business in services trade which is important and growing. The United States was the single largest destination for Australia's exports of services and also the single largest source of services imports in

2006-07.<sup>19</sup> While there have been benefits for business through additional access granted to Australian service exporters in the US market in areas such as professional, business, education, environmental, financial and transport services, two-way trade has also been strengthened through additional access granted by Australia to US service suppliers in areas such as professional and business services.<sup>20</sup> Financial services are dealt with separately and comprehensively.

Structurally, the AUSFTA in many ways improves significantly upon service liberalisation achieved in the GATS by adopting a 'negative list approach' to scheduling of commitments and by including a 'ratchet mechanism' for measures to liberalised (which ensures that any subsequent unilateral liberalisation of those measures cannot be reversed). This provides certainty to business by locking in or 'binding' progressive liberalisation. AUSFTA also accords not only national treatment for service suppliers but also includes an MFN clause which has the effect of extending any subsequent measures liberalised by either party to each other. This not only extends the benefits of more open and efficient markets arising from future liberalisation to Australian business, but also prevents discrimination arising from overlapping commitments in other FTAs either party negotiates.

Notably however, not all of Australia's FTAs have been as liberalising. Although services commitments in SAFTA also use a 'negative list' approach and both countries extend national treatment to the other's service providers, there is no commitment on MFN. Although commitments generally expand upon the parties' GATS commitments, and include separate treatment of financial services, measures shielded from liberalisation are more numerous. Some restrictions remain, particularly in the Singaporean market regarding the establishment and operation of foreign banks.

TAFTA delivers little further liberalisation than that achieved under GATS. As per GATS, a 'positive list' approach to liberalisation is adopted. The Agreement mandates future negotiations to extend its commitments to liberalize services within three years from entry into force. However, these have yet to take place.

### Intellectual property

Intellectual property extends significantly beyond WTO commitments only in relation to AUSFTA, under which Australia was required to make legislative changes to its intellectual property laws. Key provisions related to criminal proceeds and penalties for infringement of copyright<sup>21</sup> and satellite signal piracy.<sup>22</sup>

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<sup>19</sup> In 2006-07 services exports to the US were valued at \$5.7 billion and accounted for 12.3 per cent of Australia's total services exports. Imports were valued at \$8.0 billion or 18.0 per cent of Australia's total services imports. See DFAT (2007) *Australia's Trade in Services*.

<sup>20</sup> Including certain professional services, computer and related services, research and development services, real estate services, rental/leasing services without operators, other business services, postal services, courier services, on-line information and/or data processing telecommunications services, construction services, educational services, financial services, health related and social services, recreational, cultural and sporting services and transport services. Australia also made commitments in the financial services sector, where it agreed to provide new rights for life insurance branching and agreed to exempt new financial services investments from investment screening.

<sup>21</sup> Article 17.4.7 requires the parties to provide adequate legal protection against the circumvention of effective technological measures (encryption devices, registration numbers etc) that might infringe the rights of copyright holders (for example, modification chips which override encryption in X-box to permit pirated DVDs to be played). This includes providing for criminal procedures and penalties against persons who buy or use devices that allow unauthorized access to copyrighted works. Australian

In addition, following AUSFTA's negotiation and just prior to its approval by the Senate, amendments to the implementing legislation applicable to the pharmaceutical industry were passed at the insistence of the Labour party. These were designed to deter frivolous legal actions by pharmaceutical companies seeking to extend their patents and delay competition from cheaper generic copies – known as “evergreening.”<sup>23</sup> The amendment requires that where a patentee intends to sue a generic manufacturer for patent infringement, the patentee must certify that the infringement proceedings are commenced in good faith; have reasonable prospects of success; and will be conducted without unreasonable delay. Where such a certification is made and is ‘false or misleading in a material particular’, a \$10 million fine applies.

While changes to copyright have not had significant impacts on business, measures passed pursuant to the negotiation of the agreement to deal with “evergreening” egregiously impose extreme penalties which are both unwarranted and hostile to business.

### Investment

Investment is covered under all Australian FTAs except for ANZCERTA but dealt with most comprehensively under AUSFTA. A significant outcome of the FTA was agreement by Australia to lift the threshold for screening of proposed US investments in existing Australian businesses in non-sensitive sectors and in developed commercial real estate to A\$800 million, indexed annually (in 2007 this screening threshold is A\$871 million), from A\$100 million.<sup>24</sup> Like provisions for services, the agreement adopts a liberalising ‘negative list approach’ to liberalising measures and accords national treatment and MFN treatment to each party. No ratchet mechanism is provided for however.

Other agreements are far less liberalising. For example, SAFTA accords national treatment but not MFN. TAFTA includes only limited provisions on investment and adopts a ‘positive list approach’ to scheduling liberalised commitments.

While all agreements provide for liberalisation of investment, albeit to varying degrees, none include the right for investor-state arbitration as provided for in NAFTA.

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copyright law does not currently provide for this. Australia had until 2007 to bring its laws into compliance with the FTA.

<sup>22</sup> Article 17.7.1 requires each party to criminalize this, including personal end use (such as use of cards which decode an encrypted programmed-carrying satellite signal to allow unauthorized access to Foxtel broadcasting for example).

<sup>23</sup> It occurs when the original manufacturer literally “stockpiles” patent protection by obtaining separate 20-year patents (whether legitimate or not) on multiple attributes of a single product, and then takes pre-emptive action to challenge emerging generic challengers. The generic manufacturer is forced to choose between waiting for all the patents to expire and applying for marketing authorization, or run the risks of litigation and the associated costs and delays. In the US, infringement action permits an immediate injunction on the sale of goods for 180 days. Infringement notices can be continually renewed, therefore preventing the sale of the generic version of the drug indefinitely. The patent for the original drug is thus extended, or kept “ever green”

<sup>24</sup> Proposed U.S. investments in existing Australian businesses in sensitive sectors (such as transportation, telecommunication and defence investments) and all other types of real estate, as well as U.S. government investments, are subject to the same rules that apply to non-U.S. investors, generally a screening threshold of A\$100 million.

### *Addressing beyond border barriers*

FTAs can also deliver benefits to business where they address impediments to trade and investment which extend beyond the border to the regulatory framework in the trade and investment market.

While these can be addressed to some extent at the multilateral level, FTAs can permit barriers in priority areas of trade and investment to be targeted and dealt with more comprehensively than would otherwise be the case.

The capacity of FTAs to drive changes in the domestic policy framework in other countries is however limited. While FTAs can be helpful by erecting broad principles, effecting some changes and facilitating dialogue and cooperative efforts, far-reaching policy changes affecting the business environment remain a matter of broader economic policy and structural reform which is ultimately driven by the respective domestic policy agendas of governments.

#### Competition law and policy

Competition law and policy is dealt with in Australia's FTAs. In ANZCERTA an innovative development was agreement by both sides to eliminate the possibility of taking anti-dumping actions against each other upon agreement that dumping could be adequately dealt with under competition policy and laws directed at predatory pricing. Of Australia's other FTAs, provisions in AUSFTA assist with aligning Australia and US policy approaches to addressing anti-competitive business conduct. Provisions in TAFTA and SAFTA (with the exception of the telecommunications sector<sup>25</sup>) are generally weak. Most accord only agreement on cooperation for addressing anti-competitive practices and their enforcement. They offer little redress for business operating in these areas affected by anti-competitive behaviour.

#### Government procurement

Government procurement is another area which has been dealt with in Australia's current FTAs that is not the subject of multilateral disciplines. While benefits have been generated for business in terms of access to the US government procurement under AUSFTA, changes to Australia's own government procurement framework to make it more open and transparent under the AUSFTA are generally considered to be beneficial. Commitments in AUSFTA which were extended to other subsequent FTA partners are complementary to this.

#### Regulatory transparency

Provisions in FTAs which provide for increased transparency and which encourage the operation of pro-competitive regulatory frameworks deliver benefits for business operating in those markets. In telecommunications for example, disciplines which provide for review and explanation of regulatory decisions and their enforcement, such

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<sup>25</sup> Singapore agreed to maintain appropriate measures<sup>6</sup> for the purpose of preventing suppliers of public telecommunications networks or services in its territory from engaging in or continuing anti-competitive practices. The anti-competitive practices include anti-competitive horizontal arrangements; misuse of market power; anti-competitive vertical arrangements; and anti-competitive mergers and acquisitions.

as those in AUSFTA and SAFTA, are highly complementary to an open and transparent commercial environment.

#### Subsidies and tax incentives

Australia's FTAs only specifically address export subsidies on goods, which are eliminated under SAFTA and for agricultural goods under AUSFTA. ANZCERTA goes further and requires all export subsidies and incentives on goods traded between Australia and New Zealand to be eliminated. Other types of subsidies are not covered directly in any of Australia's other FTAs, which tend to affirm WTO rules. Tax measures are dealt with generally only where they are captured by obligations and commitments across other areas such as services, investment and government procurement.

In many ways this no longer adequately reflects the commercial reality of doing business in foreign markets. Domestic subsidies and related tax policies can damage businesses by artificially inflating the competitiveness of some producers. Such policy tools can include tax incentives; non-tax subsidies; loans from state owned enterprises at non-market rates; price controls or subsidies for raw materials and inputs; sector-specific industrial policies; land grants and subsidised utility charges.

#### Trade remedies

Australia's FTAs do not offer innovative approaches to dealing with trade remedies, with the exception of ANZCERTA and the treatment of anti-dumping actions. WTO obligations tend to be affirmed.

While this has not created problems for Australian business, it has not assisted business ensure maintenance of effective anti-dumping laws and administrative capacity in Australia. Confidentiality restrictions on data subject to anti-dumping actions for example, unnecessarily hamper the ability of domestic manufacturers to understand overall market activity, which is essential to making investment decisions. It also prevents effective monitoring of imports and undermines Australia's anti-dumping regime.

#### *Facilitating closer economic integration*

Of further benefit to business is the degree of closer economic integration among FTA parties which can be achieved through trade agreements in areas of bilateral interest. Many are particular to the trade and investment relationship between the parties. By their nature they take time to develop and progress. They are often difficult to progress at the multilateral level. Most are better dealt with at the bilateral level where interests more closely aligned and where fewer parties must be accommodated at the negotiating table.

Mobility of business persons, mutual recognition of qualifications, standards and conformance procedures and regulatory integration of services sectors are important areas of interest to business that have been addressed in Australia's FTAs to date.

## Mobility of business persons

Provisions which ease the mobility of workers and professionals across borders generate significant benefits for business. ANZCERTA, through the Trans Tasman Travel Arrangement, has achieved almost complete labour mobility between Australia and New Zealand. Provisions in SAFTA and TAFTA are less far reaching – they remain linked to immigration requirements and in the case of Thailand are limited to certain professions. They exclude movement of lesser skilled workers. Arrangements for mobility with the US, although outside of the FTA, have arguably been of greater benefit for business; although still remain limited to higher professionals. None of the latter three agreements facilitate seamless mobility of business professionals, nor ease the movement of workers in areas of current demand in Australia such as in the manufacturing and mining sectors.

## Recognition of professional qualifications

FTAs can provide a useful mechanism for facilitating agreements for mutual recognition of professional qualifications. In some cases this is agreed as part of the FTA itself (as with the case for recognition of a number of Australian law degrees in Singapore), while in other cases the FTA has been pivotal in creating a framework under which professional bodies themselves can negotiate mutual recognition agreements with their counterpart bodies in the other country.

The Working Group on Professional Services, set up to facilitate mutual recognition under AUSFTA, has provided a platform for relevant national and sub-national bodies and industry in both countries to develop mutual recognition agreements (MRAs) in the areas of accounting, law and engineering. To date, MRAs have been concluded in the accounting sector. There have also been several agreements negotiated between Australia and US states for the admission and practice of Australian lawyers in the US. Work in recognition of Australian engineering qualifications in the US is also progressing. While this process has been facilitated to some extent by the government and the FTA, progress has mainly been achieved due to the mutual interest and ongoing work of relevant industry bodies (such as the Law Institute, Engineers Australia and CPA Australia). The outcomes have been commercially significant for some Australian law firms and accounting firms operating in the US.

## Recognition of standards and technical regulations

Provisions in FTAs which provide for recognition of product standards and technical regulations are beneficial to business where they ease the cost of complying with differing requirements across markets. This was effectively achieved through harmonization of food standards between Australia and New Zealand, enforced by a Trans-Tasman (bi-national) regulatory agency.

Although Australia's other FTAs encourage the mutual recognition of standards and conformance procedures between FTA parties, their role is limited to providing a framework to facilitate this process. Ultimately mutual recognition efforts will be pursued by industry in areas of significant commercial interest.

### *Regulatory integration*

FTAs which drive closer regulatory integration in areas of commercial significance are of benefit to Australian business where they improve the commercial conditions in markets and facilitate the conduct of cross border commerce.

Areas of importance to Australian business in Australia's current FTAs have been in financial services integration as well as enhanced cooperation on competition matters, under the AUSFTA in particular. The joint Financial Services Committee (FSC) set up under the agreement, through its built in agenda, has been effective in ensuring a working dialogue among counterparts in both countries and in facilitating greater recognition of financial services regimes and recognition of accounting and financial services professional's qualifications. The requirement that the Committee report back to the FTA joint committee within a specified time frame has encouraged the movement of the agenda. AUSFTAs' Working Group on Competition Issues has also encouraged dialogue between US and Australian counterparts with a view to improving the transparency of operating regulatory frameworks. Progress in this area is of ongoing interest to Australian business.

### *Aligning Australian business with 21<sup>st</sup> century international best practice and needs*

Long term benefits can be derived for business from FTAs where they serve to align Australian business more closely with international best practice standards in international commerce.

As a relatively small but global trader, this remains vitally important for Australian business, particularly in services industries which are increasingly reliant on meeting best practice global standards to expand and remain competitive. Manufacturing industries are also reliant on access to globally integrated supply chains which depend on the provision of globally competitive services.

FTAs can provide Australia with opportunities to more closely align itself with global standards for international commerce and access global networks for doing business. The US remains the global benchmark for world class standards. Relatively advanced markets in Asia including Thailand and Singapore, play an increasingly important role in the Asia Pacific region as trade and investment hubs.

It is commercially important that Australia not only has access to these markets but is well placed to take advantage of emerging commercial opportunities as they arise. Australia's other trading partners, with which it does not yet have FTAs, such as the EU, Korea and India are also important in this respect.

## 6. How could FTAs be improved?

### *What should Australia's FTAs do?*

#### *Liberalisation of goods*

FTAs should achieve deeper and more extensive liberalisation of merchandise trade than that achieved in the WTO. Exemption and exclusion of certain sectors or maintenance of restrictions as applies in some current FTAs should be avoided. Liberalisation of *all* barriers to trade between the parties, albeit progressively, should be the guiding goal. Non-tariff barriers should be addressed more comprehensively.

A further consideration is that the level is that Australia's FTA grant exporters better or at least equivalent markets access than that granted to competitors under third party FTAs. While not a reason itself for seeking deeper and comprehensive liberalisation, it is a commercial reality of significant importance to business.

#### *Liberalisation of services*

As a general rule, FTAs should significantly improve on the liberalising outcomes achieved under the GATS. This means achieving more comprehensive and deeper liberalisation than that of current FTAs such as TAFTA and SAFTA. Agreements should comprehensively address barriers in services areas of strategic importance such as financial services and telecommunications.

Structurally, services liberalisation in FTAs should adopt a negative list approach to scheduling commitments. A ratchet mechanism for "bound" excluded commitments and MFN treatment should be included in all agreements to lock in the benefits of unilateral reform and extend the benefits on a non-discriminatory basis.

#### *Intellectual property*

The "evergreening" amendment should be repealed and avoided. Australia's FTAs should affirm and reinforce WTO TRIPS obligations.

#### *Investment liberalisation*

Liberalisation of investment must be included in as an integral part of all of Australia's FTAs. FTAs must provide for significant and comprehensive liberalisation of restrictions on investment, including remaining controls in Australia. The depth and scope of commitments as agreed in some FTAs, such as TAFTA, should be significantly improved upon. Australia should give consideration to lifting of the FIRB screening threshold for non-sensitive investment as applied in the AUSFTA to future trading partners in exchange for removal of investment restrictions in other markets.

Like services liberalisation, FTAs should adopt a negative list approach to investment liberalisation and, apply a ratchet mechanism for excluded measures and apply obligations on an MFN basis.

### *“Investor-State” provisions*

Australian business needs to engage further with the government on whether Australia’s FTAs should include “Investor State” provisions akin to those in NAFTA. Such provisions offer the potential benefit of de-politicizing disputes over investment and represent an advanced level of economic integration of markets.

There is an expressed preference in Government for such provision only in FTAs with developing countries. Such measures should be carefully considered, including the potential guarantees for investors in both developed and developing economies.

### *Competition policy and regulatory transparency*

The extent of regulatory change in foreign markets that can be affected through trade agreements is limited. It is most effectively dealt with through cooperative efforts for structural reform, such as that in APEC. To support this, FTAs should encourage pro-competitive regulatory frameworks and transparency in FTA which support structural reform efforts.

FTAs should include general obligations that encourage the effective functioning of competition policy and which facilitate transparency in regulatory frameworks, such as public availability of and notification of new and existing agreements and obligations. This should be augmented with specific disciplines applicable in areas of trade which are strategically important across a range of economic activity, such as financial services, competition policy and telecommunications.

Agreements should include procedures for ensuring ongoing cooperation and dialogue on developments in the regulatory framework between FTA partners which is accessible by business.

### *Government procurement*

The benefits Australia granted to the US under AUSFTA should be extended to all FTA partners in the interests of making Australia's government procurement regime more open and transparent on a non discriminatory basis.

### *Mobility of business personnel*

Commitments for business mobility in current FTAs would be improved by a more effective de-linking of access from immigration controls and extension of access to a wider range of business persons. Current commitments for professionals and executives could be improved by a further extension of benefit to spouses and minors. Business interests would also be better served by commitments which better eased the movement not only business persons and executives, but also students and tourists, as well as skilled technicians in areas of labour shortage, such as manufacturing and mining.

### *Recognition of professional qualifications and product standards*

The BCA appreciates that mechanisms to support MRAs in FTAs must be specifically suited to the trading partner in questions in terms of the regulatory issue of interest,

structures in place and levels of development. Efforts are more likely to be successful with some trading partners than with others and will vary according to the interests concerned.

For the BCA, mutual recognition of professional qualifications remains a key area of interest. FTAs should include a built - in agenda for pursuing such agreements in areas of interest (such as legal, accounting and engineering under the AUSFTA) which is sufficient to provide a government mandate for ongoing industry participation and collaboration.

#### *Subsidies and tax incentives*

Australia's FTAs should discipline the use of policy tools such as subsidies and tax policies which used as a form of protection by governments. Disciplines should be consistent with WTO rules for subsidies and trade related investment measures. Disciplines could be supported by cooperative efforts to address particular measures impacting most on trade and investment.

The lack of WTO disciplines applicable in this area, particular for subsidies in services, provide an opportunity for Australia to lead the way with sound, market based and non-discriminatory disciplines guiding trade and investment.

#### *Trade remedies*

BCA believes that greater attention could be given in FTAs to the development of disciplines for appropriate application and administration of trade remedies, including in Australia. This could include provision for greater transparency in procedures applicable to the confidentiality of data for example.

FTAs must also provide for the application of robust safeguards provisions to address the short term problems of injurious surges in imports, consistent with WTO rules.

#### *Periodic review*

All FTAs must include a review process which provides for review of implementation of liberalisation commitments, progress towards advancement of closer economic integration and assessment of negotiated goals in light of changing economic circumstances and the trade and investment relationship.

The model of the Joint Committee to oversee implementation of the agreement generally, supported by particularly regulatory structure to support integration across particular areas, such as the Financial Services Committee and the Working Group on Professional Services under AUSFTA has worked well as a role in securing sufficient high level engagement between FTA counterparts on mandated issues.

The channels for business to provide regular input into the review process at both should be improved however through higher levels of engagement between business and government in areas of interest. More specific focus could be provided for revising FTAs over a certain time period, such as three years, to ensure they are effective in delivering maximum economic benefits to both parties.

***What could be done to make Australia's FTAs better for business?***

Australia's current and prospective FTAs would offer the greatest benefits for Australian business if they were to:

- Build on the APEC Principles for best practice RTAs and FTAs to ensure consistency of liberalisation among agreements and with both APEC goals and the WTO on a non discriminatory basis;
- Strengthen commitments for deeper, more comprehensive and ongoing liberalisation of goods, services and investment across agreements which extend beyond WTO commitments and which are equivalent to or at least counter liberalisation achieved by competitors in third party FTAs;
- Support structural reform efforts in FTA markets to address beyond the border barriers and encourage pro-competitive regulatory frameworks; including in areas not currently addressed such as subsidies and tax policy;
- Target improvements in the regulatory framework applicable to the imposition and administration of trade remedies;
- Improve measures and mechanisms to support closer economic integration between FTA partners and respond and adapt to changing business and economic conditions.

## 7. How can FTAs be reconciled with the WTO?

The basic concern about clashes between or inconsistency among measures in FTAs and provision of WTO agreements is that because FTAs liberalize on a discriminatory basis, they will deliver less economically liberal and potentially sub-optimal results than if liberalization were delivered through the multilateral disciplines of the WTO.

The concern is real, although often overstated. The economic test of the impact of discriminatory measures is “do they divert trade more than they create it?” WTO agreements and instruments erect such a general test although in practice FTAs are not formally measured by that standard in the WTO.<sup>26</sup>

The quantum of the discrimination matters. If it is small, the diversion will be small and if trade creation is greater, no harm is done. As a general proposition, world trade barriers in most manufacturing industries were reduced to low levels by the mid-eighties. The average tariff in world trade was around 6 or 7 percent in industrialized economies which, at that time, dominated world trade.

The trend to negotiate FTAs began in the late eighties. Where FTAs involved industrialized economies, the margin of discrimination that could be created by commitments in FTAs could only be less than the average level of tariffs which they had bound into WTO schedules. Evidently the scope for trade diversion was small.

Several efforts have been made to quantify the trade diversionary effect of FTAs. Most notable was work in the OECD and the World Bank several years ago. The results were inconclusive. The World Bank work though demonstrated that some FTAs between certain classes of economies were likely to be disadvantageous to smaller developing economies. Its test to measure this was not theoretical but empirical.

Much has been made of the regulatory cost on trade of the multiplicity of regulation governing trade which FTAs inevitably produce. Bhagwati at Columbia University has successfully depicted the result as a “spaghetti bowl” of confusion. While experience would suggest that increased regulation should increase the costs of transactions, that too is an area where only limited empirical evidence is available.

One of the causes of the proliferation of regulations is the increasing practice to create new tariff lines to cover trade between parties to an FTA to ensure that products from markets outside the FTA don't enter markets of second FTA parties once they have entered the market of a first party.

Australia's first experience of this was with the US FTA. Notwithstanding the creation of a new tariff schedule for products for the US market, business found it an effective system.

One consideration not given much attention is that information technology (IT) has made the cost of regulation cheaper. Since the World Trade Centre bombings, regulation of trade has intensified markedly for security reasons. We are not aware of research which shows the additional cost has markedly diminished the value of trade.

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<sup>26</sup> The issue is regarded as too politically sensitive, particularly given the biggest customs union (similar in economic impact to an FTA) are the EU economic integration agreements.

Regardless of what research is available, the BCA as a general principle does not favour increased regulation of trade.

It should also be noted that the economics of trade diversion that arise from discriminatory liberalization of trade in goods, does not work in the same way when services markets are liberalized in an FTA. Contestability in services markets is what is required to produce competition among producers. That can be achieved without opening a service market to suppliers in all other trading partners. It is preferable to do this. But if discriminatory liberalization of services is provided in an FTA with a market with an open and competitive services sector, the desired improvement in the domestic services sector in the first party will be secured. As well, the interests of producers in third party markets will not be harmed as prospectively they would be if there were significant discrimination among suppliers of goods under an FTA.

As noted elsewhere in this report, good FTAs are capable of delivering benefits the WTO cannot. Australia has secured liberalization of trade in agricultural products in FTAs that it cannot secure through the WTO. FTAs enable greater liberalization of trade in services, liberalization of investment provisions and can deliver commitments to reduce “beyond the border” barriers.

That said, the rise of FTAs does carry a prospective threat to the authority and thereby the effectiveness of WTO multilateral trading system. The point is political rather than economic. The most important strength of the WTO is the network of legal obligations members have made to the organization and to each other which lock in the commitments to keep trade barriers low. Commitments in FTAs do not diminish the legal standing of the WTO web of commitments. WTO principles and measures also continue to serve as the institutional foundation of the global trading system and key aspects of most FTAs. Global rules governing use of subsidies and the dispute settlement system remain unaffected. Most FTAs do not attempt to replicate all the aspects of the multilateral system and usually re-endorse commitments to the WTO’s measures and instruments.

However, if FTAs come to be regarded as more important than the WTO, then members may come to neglect the institution and over time its pertinence and influence may diminish. As noted elsewhere, this must not be allowed to happen.

The BCA proposes that:

- Australia continues to support activity in the WTO to highlight the importance of WTO principles that seek to encourage FTAs and regional agreements that do not create trade diversion that outweighs trade creation;
- Measures to improve FTAs set out elsewhere also serve to ensure that WTO principles and measures continue to be treated as the reference points for related measures in FTAs.

## 8. How can regional integration be advanced?

The interest in regional institutions to promote regional integration in the Asian region has accelerated in recent years. The driver is the rise of China as a regional and global economic power. Ensuring Australia is part of regional economic structures is long standing strategic goal and was the driver for Australia's taking the initiative to establish APEC and for negotiating bilateral FTAs with individual ASEAN economies.<sup>27</sup> The goal remains important to Australia's economic prospects in the future the capacity of business to build prosperity in Australia by operating in those markets.

The current situation is confused. With Chinese encouragement, ASEAN is negotiating an FTA with China, Japan and Korea (ASEAN plus 3), ASEAN has separately set the goal of creating an economic community among ASEAN economies, Japan has proposed an FTA comprehending the ASEAN plus 3 group as well as Australia, NZ and India, and there is now support in the APEC region for an FTA among the APEC economies. All these concepts are under study by Governments.

In addition, every major economy in East Asia is now negotiating FTAs with ASEAN and other major economies. India and now the EU have started negotiating FTAs. The point has been reached where every major economy feels it should have an FTA with everyone else in East Asia.

China initiated this to demonstrate regional leadership. By and large the FTAs it has negotiated are poor; they lack comprehensiveness, carry little Chinese commitment to liberalize and ignore or contain weak provisions on investment and services. The upside is that economies which have serious commitments to integration, South Korea and now Japan, have started to negotiate comprehensive FTAs. This is also the case when the US negotiates an FTA.

Given that trade barriers among developing countries in the Asian Pacific region are on average higher than those of industrialized economies, there is some risk of trade diversion and sub-optimal results from the plethora of agreements that is emerging.

Australia's interest in FTAs has been both political and economic. To date, an Australian goal has been to ensure the FTAs are of high quality and promote effective economic integration.

Australia has two interests at this juncture; to promote economic integration through the Asian Pacific region which optimizes opportunities for Australian companies to operate easily and profitably in other markets and to promote a system of economic integration which fully engages US economic interests.

Australia faces a threat of trade discrimination. US beef producers and other agricultural exporters have secured preferential access to the Korean market through the US Korea FTA. Australia is about to negotiate an FTA with Korea and one goal would be to mitigate any disadvantage created by the US FTA. (Australia has also enjoyed the benefits of some discriminatory measures, for example increased automobile trade with Thailand.)

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<sup>27</sup> This occurred after Malaysia blocked a recommendation several years ago that ASEAN negotiate an FTA with Australia. After negotiating FTAs with Singapore, Thailand, ASEAN reversed its position.

Australia will have to opportunistically negotiate FTAs with any party in the region to obviate such risks.

A regional FTA which included all economies in the region would be an obvious safeguard. One thing Australia would not want to see is a regional arrangement which excluded the US. The reason is that the US is the leading proponent of open market systems in the global economy. Australia's prosperity in the long run will depend on the capacity of Australian companies to operate in any of the markets in the region. While they have advanced quickly and admirably towards the institutionalization of free market systems, there is still a considerable distance to travel.

Property rights need to be more secure, the independence of the judiciary needs to be established, the right of governments to interfere in economic affairs needs to be formally constrained and competition principles need to be considered a norm in domestic markets. In international public policy, these are issues that US Administrations typically pursue. Major East Asian economies (Japan and Korea) support them generally but are not proactive in advancing them. This may change over the next quarter century. In the meantime, the region needs the US shoulder at that wheel to advance institutionalization of these features.

A problem for Australia is that the US focus on East Asia, apart from the economic relationship with China and security concerns about North Korea, has been weak throughout the Bush Administrations, principally because of preoccupation with the Middle East and the War on Terror.

Australia cannot be seen to be opposing the Chinese, ASEAN and Japanese initiatives, but it is in its interests to advance the APEC FTA idea as a long term goal. Unlike the other initiatives, it binds the US into a regional economic arrangement. An essential step to moving towards it would be the negotiation of an FTA between Japan and the US. That will take some time. That time is also required to enable China to settle into its role as a leading economy in an open global and regional economy. A number of important domestic reforms are required, in particular completion of reform of the banking system and a shift away from its current policy of building massive domestic surpluses. These are developments which can be reasonably anticipated over the next decade. By then, an APEC FTA will seem feasible.

In the interim Australia can take action to promote that outcome. The first is to support strongly the initiative taken at Sydney to build a strong institutional basis in APEC to promote structural economic change. A new institution has been created in APEC: the first meeting of APEC Economic Affairs Ministers will be held in Melbourne in August, and Australia has provided professional staff and funding to build up the bureaucratic support necessary in the APEC Secretariat to enhance this activity in APEC.

This is the necessary institutional path to advance the existing support in APEC for improving "beyond the border" measures. To date, these have been advanced by Trade Ministers. Many of the key issues – improved investment policies, improved domestic competition policy are the natural areas of responsibility of Economic Affairs Ministers, as are other core areas central to domestic economic reform – improved financial management and reform of domestic economic structures.

The second is to start to advance in FTAs measures which can set the precedent for tools in an APEC wide FTA. Australia can work with likeminded economies to ensure FTAs include the sort of measures identified in work in APEC to maximize the liberalizing quality of FTAs, such as extending commitments to parties outside FTAs, and committing to extend domestic liberalization automatically into FTAs.

In addition Australia should consider building more effective regional FTAs out of existing arrangements. It was always a missed opportunity that Australia and New Zealand did not bring Singapore into and ANZCERTA and modernize it, rather than separately negotiating bilateral FTAs with Singapore. This may still be feasible.

Australia should consider the invitation to join the NZ, Chilean, Singaporean and Bruneian FTA with such a purpose in mind. That expanded group could seek to build a regional model FTA with the optimal principles and measures that would maximize its liberalizing impact and minimize negative features. It could serve as a precedent and model for an APEC wide FTA. Once FTAs are completed with South Korea and Japan, expansion of that minor Asian Pacific FTA to include them could be a second step.

In summary Australia should:

- Actively promote open market economic integration in the Asian Pacific region, in particular encouraging active US engagement in that process
- Formally support all models of regional integration being proposed in the Asian Pacific region, but set a strategic goal of building an effective APEC based FTA.;
- Work with other open, like-minded economically liberal economies to build regional economic integration models that could lay down precedents for an APEC wide FTA in the long run;
- Consider building small regional agreements out of existing bilateral agreements, such as integrating bilateral FTAs with ANZCERTA, in the process modernizing it; consider joining the Asian Pacific proposal (NZ, Chile, Brunei and Singapore) and developing that concept for that purpose;
- Actively support development of the Economic Structural Change program launched at the APEC Sydney Summit to take the historic focus on trade liberalization to another plane to promote regional economic integration by focusing on domestic economic reform in APEC economies.

## 9. What are the impacts of climate change regimes on competitiveness and international trade rules?

A key concern of Australian business is that measures to mitigate emissions of greenhouse gases may weaken competitiveness in the absence of a global agreement on a cap to set a global price on emissions and reduce economic growth which in turn will reduce Australia's capacity to respond to the challenge of climate change. This is especially important to businesses which are trade exposed and emissions intensive - businesses that export as well as those which face global competition in the domestic market. The Business Council welcomes Government assurances that competitiveness of business will be protected until there is a globally agreed cap on emissions.

Today, measures that increase the cost of power reduce competitiveness. That includes regulations to increase use of more expensive renewable resources and to reduce consumption of energy generated from carbon based fuels (such as to support emissions trading), standards which limit emissions from certain industries, such as transport or agriculture), and taxes to reduce consumption of carbon.

These are the tools that will be used to reduce emissions of greenhouse gases. The aspiration is that the higher the cost of carbon based power the greater the incentive to develop and deploy more efficient sources of energy. It is widely acknowledged that such technologies which can economically substitute for carbon based fuels are not currently available.

The only way to ensure that an industry carrying these imposts in one country would not be competitively disadvantaged on global markets would be agreement among all major emitters of carbon dioxide to incur similar imposts. This was envisaged in the Kyoto Protocol which aspired to promote an abatement strategy based on ultimate adoption by parties of a common target to reduce emissions.

A key consideration which received little attention at the time was the soundness of the idea of a common target. It is perceived wisdom in economics that common standards, such as tax rates, as opposed to common processes, such as shifting primacy of tax collection from direct to indirect taxes, should not be commonly applied across economies. Internal conditions are not the same in any economy.<sup>28</sup>

The idea of a common target was also impolitic. Developing countries would not adopt it.

Realizing the strategy in the Kyoto Protocol was ineffective, G8 Leaders decided in 2008 to initiate negotiation of a new international agreement on collective global action to address global warming. That work began at the Bali meeting of parties to the UN Framework Convention on Climate Change, the parent instrument of the Kyoto Protocol. There is still no sign there will be agreement among major emitters to agree to reduce emissions by a common target by 2009 when the negotiations are scheduled to conclude, or any anytime soon after that.

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<sup>28</sup> To a degree, the reality of the difficulty of applying common targets was reflected in targets set under Kyoto. Developing parties were exempted and targets varied among Annex I parties. Australia and some others were allowed to increase emissions. Nevertheless, the clear objective was ultimate adoption of common targets for abatement.

China, the leading economy among developing countries, has indicated that it expects to become the world's largest emitter of greenhouse gases by 2030 and that while it will improve the efficiency of the way it generates and consumes power, it will not subject that process to controls that constrain economic growth. China's climate change policy also will not rely primarily on mitigation of greenhouse gases.<sup>29</sup> Adaptation to the changes caused by global warming will be a leading strategy.

India, the other major emitter of greenhouse gases among developing countries, as well as the rest of the developing country bloc also opposes such measures for developing countries.

There is political commitment in most industrialized economies to take action to reduce emissions. The EU has led the way, being first to set targets for members under Kyoto, and now seeking a new instrument that reflects the architecture of the Kyoto Protocol, in particular common targets to reduce emissions. It is pressing for reductions by at least 25 percent in 2020 and more if other countries follow suit. As it did in the end with Kyoto, it will contemplate different commitments by developing economies, but the underlying strategy rests on reducing emissions by compulsory and where possible common targets.

### **The global debate about competitiveness**

While EU policy remains to lead global policy development and serving as exemplar in setting targets, the threat to the competitiveness of European industry is also recognized.

The EU representative at the UNFCCC meeting in Bangkok in April stated that the EU needed the rest of the international community to reduce emissions if it were to be able to manage the impact of meeting the targets it had set itself for 2020. Business in Europe has started to make the extent of the threat clear.<sup>30</sup>

The result is that proposals are being made to impose "carbon tariffs" against imports from countries which don't impose similar carbon charges on their exports. Some European business would find that attractive. But the interest of Green and Environmental agencies would be to see access to EU markets leveraged against adoption of climate change abatement policies.

To date use of Carbon Tariffs is reportedly opposed by the EU Trade Directorate.<sup>31</sup> One strand of thinking in the EU is to defer this issue until the results of the negotiating process initiated in Bali are known, possibly in the hope that there will be some agreement on how to address this in the UNFCCC negotiations. That is unlikely in the short term.

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<sup>29</sup> This is spelt out in a report by the National Development Reform Commission published in June 2007.

<sup>30</sup> German business leaders told a CEDA conference of international counterparts in Sydney in December 2007 that EU abatement commitments to meet the Kyoto targets had reduced competitiveness in key processing industries (steel, cement, aluminium by between 2 and 7 percent) and that initial analysis showed they did not believe it was possible to meet the commitment adopted by the German Government to reduce emissions by 30 percent.

<sup>31</sup> EU Trade Commissioner Peter Mandelson was reported as stating that carbon tariffs had been designed and assessed, but could not be made to work.

The debate about competitiveness and greenhouse gas abatement is now global. The US Special Trade Representative has already stated that the Bush Administration does not agree trade bans should be used to support abatement, as has Australia's Trade Minister.

US policy is evolving. Proposals to introduce a cap and trade system to reduce emissions have been introduced into the US Congress. All leading presidential candidates support it. The leading issue in discussion so far is the impact on competitiveness. Reports by Congressional agencies reflect the concern shown in the Senate Hagel-Byrd resolution adopted unanimously in 1999 that no action to reduce emissions should be taken unless developing countries adopt similar measures.

They suggest Congress is accordingly unlikely to adopt cap and trade measures unless developing countries do so as well. They propose "incentives" to encourage developing countries to do so. A report by the Congressional Budget office reviews the options to do this, in particular the idea of imposing a tax on imports from non-abating economies.<sup>32</sup> The idea is to impose taxes on imports at a rate equivalent to the cost of abatement to US producers, in particular from participating in an emissions trading system.

### **WTO implications**

Meeting WTO requirements that such measures must be equivalent in effect to a domestic indirect tax and applied equally to imports from all sources, is difficult. One report of the US Congressional Budget Office concludes there is no certainty such measures would not conflict with WTO rules.<sup>33</sup>

There is a second question about consistency of climate change trade measures with WTO provisions. Do they allow waiver of the cost of compliance with abatement measures on exports to foreign markets? The grant of free permits to trade exposed industries in an Australian emissions trading scheme is widely suggested. There is a possibility such a measure may be considered to be a subsidy under WTO rules which do not allow direct subsidization of exports and generally permit countervailing action in import markets if subsidies materially injure domestic producers.

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<sup>32</sup> Other options reviewed in academe include a. setting a technical standard to reduce emissions which would also apply to imports (as permitted in some WTO provisions); b. measures permitted under the general exemptions clause of the GATT in particular where those to protect the environment have been established as allowable under GATT and WTO disputes jurisprudence; and c. securing a formal waiver from WTO rules for trade measures designed to reduce greenhouse gases. (There is a precedent. Trade in diamonds is now regulated by Governments which subscribe to the "Kimberly accord". It obliges retailers to demonstrate their products are not "Conflict Diamonds". WTO rules would not ordinarily permit this type of trade restriction. A formal waiver from WTO rules to allow such a trade control was sought from members and granted.)

<sup>33</sup> WTO rules do not permit restrictions on imports unless they are identical to taxes (generally indirect taxes) levied on like products in the domestic economy and the taxes are applied equally on all comparable imports from all sources. Levying the equivalent value of carbon tax would be straightforward where carbon was consumed in the production of product. Matching the value of indirect carbon generated, such as through the power consumed to create a product would be more complicated. A direct carbon tax could be rebated in the way indirect taxes such as GST is now rebated on exports.

The foregoing indicates that maintenance of competitiveness in climate abatement arrangements is a concern for policy makers worldwide and that aligning such measures with WTO rules is difficult.

### **A more fundamental problem?**

To date, discussion has focused the technical question of how to fit with WTO rules measures to exempt trade exposed industries from the cost of abatement or to protect them from more competitive carbon “unconstrained” competition. It is not proving easy and it may be that the problem is not how to find a technical adjustment but how to confront a fundamental economic problem.

Emissions trading requires a cap. The purpose of the cap is to alter the cost of a key input into competitiveness. Setting a cap is a conscious decision to alter the comparative advantage of an economy. The WTO operates on the presumption that comparative advantage in each economy is taken as a given. The primary purpose of the WTO is to promote trade among nations on the basis of their comparative advantage.

Evidently any measure which seeks to try to protect domestic competition from foreign producers which have been made relatively more competitive by costly domestic measures will conflict with the idea of promoting free and open global trade. The presumption under WTO rules is that each economy absorbs the cost of domestic measures and does not seek to “export” the cost by requiring imports to add that cost to their product in foreign markets.

### **Policy issues in Australia**

This would explain why initial thinking on the shape of an Australian emissions trading scheme<sup>34</sup> was that no long term exemptions should be permitted: over time, Australian industry would have to adjust to high energy costs as part of Australia’s greenhouse gas abatement policies.

The Business Council policy position is that Australia should consider a national emissions trading scheme which covers as many industry sectors as possible (or an alternative policy instrument be used for those sectors not covered) which is linkable over time and that a key principle underlying the design of this scheme is that Australia’s competitiveness be maintained in the absence of a globally agreed cap to set a global price for greenhouse gas emissions.

It remains essential that Government policy address this and the competitiveness issue in any emissions trading scheme design.

It has been suggested that Australia should set an example for others to follow<sup>35</sup> in an effort to encourage development of an effective global regime and that Australia can benefit from this, securing a first mover advantage by creating price incentives to develop and adopt new power technologies and systems which will give Australian industry a leading edge in the forthcoming carbon constrained economy.

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<sup>34</sup> As shown in Commonwealth Government background papers and the Garnaut Review.

<sup>35</sup> See the early papers of the Garnaut Review.

There are several serious problems in these ideas. First, it is not at all clear that Australia's setting a global example would work in the way suggested. European environmental officials argued from the time the Kyoto Protocol was signed that others (meaning the US and developing countries) would be influenced by the example of the EU. They were not. Why would a much smaller economy be regarded as a precedent if the EU's policies were not persuasive?

Second, Australia's leading would certainly be at the cost of competitive advantage in the global economy.

Third, the idea Australian business could win a competitive edge by innovating, developing and adopting new technologies overlooks the reality that in the global economy Australia is a price taker, not a price setter. For example, no business in Australia is a leading manufacturer of power station generators. If the Government decided to pay to meet the costs of developing new technologies by the private sector, that would be one thing. But if the thinking were that introduction of progressively higher carbon prices would provide incentives for Australian companies to invest in development of new technologies that would be a mistake. Companies are obliged to deliver returns to shareholders. That is the primary determinant of investment decisions.

To protect the competitive position of Australian business, the Australian Government should aim to move with the pack, not lead it. If that position were to be charted among the positions of others, Australia's reference point for competitiveness should be charted against the position of competing industries in China, the US and increasingly India and South America.

So how is competitiveness to be preserved? If Australia followed the trend of thinking in the EU and in some circles in the US to adjust the trading system to allow use of trade measures to protect industry from the competitive threat of others, this would have serious implications for Australian business.

This strategy challenges a fundamental premise of the open international trading system. First, it endorses the principle that countries may use border controls to protect domestic industries which are uncompetitive. Second, it could well lead to creation of new right to restrict trade which could be used against Australian companies. This is a tool much more likely to be used by large economies against business in small economies like Australia than by Australia.<sup>36</sup>

The Business Council considers the open market trading system established under WTO rules as essential. Global and national measures to mitigate the emission of greenhouse gases should not result in alteration of the core principles of the WTO.

### **Strategies to preserve Australian competitiveness**

It should be acknowledged that agreement on a global emissions trading scheme is unlikely in the foreseeable future.

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<sup>36</sup> This is most clearly demonstrated in the idea of using some form of border tax adjustment against competitive carbon "unconstrained" products. This is eloquently argued by Goh in the Journal of the World Economy.

Preserving the competitiveness of Australian business must be a leading criterion for formation of an Australian emissions trading scheme.

While not recommending the EU strategy as one for Australia to follow<sup>37</sup>, the lessons gained by the Europeans who have pioneered efforts to use emissions trading to abate emissions should be learned. Where management of emissions through an emissions trading scheme is not practicable in certain circumstances or with particular industries it may be necessary to use standards, regulations or other policy levers.

It should also be noted that we are at the beginning of what is going to be a very long term process of management of emissions. Australia should recognise the importance of ensuring there is a review mechanism in the introduction of an emissions trading scheme. The first stage will be experimental in nature, the lessons of which must be reviewed and assessed before a long term arrangement is locked into place.

Flexibility will be necessary to meet the economic, environmental and political pressures that inevitably will emerge as well as ensuring the competitive impact of the system is contained.

This would also argue for setting a low cap at the outset. A low cap beginning would also diminish the questions that would arise about whether or not Australian measures were consistent with the WTO. If the cap were low, the economic effect of the measures and provision to provide exemption from them would also be low. The general principle in the WTO is that parties usually complain about transgressions when the measures others take are deemed to be in contravention of WTO rules and affect the trade interests of others.

In summary:

- Global agreement on a global emissions trading scheme is unlikely in the foreseeable future.
- Preserving the competitiveness of Australian industry in the absence of a globally agreed cap to set a global price for emissions should be the leading criterion for the successful introduction of an emissions trading scheme. Other criteria should be equal or subordinate to that, not superior.
- Australian policy should recognize that in general Australian industry is a price taker in the global market, not a price setter.
- Australia should “move with the pack” on measures to abate, not seek to lead it to ensure Australian business is not made uncompetitive in global markets.
- The core principles of the open multilateral trading system created by WTO agreements must remain inviolate. Australia should not adopt measures on the

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<sup>37</sup> The development of the EU ETS had been widely criticized by analysts. It only covers major emission source, it exempts important industries, and it relies on other instruments, such as transport and indirect taxes to regulate emissions in key sectors (for example transport) and does not yet address the agricultural sector. The scheme is forged by the political reality of having to tackle difficult problems. Australia faces the same problems.

presumption that core values of the WTO system need accommodation.

- In the first iteration of the emissions trading system, Australia should set a low cap so any risks of loss of competitiveness will be small.
- The ETS should be introduced with a clear review process at the end of the first stage so the effectiveness and efficacy can be assessed and adjustments made to address any issues before any further stage of the scheme is implemented as a feature of Australian measures to mitigate greenhouse gas emissions.
- Flexibility should be a guiding principle. Trade exposed emissions intensive industries should be relieved from competitive pressures with granting of free permits to emit, or being subject to other tools where increased charges for reducing carbon can be rebated from exports. Measures to restrain emissions other than an ETS should be considered if they are the only practicable option at this stage.

## 10. How should government resources be allocated?

The growth in regional and global economic integration requires greater resources to cope with the workload. While DFAT staff acquit their responsibilities in a highly commendable way, the demand to keep up with the expanding agenda is challenging.

The traditional DFAT model of rotating personnel through a mix of experiences has advantages. However the level of technical knowledge now required for dealing with economic integration issues warrant a more formal process for acquiring and deepening the technical knowledge required to service these needs.

The potential for continued growth and entry into new markets by Australian businesses has resulted in a number of BCA Member Companies recognising the important roles performed by DFAT personnel in countries where Australia has strategic interests or potential new interests. While the BCA has only undertaken a preliminary assessment of emerging investment and economic interests, considerable new opportunities continue to emerge in China and India. In addition, a number of Australian businesses have new and potential interests in both South America and Africa. In short, to meet the changing interest of Australian business in this emerging environment, it would be desirable for DFAT missions to have a stronger capacity to support the entry of Australian business into these markets.

In light of the potential for a significant new investments in nations where there are unfamiliar governments and regulatory systems, there are potentially a number of vital roles for DFAT beyond formal diplomatic tasks and the negotiation of specific agreements. First, there is the potential for the department through government to government relationships to make an important contribution to supporting new investment opportunities, including through informal and formal representations on behalf of Australian business. Second, there is the economic intelligence and expertise that DFAT provides and foreign markets and the political and economic influences on them. Third, the department provides a crucial service in supporting the movement of people for business purposes. In addition, we anticipate demand for further developing the effective cooperation between DFAT and business in the area of risk management with respect to people and business operations overseas.

The practice to date has for these functions to be performed by officers with responsibility for economic issues. Often, but not in all cases, officers with these responsibilities have worked on trade policy. It is highly desirable that all officers in these positions should have had economic training and/or previous technical experience working on trade policy. In addition, they should understand regulatory policy which shapes inward investment policy, internal competitiveness, business rules and taxation and residence policy requirements on foreign business personnel.

As well as better equipping DFAT personnel to support these requirements, DFAT should consider better coordination of resources across agencies represented in key missions. In some posts, there are personnel from Treasury, Industry and Innovation and Austrade who also have technical expertise on some of these matters. These resources should be marshalled into “Business Support Teams” or the like, to bring together the resources available to support business.

In giving consideration to the roles of DFAT in the context of emerging global opportunities, the BCA proposes that a new effectiveness model might be developed to guide strategic decision making about the future structure and resourcing of the department. This might involve ensuring there is a focus on innovative and flexible ways to address the needs of stakeholders/customers, including business interests or potential business interests in foreign markets. A new effectiveness model might also give greater emphasis to outcomes that support Australia's medium to longer term economic interests.

The Business Council also proposes that the pool of trade and economic expertise in DFAT be expanded and deepened to provide expert knowledge not only of trade policy, but economic regulatory policy which controls foreign investment and shapes the regulatory environment governing business. This suggests more formal training rather than the largely "learn as you go" process through which technical skill has traditionally been the default means of building expertise acquired in DFAT be developed.