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## 4 Recent developments in trade policy

Australia has traditionally reduced its trade barriers as part of domestic programs of industry assistance reform, supported by participation in multilateral trade arrangements under the GATT and the WTO. Until the last few years, preferential trade agreements (PTAs) with New Zealand and neighbouring countries in the South Pacific were the only exceptions to Australia's unilateral/multilateral approach to trade policy. This has now changed, with bilateral trade agreements having been negotiated with Singapore, Thailand and the United States of America, and more in prospect. This chapter documents these and other developments in international trade policy involving Australia. It also reports on, and extends, recent Commission research on aspects of PTAs.

### 4.1 Multilateral trade negotiations

The WTO provides a stable, rules-based system for the conduct of international trade, and has provided significant benefits and legal protection for small to medium-sized trading nations such as Australia. Successive rounds of trade negotiations within the WTO and its predecessor (the General Agreement on Tariffs and Trade — GATT) have facilitated substantial reductions in many trade barriers over more than 50 years, and underpinned strong expansion of international trade and growth in living standards (PC 2000a).

However, barriers to trade remain, particularly in areas such as agriculture, textiles and clothing. Multilateral trade negotiations require compromises and trade-offs between the preferred positions of different countries to find a 'consensus' position that is acceptable to all parties. With the growth in membership of the WTO (which now stands at 148 governments, most of which are from developing countries), achieving agreement on further liberalisation has become more complex.

In November 2001, a new round of WTO trade negotiations was launched at the Fourth WTO Ministerial Conference, held in Doha, Qatar. WTO members agreed to negotiations covering a broad range of issues with potentially far-reaching implications for the development of world trade (box 4.1). The Commission commented on the scope of the negotiations mandated at the Doha Ministerial in *Trade & Assistance Review 2000-01* (PC 2001b), and discussed subsequent progress with the negotiations in the last two *Reviews* (PC 2002b, 2003b).

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#### Box 4.1 The key Doha outcomes

At the Fourth WTO Ministerial Conference in Doha in 2001, trade ministers from the WTO member governments agreed to launch a new round of multilateral trade negotiations. The Doha agreement indicated that negotiations were to be conducted over three years and were to cover the following.

- *Agriculture* — comprehensive negotiations with the aims to substantially improve market access, to reduce, with a view to phasing out, all export subsidies and to substantially reduce long standing domestic support.
- *Non-agricultural goods* — negotiations to increase market access through reductions in tariffs and increased disciplines on non-tariff barriers.
- *Services* — improved access and reduced barriers for service providers.
- *Environment* — negotiations to look at the relationship between WTO rules and the Multilateral Environmental Agreements and to reduce trade barriers on environmental goods and services.
- *Intellectual property rights* — negotiations to establish a multilateral system for registration and notification of geographical indications for wines and spirits, with the possible extension of geographical indications protections to other products.
- *Foreign investment, competition policy, transparency in government procurement and trade facilitation* — negotiations on these issues to take place subject to explicit consensus at the Fifth WTO Ministerial Conference in 2003.
- *Subsidies and countervailing measures and the dispute settlement understanding* — negotiations to clarify and improve existing WTO rules.
- *Regional trading arrangements* — negotiations seeking to clarify and improve existing WTO disciplines on preferential trade.

In addition, the Doha conference agreed to several measures to assist developing countries, and clarified some contentious aspects of the TRIPS agreement.

In September 2003, the Fifth WTO Ministerial Conference was held at Cancún, Mexico. The conference provided an opportunity to advance the Doha agenda. However, WTO members were unable to agree on the scope and pace of reform in various areas, and the conference ended in deadlock (box 4.2).

Following the Cancún conference, a number of intergovernmental forums, involving both developed and developing countries, subsequently called on WTO members to restart serious negotiations on the Doha agenda. For example, at the APEC summit in Thailand in October 2003, APEC ministers strongly reaffirmed their commitment to ‘press for an ambitious and balanced outcome to the Doha Development Agenda, reiterating that the development dimension is at its core.’ There was also renewed political engagement by the key players (including the European Community and the United States) in efforts to push negotiations forward.

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#### **Box 4.2 The Cancún stalemate**

The Fifth WTO Ministerial Conference, held in Cancún, Mexico, in September 2003, provided an opportunity to advance the Doha agenda. However, both during the lead-up and at the Cancún Conference itself, disagreements emerged on the pace and scope of reform in a number of areas, including:

- reductions in agricultural protection and support;
- the inclusion of the four so-called ‘Singapore’ issues — investment rules, competition policy, transparency in government procurement and trade facilitation measures — in the negotiating agenda; and
- other issues, such as non-agricultural market access, geographical indications, and reform of cotton subsidies.

Underlying the discussions was a concern among developing countries that their interests were not being given enough emphasis in negotiations. Notwithstanding progress towards consensus on some issues during the Cancún conference, the Conference disbanded in deadlock.

Subsequently, a ‘framework package’ was agreed to by the WTO General Council in Geneva in July 2004. The package provides more detail on the reform commitments by WTO members that are needed to achieve the objectives agreed to at the Doha conference, particularly in the area of agriculture. The package effectively narrows down the matters open to contest in future negotiations. Key outcomes from the package are set out in box 4.3. In commenting on the package, the Director-General of the WTO, Supachai Panitchpakdi (2004), stated:

For the first time, member governments have agreed to abolish all forms of agricultural export subsidies by a certain date. They have agreed to substantial reductions in trade distorting domestic support in agriculture. As part of this agreement we have achieved a significant breakthrough in cotton trade which offers great opportunity for cotton farmers in West Africa and throughout the developing world. Governments have agreed to launch negotiations to set new rules streamlining trade and customs procedures. We have assigned ourselves ambitious guidelines for opening trade in manufactured products and we have set ourselves a clear agenda for improving rules that are of great benefit to developing countries. As importantly, WTO governments have sharpened the focus of the Doha round and provided a foundation which will enable negotiators to continue these talks from significantly higher level; greatly enhancing our chances for successful completion of these important talks.

While these recent developments are a positive sign for multilateral trade reform, effectively breaking the deadlock experienced at the Cancún Conference, the extent to which they are translated into reform will depend on the detailed negotiations that lie ahead. A large number of unresolved issues remain, particularly on modalities

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for the agriculture and non-agricultural market access negotiations. The next WTO Ministerial Conference is scheduled to be held in Hong Kong in December 2005.

**Box 4.3 The July 2004 Framework Package: key outcomes**

*Agriculture*

- *Market access* — All WTO members (except ‘least developed countries’) are to reduce agricultural tariffs, based on a tiered formula to ensure that higher tariffs attract deeper reductions. There will be provision for lesser reductions in tariff and quota protection for some ‘sensitive’ products, and differentiated treatment for developing countries. The issues of tariff escalation, tariff simplification and special agricultural safeguards remain under negotiation.
- *Domestic support* — Each WTO member is to substantially reduce its overall level of trade-distorting support from bound levels, based on a tiered formula to ensure that the largest reductions occur in those areas of highest support. 20 per cent of the overall reduction is to occur in the first year after the negotiations are concluded.
- *Export subsidies* — WTO members are to phase out all export subsidies and subsidised export credit arrangements by a date to be agreed, with a longer phasing period for developing countries. There will be provision for non-trade distorting “export” of food for aid purposes.

*Non-agricultural goods*

Use of a formula has been agreed to reduce tariffs, and to reduce or eliminate tariff peaks, high tariffs and tariff escalation on all non-agricultural goods, with the aim of harmonising tariffs to a similar level across-the-board. Developing countries are to be provided with longer implementation periods for tariff reductions, and additional flexibilities to lessen or quarantine tariff reductions for some items. Least developed countries are exempt from tariff reductions but asked to bind their tariffs. All WTO members were also requested to make notifications of their non-tariff barriers by October 2004, as a precursor to further negotiations.

*Services*

Following an initial series of ‘requests’ and an (incomplete) round of ‘offers’, all WTO members have been requested to submit improved ‘offers’ to reduce their barriers to trade in services by May 2005, to facilitate subsequent negotiations. Members that have not yet submitted an offer are asked to do so as soon as possible.

*Trade facilitation and other ‘Singapore’ issues*

It was agreed that WTO members will negotiate on trade facilitation proposals (improvements in customs, transit and border procedures) as part of the Doha Round. However, the other three ‘Singapore issues’ — investment rules, competition policy and transparency in government procurement — are off the Doha Round negotiating agenda.

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## 4.2 Preferential trade negotiations

Until recently, Australia was a member of only three preferential trade agreements (PTAs), with Papua New Guinea, South Pacific countries and New Zealand.<sup>1</sup> As discussed in last year's *Review* (PC 2003b), the Australian Government completed a PTA with Singapore which became operational in July 2003. More recently, the Government has signed agreements with Thailand and the United States and has signalled an interest in agreements with China, Japan, Malaysia and ASEAN nations. Some details of these recent agreements and negotiations are outlined below.

### **The Thailand–Australia Free Trade Agreement**

In October 2003, the Prime Ministers of Australia and Thailand announced the conclusion of a Thailand–Australia Free Trade Agreement (Howard 2003, Vaile 2003b). The Agreement was signed in March 2004 and will enter into force on 1 January 2005. The Agreement is comprehensive, covering trade in goods and services and including provisions for the reduction or elimination of barriers to market entry as well as discrimination in domestic regulation.

#### *Merchandise trade*

Australia and Thailand are to eliminate virtually all tariffs on goods imported from the other country by 1 January 2010. Australia is to eliminate 83 per cent of its tariffs on imports of Thai origin upon the agreement entering into force, and to phase down 13 per cent of its tariffs to zero by 1 January 2010 and the remainder by 1 January 2015. Thailand is to immediately eliminate 49 per cent of its tariffs on imports of Australian origin, and to phase down 44 per cent of its tariffs to zero by 1 January 2010 and the remainder over the period 2015 and 2020.

Thailand is to expand access for Australian imports under 'tariff rate quotas' over a transition period that varies according to the product, with the eventual elimination of all tariff rate quota restrictions on imports from Australia.

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<sup>1</sup> The PTAs are the Papua New Guinea–Australia Trade and Commercial Relations Agreement (PATCRA), the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) and the Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA or 'CER'). However, only the CER is a reciprocal agreement.

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‘Rules of origin’<sup>2</sup> specifying local processing and/or content requirements are used to determine whether a good is deemed to come from the Thailand or Australia for the purpose of obtaining tariff concessions under the agreement. The content and processing requirements which qualify a good vary between items of trade (see below for details). Certification of origin must be provided by the exporting party under the Agreement.

The agreement also prohibits the use of export subsidies in agricultural trade between partners.

### *Services*

The agreement seeks to strengthen trade between partners in a range of services by treating each partner’s service suppliers on the same terms as their own businesses and by progressively liberalising the barriers that prevent service suppliers from entering each other’s markets. Australia has given commitments regarding access to, among other sectors, a range of professional and business services; banking and finance; and telecommunications. In return, Thailand has given commitments to liberalise specified parts of sectors, including: business services; construction; communication services; tertiary education services; and hotel, restaurant and recreational services.

### *Other matters*

Investors in both countries are to be afforded treatment no less favourable than that available to local investors or nationals of any other country. Australian and Thai investors will be able to transfer funds at any time and both will have the right to seek an impartial resolution of any disputes that may not be able to be addressed through the respective legal systems. Both countries are to improve the transparency and certainty of their investment regimes. Thailand is to permit majority Australian ownership in a range of sectors and sub-sectors, including mining. Australia is to bind its current foreign investment policy settings in manufacturing and mining.

Other matters addressed in the agreement include competition policy, e-commerce, industrial standards, quarantine procedures, intellectual property, government procurement and dispute settlement procedures.

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<sup>2</sup> ‘Rules of origin’ (RoO) are the criteria used to define where a product has been made for the purposes of ensuring that only the products of countries which are party to a PTA obtain the benefits of the agreement. RoO are discussed further in section 4.3.

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## The Australia–United States Free Trade Agreement

Negotiations between Australia and the United States began early in 2003, and the Australia-United States Free Trade Agreement was signed in May 2004. In August 2004, the Australian Federal Parliament passed legislation necessary for Australia to meet its commitments under Agreement, which is to enter into force on 1 January 2005 (DFAT 2004a). The agreement is broad ranging and characterised by detailed sector-specific provisions.

### *Merchandise trade*

Under the Agreement, preferential tariffs will apply between Australia and the United States. More than half of Australia's items of merchandise trade and one-third of the United States' items are already duty free and will not be affected by tariff preferences.<sup>3</sup> For most of the remaining products (ie products currently subject to tariffs), the tariffs on bilateral trade will be eliminated when the Agreement comes into force. For the balance, the tariffs will be eliminated in stages.

United States' 'tariff rate quotas' on certain agricultural products imported from Australia will also be expanded and, except for dairy, will be removed by year 18 of the Agreement through the elimination of all tariffs. However, tariffs and tariff rate quotas on Australian sugar imported into the United States will remain unchanged under the Agreement.

Staging of the removal of tariffs and the expansion of United States tariff-quotas is subject to product specific-rules (box 4.4).

Product-specific 'rules of origin' will be used to determine whether a good is deemed to come from the United States or Australia for the purpose of obtaining trade concessions under the Agreement. An importer may make a claim for preferential treatment under the Agreement based on the importer's knowledge or on information it holds that the good qualifies as an 'originating good'.

'Safeguard' provisions against the competitive effects of lower bilateral tariffs will apply for goods until tariffs on them are eliminated or, for selected agricultural products, until new tariff quotas come into force under the Agreement. The safeguard measures may lead to the suspension of further reductions in tariffs or an increase in customs duties to MFN rates. Special safeguard provisions are included for some products such as beef.

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<sup>3</sup> Evaluated at the 6-digit sub-heading level of the Harmonized System.

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**Box 4.4 Product-specific changes to tariff arrangements between Australia and the United States under the AUSFTA**

The staging schedule for Australia involves product-specific rules for textiles, clothing and footwear (TCF) and passenger motor vehicles products. In addition to product-specific rules for TCF, the staging schedule for the United States, amongst other things, contains product-specific rules for certain agricultural product groups.

- Australian and United States duties on specified TCF will be phased down progressively and removed by 2015.
- Australian duties on some specified passenger motor vehicle tariff lines will be phased down progressively and removed by 2010 while United States duties will be eliminated immediately upon the Agreement coming into force.
- United States duties on some non-agricultural items will be eliminated between years 4 and 10 of the Agreement coming into force.
- United States duties on around 9 per cent of agricultural items to be eliminated within 4 years of the Agreement coming into force. The remainder (including avocados, peanuts, goya cheese, tobacco and wine) will be phased out over 10 to 18 years. Annual tariff quotas, where they apply, will be increased and for most items eliminated in year 18.
- For Australian beef imported to the United States, the annual tariff rate quota will be increased by 20 000 tonnes within three years of the Agreement coming into force and will be progressively increased to reach a total of 70 000 additional tonnes after 18 years. From year 19, no tariff rate quota will apply. In-quota duty will be eliminated immediately while over-quota duty will be phased out over years 9 to 18 of the Agreement.
- For Australian dairy products imported into the United States, in-quota tariffs will be eliminated immediately while over-quota tariffs remain unchanged. Tariff rate quotas will be expanded over years 1 to 18, and thereafter, according to a product-specific growth rate.

*Source:* AUSFTA, Annex 2B

### *Services*

Under the Agreement, service providers cannot be discriminated against in the partner market. In particular, obligations require, in principle, that:

- service suppliers of the partner country will be accorded no less favourable treatment than is accorded local service suppliers, in like circumstances (national treatment); or, if better,
- service suppliers of the partner country will be accorded no less favourable treatment than is accorded to service suppliers of another country, in like circumstances (most favoured nation treatment) ;

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- neither country will maintain measures that limit the number of suppliers or operators, the value of their operation or employment (market access); and
  - neither country will require that a service supplier of the partner country establish a local presence as a condition of cross border supply (local presence).

In addition, sector-specific provisions apply to trade in telecommunications services, electronic commerce and financial services.

Where an existing measure does not comply with obligations for national treatment, most favoured nation treatment, market access and local presence, it may be retained as a ‘non-conforming measure’ under the Agreement. For example, in Australia, existing local content requirements in free-to-air commercial television will be retained. Australian standards require 55 per cent local content in free-to-air television and 80 per cent local content in television advertising. For subscription television, 10 per cent expenditure on Australian drama is required. The Agreement also provides scope to apply local content requirements to new free-to-air media (eg multi channelling, pay television).

However, future amendments to such a measure must not decrease their conformity with the Agreement.

#### *Other matters*

Under the agreement, investors cannot be discriminated against in the partner market. Where an existing measure does not comply with obligations for the treatment of investment, it may be retained as a ‘non-conforming measure’. Under the non-conforming measures provisions of the Agreement, Australia has agreed to raise the screening threshold from \$A50 million to \$A800 million for US proposals for investment in Australian businesses (other than financial sector companies) and for acquisition of developed non-commercial residential land. Certain sensitive investments can still be screened under pre-existing foreign investment guidelines, and existing foreign investment limits relating to specified entities including Telstra, Qantas, certain airports, shipping and the media have been retained.

While most areas of Australia’s intellectual property law will be unchanged under the agreement, Australia will afford more protection to intellectual property owners in some areas. This will include the extension of copyright from 50 to 70 years.

Australia’s Pharmaceutical Benefits Scheme (PBS) delivers subsidised medicines to the Australian community. The agreement does not entail any direct changes to the PBS apart from the establishment of an independent body to deal with

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pharmaceutical companies' requests to review decisions by the Pharmaceutical Benefits Advisory Committee not to list new drugs

Australia's quarantine system will be maintained under the Agreement. However, working groups on sanitary and phytosanitary measures, including plant and animal health measures, will be established under the Agreement.

Under the Agreement, a working group to examine the extension of mutual recognition of professional qualifications will be established.

The Agreement also includes provisions on customs administration, technical barriers to trade, competition related matters, government procurement, labour and the environment, institutional arrangements and dispute settlement.

## **Other bilateral negotiations and developments**

### *China*

Following negotiations which commenced in May 2002, in October 2003 the Australian Trade Minister and Chinese Vice Minister for Commerce signed the Australia-China Trade and Economic Framework (Vaile 2003c). Among other things, the Framework covers cooperative activities in sectors such as energy and minerals, agriculture, services and investment, and refers to other matters including education, health, food safety, customs cooperation and intellectual property rights.

A key element of the Trade and Economic Framework is a commitment to undertake a joint feasibility study into a possible preferential trade agreement between Australia and China. The Australia-China joint trade agreement feasibility study does not commit China or Australia to an agreement. Rather, the feasibility study will present a basis upon which the Australian and Chinese governments may consider the opportunities and challenges of an agreement prior to any decision being taken to commence negotiations.

As noted in the Framework, when the Australian government considers whether to enter into negotiations for an agreement, it will also consider whether to recognise China as a market economy. Paragraph 8 of the Trade and Economic Framework states that 'Recognising that Australia and China should negotiate on an equal basis, a joint decision by the two Parties to negotiate an agreement will take account of the results of the feasibility study and only follow Australia's formal recognition of China's full market economy status' (DFAT 2004b).

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In April 2004, Ministers agreed to fast track the feasibility study process, to conclude the study by the end of March 2005 (DFAT 2004b). As part of Australia's study, the Department of Foreign Affairs and Trade called for public submissions or comment on issues relevant to a possible trade agreement.

### *Malaysia*

At the Australia-Malaysia Joint Trade Committee Meeting on 26 July 2004, Australia's Trade Minister and the Malaysian Minister for International Trade and Industry agreed that the two countries would '...conduct parallel scoping studies of an FTA between Australia and Malaysia...' (DFAT 2004c).

The studies are to be completed in the first quarter of 2005. They will provide a basis for the Australian and Malaysian Governments to decide whether to negotiate a trade agreement. As part of Australia's study, the Department of Foreign Affairs and Trade has called for public submissions or comment on issues relevant to a possible agreement.

### *Japan*

In 27 July 2003, the Prime Ministers of Australia and Japan signed the Australia-Japan Trade and Economic Framework. The Framework includes a commitment by the two countries to work towards comprehensive liberalisation of trade and investment. A detailed study will be carried out by the two governments into the benefits of trade and investment liberalisation between Australia and Japan and how to achieve that goal.

The Department of Foreign Affairs and Trade has called for comment on issues that should be pursued as part of the Australia-Japan Trade and Economic Framework and Joint Study process. These could include issues such as market access restrictions, regulatory arrangements affecting trade, or problems with transparency.

### *ASEAN*

On 30 November 2004, the Joint Declaration of ASEAN Leaders announced that negotiations are to commence in early 2005 on an Australia-ASEAN-New Zealand Free Trade Area. The negotiations, to be completed within two years, are to be guided by agreed principles, including that:

- the agreement should be comprehensive in scope, covering trade in goods, services and investment; and

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- an objective would be a move towards deeper economic integration between ASEAN and Australia and New Zealand through progressive elimination of all forms of barriers to trade in goods, services and investment; and through trade, investment and economic cooperation measures (ASEAN 2004).

It is intended that the agreement would be fully implemented within 10 years. The Department of Foreign Affairs and Trade has called for public submissions or comment on issues relevant to a potential agreement with ASEAN and New Zealand.

### *Australia and New Zealand economic relations*

At the annual meeting of Australian and New Zealand Trade and Economic Ministers held in Queenstown in December 2004, Ministers agreed to change the rules of origin under the Australia and New Zealand Closer Economic Relations (CER) Trade Agreement. According to the Joint Ministerial Communiqué:

...A Change of Tariff Classification (CTC) approach will be adopted, subject to final agreement on sensitive sectors. Ministers are committed to the liberalisation of all tariff items over time. A detailed proposal will be developed by the end of March 2005 for submission to Ministers (CERMF 2004).<sup>4</sup>

While details of the changed origin rules are yet to be announced, the agreed change represents a departure from the approach recommended by the Productivity Commission in its report on CER rules of origin (PC 2004a). Details of the Commission's recommendations and some aspects of trade agreements are discussed in section 4.3.

The Commission has also undertaken two commissioned research reports recently into across border measures governing trade and commerce between Australia and New Zealand:

- the Trans-Tasman Mutual Recognition Agreement (TTMRA); and
- the Australia and New Zealand Competition and Consumer Protection Regimes.

The Commission's reviews found that there was scope to improve the operation of these measures and thereby further integrate the two economies (box 4.5).

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<sup>4</sup> The Australian Ministers also agreed, in principle, to extend the Australian Wine Equalisation Tax rebate to certain New Zealand wine producers selling into Australia.

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## Box 4.5 Cross border measures between Australia and New Zealand

### *The Trans-Tasman Mutual Recognition Arrangement (TTMRA)*

The Government requested the Commission to undertake a review of the TTMRA and the Australian Mutual Recognition Agreement (MRA) on which it is based, in January 2003. These two schemes embody two basic principles:

- goods that can be sold lawfully in one jurisdiction may, unless specifically excluded, be sold in any other, even where regulatory requirements on sale differ between jurisdictions; and
- if a person is registered to carry out an occupation in one jurisdiction, he or she can be registered to carry out the equivalent occupation in an other jurisdiction without the need for further assessment of qualifications.

In its final report (PC 2003a), the Commission found that there was scope to selectively extend mutual recognition to the use of goods in areas, where this is assessed to provide net benefits as judged by a proposed review body. Further progress in expanding mutual recognition to six special exemptions under the TTMRA — chemicals, therapeutic goods, road vehicles, gas appliances, electromagnetic and radio-communication equipment, and consumer product safety standards and bans — will require greater cooperation across agencies and jurisdictions to address inconsistent and cumbersome regulation and regulatory practices. Selective modifications to coverage, scope, administrative practices and review mechanisms were also recommended.

### *Australia and New Zealand Competition and Consumer Protection Regimes*

In July 2004, the Commission was asked to examine the potential for greater cooperation, coordination and integration of the competition and consumer protection regimes in Australia and New Zealand.

The Commission's draft report (PC 2004d) found that there has already been significant convergence of Australia's and New Zealand's competition and consumer protection laws. The Commission suggested that major change was not warranted. Nevertheless, it found that there was scope for regulators in each country to engage in greater cooperation, including in operations, enforcement, information sharing and research.

The report and its recommendations are being finalised, following comments received on the draft. The Commission's final report is expected to be submitted to the Australian and New Zealand Governments in late December 2004.

*Sources:* PC (2003a), PC (2004d)

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### 4.3 Some aspects of preferential trade agreements

The recent increase in the negotiation of PTAs by Australia reflects a global trend. Until relatively recently, the number of preferential trade agreements in force world-wide was small (WTO 2004b). Most world trade between market economies was conducted on a non-preferential — or most favoured nation (MFN) — basis whereby all countries are obliged to receive tariff treatment equivalent to the lowest rate applied. Since 1990, however, the global trading system has seen a substantial increase in the number of PTAs which encourage trade and economic integration between two or more countries. Unlike many earlier PTAs which involved several nations, the vast majority of PTAs created since 1990 have been bilateral agreements. By October 2004, more than 260 arrangements covering trade in goods or services had been notified to the GATT/WTO — with 15 being notified in the last year alone. Of those notified, 156 are currently in force. By the end of 2005, if trade agreements reportedly planned or already under negotiation are concluded, the total number of agreements notified could approach 300 (WTO 2004b).

The term ‘trade agreement’ (and especially ‘free’ trade agreement) is used loosely. It covers a wide variety of arrangements for providing more favourable market access to and among a selected group of countries. At a basic level, such arrangements can refer to the reduction or elimination of traditional border protection such as tariffs on imports and barriers to trade in services, investment and the movement of people imposed at the border. They can also refer to the liberalisation of measures that are ‘beyond the border’ such as local content schemes and ownership rules. Finally, they can relate to the harmonisation of standards ‘across the border’, such as alignment of competition policy and the mutual recognition of each others standards. The full implementation of these reforms would lead to a single market encompassing countries within an agreement.

With trading agreements being determined by the economic and political factors particular to each, the design and coverage of individual agreements and supporting regulation differ significantly. For example, in a recent survey of trade agreements involving Australia, Lloyd and MacLaren (2004) found little consistency in the coverage of beyond-the-border and across-the-border measures. The Commission’s analysis of rules for determining the origin of goods (discussed below) also found little consistency between agreements despite important similarities in the basic frameworks for the design of origin rules.

With many possible design features, with scope for provisions to erode the trade liberalising intent of an agreement and with the emergence of numerous overlapping agreements with different provisions, the effects of PTAs are significantly more complex and uncertain than the effects of multilateral reform. The recent surge in the creation of PTAs, while affording possible benefits, also carries some risk.

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The Commission has recently undertaken a number of studies which have explored aspects of PTAs, including:

- a staff study which measured changes in trade and investment flows following the establishment of some longer-standing trade agreements between market economies (Adams et al. 2003);
- a commissioned research report on ‘rules of origin’ that apply under the CER agreement, and options for their reform (PC 2004a — see box 4.6); and
- as supplements to the above report, an analysis of assistance to Australian and New Zealand industries provided by CER (PC 2004b); and an analysis (in the form of a restrictiveness index) of preferential ‘rules of origin’ in 18 PTAs (PC 2004c).

**Box 4.6 Rules of origin under CER: the Commission’s study**

In August 2003, the Commission was asked to examine Australia’s rules of origin (RoO) arrangements under the Australia–New Zealand Closer Economic Relations (CER) Agreement and, amongst other things, to propose changes to ensure the CER RoO promote the goals of the CER.

As noted, RoO in preferential trade agreements, such as the CER Agreement between Australia and New Zealand, are required to confine access to trade concessions to goods from member countries.

In its research report released in May 2004, the Commission found that CER RoO are relatively ‘clean’ and simple. Nevertheless, it found that the rules had not kept pace with changes in technology and business practices. The Commission also found that:

- trade concessions under CER had declined in value as tariffs in both countries had been reduced and that the relevance of origin rules has consequently diminished; and
- in view of the maturity of the CER Agreement and the significant limitations of alternative models for determining origin, the basic framework of the CER RoO should remain unchanged.

The Commission found that the most fruitful approach to addressing problems with CER origin rules would be:

- to implement some relatively minor changes to reduce operational problems; and
- to liberalise the current rules by applying a waiver to provide duty free entry to CER goods manufactured within Australia or New Zealand which face trans-Tasman tariff differences of 5 percentage points or less.

The report also suggested some design principles to guide the assessment of options for change.

*Source:* PC 2004a

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This section discusses some of the findings of this research. It also extends the analysis of the restrictiveness of different rules of origin to cover the recent PTAs negotiated with Thailand and the United States.

### **Some general trade and investment effects of PTAs**

As the Commission has previously noted (PC 2001a), preferential reductions of tariffs among PTA members may have beneficial or adverse effects for members and for third parties. For example, the exchange of tariff preferences may generate new trade, to the benefit of members and their trading partners. However, such an agreement may also divert trade from more efficient third-party producers to less efficient PTA members, to the detriment of both members and third parties. The net effect of the trade provisions of any PTA may be positive or negative.

An empirical study by Commission staff (Adams et al. 2003) suggested that a number of longer-standing PTAs may have diverted more trade than they created, although it also found evidence that some non-trade provisions could enhance international investment flows, particularly if the provisions are non-preferential in nature. The results of this and other studies highlight the desirability of undertaking careful assessments of the details of proposed PTAs.

### **Assistance provided by preferential tariffs**

One side-effect of PTAs is that, in seeking to increase trade by providing preferential access to goods originating in the preferential area, they may extend assistance afforded by the tariffs of one country to producers in the other. Under the CER agreement, for example, New Zealand products exported to Australia are exempt from Australian tariffs, whereas competing products exported to Australia from other nations are not exempt. This provides a degree of assistance to the New Zealand producers — who may be able to maintain their prices on the Australian market and effectively ‘pocket’ the tariff saving. Similarly, duty free access available to Australian producers in the New Zealand market can extend that country’s tariff protection to them.

Even when tariffs are low, as they generally now are in Australia and New Zealand, tariff preferences can expand the protected market available to domestic producers in both countries and raise assistance. For example, using an extension of conventional assistance measurement methodologies (see box 4.7), the Commission found in its recent study on the CER (PC 2004a) that the Agreement is likely to have increased the effective assistance to manufacturing in Australia by nearly 0.1 percentage point and in New Zealand by 0.7 percentage points in 2001-02. The

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greatest advantage was afforded textiles, clothing and footwear producers in New Zealand, who received an additional 2 percentage points in effective assistance.

Clearly when tariffs are high, as they were at the inception of the CER Agreement in 1984, preferential trade agreements can afford significant additional border protection to producers in the partner countries. When tariffs are disparate, the assistance afforded by tariff preferences to producers of similar products can also differ significantly. The extent to which such assistance differences erode economic efficiency and welfare in partner countries depend on the level of trade between partners and market conditions.

**Box 4.7 Measuring assistance afforded by preferential trade**

To assist in assessing the link between tariff preferences and industry assistance in trade agreements, the standard effective assistance framework can be extended to include the assistance effects of a preferential agreement and provide new measures of the value of this assistance to Australian producers. In calculating total assistance to industry in Australia (and the partner country), standard assistance calculations are first applied to that part of output sold to the local market. Assistance to that part of production which enters the PTA trade is then added to traditional assistance measures.

The assistance calculations invoke the standard assumptions of assistance measurement. They include the 'small country assumption', whereby a country is assumed to be unable to influence world prices of either their imports or exports. In conjunction with this assumption, it is normally assumed that Australian producers price up to the value of competing imports plus the effect of duty or other border restrictions on trade. In addition, the analysis of preferential assistance assumes that the landed price available to an Australian exporter in the partner country is equal to the import parity price plus the margin of preference implied by the MFN rates in the partner economy.

The assistance measures are derived using static, partial-equilibrium assumptions. These focus attention on the initial impact of border protection and other interventions on prices, costs and returns. Thus, while the assistance measures indicate the initial transfers associated with industry protection, they do not indicate changes in industry supply, demand or productivity, or economy-wide effects.

Similarly, when applied to the measurement of assistance afforded by a preferential trade agreement, while the measures indicate the initial transfers associated with trade preferences, they do not indicate the extent to which trade is created or diverted to higher cost sources, the impacts of rules of origin on productivity, or the economy-wide effects of trade preferences.

*Source:* PC 2004b.

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## The restrictiveness of rules of origin

As noted above, RoO are the criteria used to define where a product has been made for the purposes of ensuring that only the products of countries which are party to a PTA obtain the benefits of the agreement. In the case the AUSFTA for example, RoO would be used to determine whether a product exported to the United States from Australia, which comprises inputs or components sourced from another country, can be considered to be an Australian product and thus receive preferential access to the United States market (and vice versa).

Origin rules are a necessary part of a PTA. However, depending upon how they are specified, they can — to varying degrees — restrict trade, misdirect investment, inhibit productivity growth and reduce welfare. They can also raise the administrative costs to firms of doing business (including complying with paperwork requirements) and the Customs Services face costs in administering and auditing the RoO. The global increase in the number of PTAs will result in diverse RoO, adding to the complexity and compliance costs of engaging in trade. However, because RoO act as regulatory (non-tariff) barriers to trade, their impact is not easily measured or evaluated.

To assist in addressing the issues raised in the study and to help fill the information gap concerning the impact of origin rules, the Commission estimated the relative restrictiveness of RoO for various PTAs using an index framework. This is a useful way to assess the degree of restrictiveness when price and quantity measures are not available. The index measures provide insights into the extent to which RoO-related regulatory barriers may restrict trade. An overview of the index methodology is provided in box 4.8.

Results from index calculations show variation in restrictiveness of origin rules across PTAs. They suggest that the restrictiveness of RoO in the CER Agreement is low to moderate, relative to the level of restrictiveness identified in seventeen other agreements (figure 4.1). They also suggest that NAFTA and related agreements and agreements entered into by the European Union, have the most restrictive rules. These agreements tend to be associated with regimes that adopt multiple criteria for determining origin, more restrictive variants of individual criteria and product specific rules, particularly in areas otherwise supported by higher tariffs. In addition, the more restrictive RoO tend to be associated with PTAs where member countries have higher average tariffs and non-tariff barriers and where differences in tariffs in each member country are also relatively high (PC 2004a).

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#### Box 4.8      **The restrictiveness index**

Index methodologies have been applied in the assessment of North American and European Union-related trade agreements. Indexes developed in previous studies have focused on primary provisions of origin rules. Other, supplementary, factors affecting the restrictiveness or origin rules have also been taken into account. The Commission's study expands the range of factors taken into account. It includes for example, details of regional value requirements and factors influencing market access in the index.

The overall index score for a particular set of RoO in the Commission's index reflects the number of restrictions that are applied and the relative importance of those restrictions. The higher the overall index, the more restrictive is the trading regime for the members of that PTA. Within each restriction category, a score is assigned to the particular category of origin determination. The score ranges from 0 (least restrictive) to 1 (most restrictive). Each category also receives a weighting that indicates the relative restrictiveness of that category on the aggregate merchandise trade and firms' economic efficiency. The results for all relevant RoO provisions are normalised to a scale of zero to 1. The higher the weighting, the more restrictive an origin category is considered to be, relative to other categories. However, it needs to be appreciated that the information base for compiling the index — for example, for nominating the weights to be used — is limited. The results should therefore be seen as indicative of orders of magnitude, rather than as a precise measure of restrictiveness.

RoO are not readily modelled in quantitative assessments of the welfare implications of agreements. Nevertheless, simulations of the possible welfare gains from an agreement will be biased upward because these rules reduce the degree of liberalisation implicit in the size of the reductions in tariffs. The more restrictive the RoO the larger the bias is likely to be. By indicating the restrictiveness of origin rules, the index also reflects the welfare implications of those rules.

*Source:* PC 2004c.

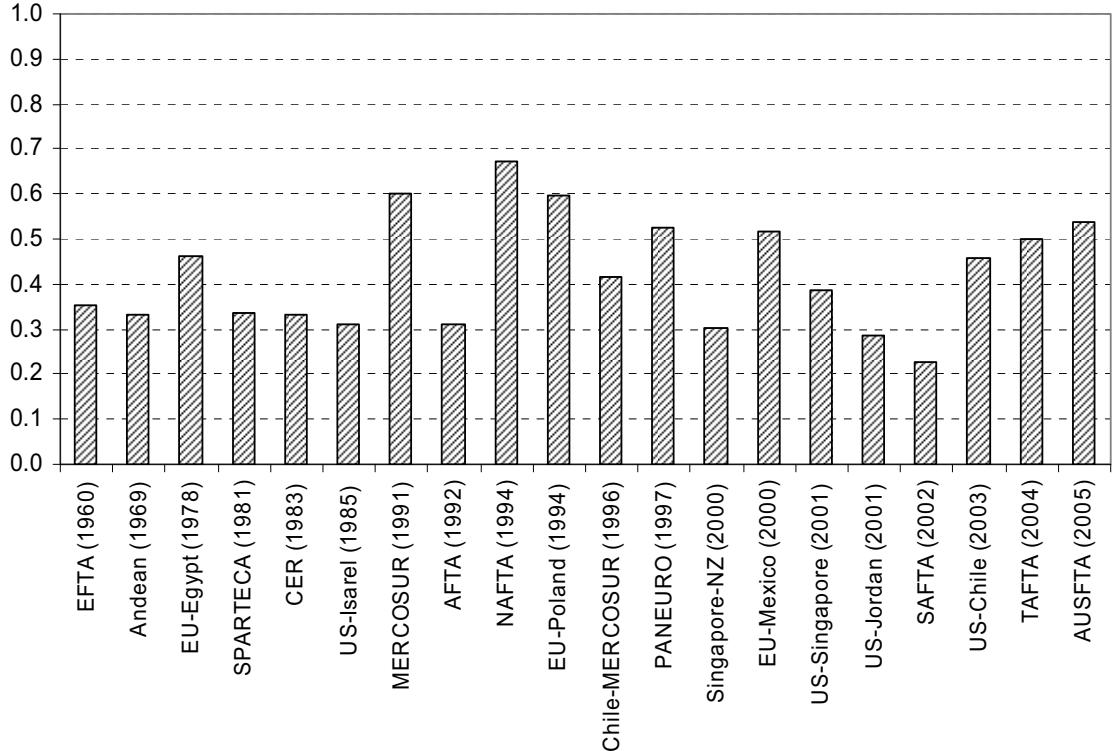
The methodology has also been applied to consider the relative restrictiveness of origin rules that will apply in the AUSFTA and TAFTA outlined above. The index suggests that the regimes will be of medium to high restrictiveness. This reflects the product-specific nature of the rules, which often involve multiple criteria and more restrictive variants of some criteria. In particular, regional value content tests will apply in conjunction with one or more other tests in around one quarter of trade items with non-zero tariffs under TAFTA origin rules.<sup>5</sup> Under the AUSFTA origin rules, about 15 percent of non-zero items in the US tariff will be subject to regional value content requirements. Where regional value content requirements do not apply, more restrictive variants of other provisions are often applied. For example,

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<sup>5</sup> Items of trade as defined at the 6-digit sub-heading level of the Harmonized Commodity Description and Coding System (Harmonized System) for the classification of international trade.

in AUSFTA, a NAFTA-based ‘yarn-forward’ rule applies, which in many cases requires that the yarn used to make fabric must be ‘formed’ within the territory of the trade agreement. This rule is widely regarded as being highly prescriptive concerning the sourcing of inputs into textile production and hence restrictive.<sup>6</sup>

**Figure 4.1 Restrictiveness of preferential RoO in selected PTAs**  
 Index score ranges from zero (least restrictive) to 1 (most restrictive).



Source: Commission estimates.

The indexes also suggest that the TAFTA and AUSFTA rules will be more restrictive than those applying in pre-existing agreements made by Australia — CER, Singapore–Australia Free Trade Agreement (SAFTA) and South Pacific Region Trade and Economic Cooperation Agreement (SPARTECA).<sup>7</sup> These other

<sup>6</sup> The basic origin rule for textile and clothing articles under NAFTA and like agreements is the yarn–forward rule. Variations of this rule are used in more recent US trade agreements, such as with Chile and Singapore.

<sup>7</sup> Under SAFTA and CER, members offer trade concessions to each other on a reciprocal basis. SPARTECA is a non-reciprocal trade agreement under which Australia and New Zealand offer duty free and unrestricted or concessional access for virtually all products originating from Forum Island Countries. The Agreement on Trade and Commercial Relations between the Government of Australia and the Government of Papua New Guinea (PATCRA II) is also non-reciprocal. The rules of origin for this agreement are similar to those applying in SPARTECA.

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agreements are free from product-specific rules and more restrictive variants of provisions in use for determining origin.

## **Design principles for RoO**

Countries engage in trade agreements with the expectation that the agreements will yield gains in income to members. However, as mentioned, rules of origin raise costs and lower productivity and can erode the potential benefits that may otherwise accrue from the formation a PTA. Any costs would be on top of losses of efficiency and productivity arising from higher effective assistance to industry arising from preferential trade. The risk of erosion of potential benefits of bilateral tariff reductions from RoO are highest when tariff rates are high and disparate.

To fully realise the potential benefits of bilateral tariff reductions from a PTA, the Commission found that the formation of origin rules should be guided by certain design principles (box 4.9).

### **Box 4.9 Rules of origin: some design principles**

To help ensure that the potential benefits from a PTA are fully realised, RoO should:

- include a clear and unambiguous statement of their objective;
- conform with the goals of the PTA;
- be consistent with the country's international obligations;
- avoid product-specific rules;
- avoid undue distortions in the allocation of resources and associated reductions in economic efficiency;
- facilitate organisational and technological innovation and the capacity of producers to respond to changes in consumer tastes;
- minimise compliance costs for industry;
- minimise administration costs for government;
- be certain and consistent in the determination of origin; and
- operate in a transparent and accountable manner.

Ideally, the design of RoO in a PTA would comply with each of these principles. In practice, however, the presence of tariff and non-tariff barriers that differ between countries, together with other factors specific to the economies of particular members of a PTA, can make it difficult to achieve full compliance with some of these principles, or simultaneous compliance with all of them.

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Hence, some trade-offs between these design principles are likely — for example, the mere introduction of RoO that conform to the goals of the PTA would distort the allocation of resources and raise costs, relative to a situation of multilateral liberalisation. This means that application of the design principles should be aimed at moving toward unrestrictive RoO and ultimately, freer trade, rather than toward RoO which reinforce the discriminatory nature of a PTA.

The Commission's analysis suggests that, as a minimum objective, RoO should not be used as an instrument for *increasing* border protection afforded to producers in participating economies, nor as a means to compensate them for differences in input costs or tariffs on inputs between member countries. It found that it would not be appropriate to use preferential origin rules in trade agreements:

- as a substitute for tariff assistance, particularly to compensate for increased competition arising from bilateral tariff reductions implemented through the PTA; or
- to implement specific industry policy objectives, such as encouraging investment in a particular activity or region.