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## 13 Design of future BRTAs

Whether any particular BRTA generates net benefits, and the extent of those benefits, depends crucially on its design. This chapter sets out a range of design matters that, together with the ‘good process’ requirements discussed in chapter 15, should help minimise the risk that Australia might enter into welfare-reducing BRTAs and enhance the likelihood that BRTAs negotiated will be of most benefit.

Of course, the optimal design of BRTAs will vary to some extent from agreement to agreement, depending on the characteristics of particular partner countries and Australia’s economic relationships with them. Further, whatever Australia may consider to be an ideally designed BRTA, some divergence from this ideal may be necessary where prospective partner countries hold a different view. This calls for a degree of variability between BRTAs and some flexibility during negotiations.

This chapter first catalogues existing sets of ‘best-practice’ principles suggested for BRTAs (section 13.1). Drawing on those principles, and the analysis presented earlier in this report, the chapter then discusses:

- the appropriate coverage of Australian BRTAs (section 13.2);
- the role and appropriate form of rules of origin embodied in preferential BRTAs (13.3);
- options for multilateralising provisions in BRTAs (13.4); and
- assisting other countries through trade facilitation and capacity building (13.5).

### 13.1 Existing best practice principles

In recent years, a number of Australian and international bodies have produced best-practice principles or guidelines for BRTAs. While many of these have some key features in common, they also differ in their level of detail, focus and on some particular issues.

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## APEC and the Asian Development Bank

APEC Economic Leaders adopted a set of non-binding best-practice principles for free trade and regional trade agreements at their meeting in Santiago in November 2004. These principles emphasise consistency with broader APEC principles and goals, consistency with the WTO rules for trade agreements, and going beyond WTO commitments. Other key aspects are comprehensiveness of coverage, transparency, inclusion of mechanisms for consultation and dispute settlement, simple rules of origin that facilitate trade, scope for accession of third parties, and provision for periodic review.

Observing the highly general nature of the WTO rules regarding trade agreements, the Asian Development Bank (ADB) considered it would be useful to define some best practice rules that would minimise the negative effects of free trade agreements and maximize the positive effects. The rules devised by the ADB extend APEC's best practice principles to include guidance on specific matters such as investment, intellectual property, anti-dumping and technical barriers to trade. They emphasise the desirability of non-discriminatory provisions and transparent processes and procedures (box 13.1).

### Box 13.1 Asian Development Bank principles for BRTAs

The ADB's best practice rules address the following major areas:

- comprehensive coverage of goods and services;
- rules of origin should be as low as possible and consistent;
- customs procedures should follow global best practices and GATT/WTO-consistent protocols;
- intellectual property rights guidelines should be non-discriminatory and consistent with TRIPS, TRIPS Plus, and related international conventions;
- foreign direct investment provisions should embrace national treatment and non-discrimination, shun performance requirements, have a highly inclusive negative list, and provide the usual protection to foreign investors;
- antidumping procedures and dispute resolution need to be transparent and fair;
- government procurement should be as open and non-discriminatory, and procedures as clear and open, as possible;
- competition related policies should create a level playing field for all partners and should not disadvantage non-partner competition; and
- technical barriers to trade should be kept to a minimum and harmonized in a non-discriminatory way.

Source: ADB (2008).

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## Rural Industries Research and Development Corporation

In 2005 the Rural Industries Research and Development Corporation (RIRDC) published a set of guidelines which details the features of a ‘good’ preferential trade agreement (box 13.2).

### Box 13.2 Features of a ‘good’ preferential trade agreement — RIRDC

In *‘Free’ Trade Agreements: Making Them Better*, the Rural Industries Research and Development Corporation sets out ten features of a ‘good’ PTA:

- ensure that prices are reduced — the greater the price reduction, the greater the probability that the agreement will facilitate trade creation rather than trade diversion;
- do not exclude ‘problem’ industries — while typically sensitive, reform in these industries can also be the most beneficial; PTAs provide a good opportunity to gently expose sensitive industries to international competition, as well as those sensitive industries delivering some of the greatest price reductions from trade liberalisation;
- make PTAs comprehensive — no industry or sector should be exempted from a PTA, as this creates distortions and entrenches protection and special treatment;
- make rules of origin simple and consistent — inherent to the formation of a PTA are rules of origin which can restrict trade and increase compliance costs. RoO should be minimised and simplified to minimise this cost;
- maximise certainty — this is achieved through consistency of rules and when trade and investment restrictions are low;
- investment liberalisation — by including this area in PTAs, the potential benefits from the agreement are improved. Furthermore, investment liberalisation is key to services trade liberalisation;
- avoid ‘new protectionism’ — there is some shift towards including issues such as intellectual property, competition laws, labour market regulations and the environment into PTAs. However, since there is disagreement about how these issues should be managed, it is best not to let these issues cloud the more important ones of trade and investment liberalisation;
- transparent process, consultation and detailed analysis — transparency is important at all stages to ensure that the political motivations do not hijack PTA negotiations;
- continue commitment to WTO — PTAs should be structured to complement WTO negotiations through either a sunset clause or the winding back of preferences; and
- pursue evolutionary PTAs — to facilitate the shift of preferential agreements to free trade, PTAs should be designed to be able to include more economies over time.

Source: CIE (2005b).

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## University of Sussex

The University of Sussex has developed a framework to enable the elements of a proposed trade agreement to be set out — and systematically evaluated using a set of policy ‘rules of thumb’ — allowing an overall judgement on the likely balance of economic welfare effects of the proposed agreement (box 13.3).

### Box 13.3 **Sussex Framework**

The Sussex Framework was developed particularly for trade agreements involving developing countries and is intended to encourage consideration of the political, social and economic viability of a proposed agreement. The main factors to be evaluated include:

- the nature of the economic relationship between the partner countries and the existing barriers to trade;
- the nature of the proposed agreement and the extent to which it will overlap with other agreements and be WTO compatible;
- the expected ease or difficulty of the negotiations and the role of foreign donors in driving the agreement; and
- the presence of elements of deep integration — such as investment rules, competition policy alignment and rules on movement of natural persons — in the proposed agreement.

Source: Evans et al. (2006).

## Mortimer review

The Mortimer review (2008) considered it would be in Australia’s best interests to maintain sufficient flexibility in its approach to agreements to enable it to participate in as many emerging ‘free trade agreement clusters’ as possible. Accordingly, it did not favour Australia adopting a model free trade agreement or an overly prescriptive approach to the design of trade agreements.

However, it considered there would be value in the Government adopting clear principles to guide its future approach to free trade agreements. In this regard, it proposed that the Government should, when assessing prospective free trade agreement partners, determine whether the agreement has the potential to:

- counter trade diversion or deliver substantial commercial and wider economic benefits more quickly than would be possible through other efforts;
- be fully consistent with WTO provisions;

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- deliver ‘WTO-plus’ outcomes in the form of liberalising commitments that are broader and deeper than those undertaken in the WTO;
  - provide for substantial liberalisation — including by eliminating virtually all tariffs and delivering new and significant access opportunities for services and investment — within a reasonable time period;
  - allow, where possible, for the accession of third countries and be consistent with the goal of regional free and open trade and investment; and
  - promote Australia’s foreign and security policy interests.

## 13.2 Sectoral coverage of agreements

As noted in chapter 4, Article XXIV of the GATT requires that in BRTAs formed by WTO members, duties and other restrictive regulations on commerce must be eliminated on ‘substantially all the trade’ between the parties. For BRTAs covering trade in services, GATS Article V mandates that a BRTA must have substantial sectoral coverage (requiring *inter alia* that there are no *a priori* exclusions of any mode of supply) and provide for the absence or elimination of substantially all discrimination between, or among, the parties in the sectors covered. Although there are important disagreements among WTO members over the precise definition of terms like ‘substantially all the trade’, many countries state their desire of substantial coverage when forming BRTAs (for example, as noted in chapter 6, Australia advocates coverage of 95 per cent of tariff lines as consistent with ‘substantially all’).

Beyond this ‘substantial’ coverage of most or all traded goods or services, trade agreements can also be ‘comprehensive’ in their scope by including not only goods and services, but also investment; competition policy; intellectual property; trade facilitation measures; and labour issues, among other topics (see chapter 14) .

In its initial submission, DFAT stated that ‘Australia seeks to ensure that its agreements are comprehensive in coverage and scope and reflect contemporary expectations of both border protection and behind the border measures’ (sub. 53, p.7). According to the Mortimer review, Australia’s agreements are among the most comprehensive, being at least as comprehensive as those negotiated between other industrialised countries and, on average, much more comprehensive than those negotiated between developing countries (Mortimer 2008, p. 96).

Even so, Australia’s recent agreements have allowed significant protection to remain in some areas (chapter 6) and many provisions, particularly in services, do not appear to have been taken advantage of by Australian exporters. Elek (sub. 44,

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p. 30) has suggested that it is not realistic to expect most prospective partners to make politically difficult decisions to secure a comprehensive agreement with Australia, given that Australia is not a large market for these partners. The current difficulties in progressing a BRTA with China may in part reflect such dynamics and the challenges that arise when pursuing ‘ambitious’ agreements.

Importantly though, to meet the WTO guidelines, agreements do not necessarily need to be ‘comprehensive’ in scope. For instance, the WTO does not stipulate that agreements must address both services and merchandise in a single undertaking. In this vein, the Mortimer review suggested that consideration could be given to an agreement between Australia and the European Union covering only services. This raises the broader question of whether Australia should be willing to trade off the pursuit of comprehensive agreements in order to obtain at least some reductions in barriers to trade and investment.

There are, of course, several advantages to achieving comprehensive agreements that cover all (or most) sectors (including both goods and services). Endeavouring to include sensitive sectors, which often enjoy the highest protection, increases the potential gains, in particular where the agreement is on a non-preferential basis or where one of the partners is a low cost producer (by global standards) of the protected products. If low cost foreign producers are involved, including as many sectors as possible also increases the likelihood that domestic industries will become subject to increased competition — the key source of the benefits of trade liberalisation. Indeed, some suggest that, in this way, trade agreements ‘provide a good opportunity to gently expose sensitive industries to international competition’ and that allowing for sensitive areas to be ‘carved out’ of agreements ‘creates distortions and entrenches protection and special treatment’ (RIRDC, sub. 10, p. 25). In addition, negotiating agreements that minimise carve outs in the partner country maximises the market access for Australian exporters.

As alluded to above, however, the pursuit of comprehensive agreements can also bring costs. Negotiations for comprehensive agreements can be lengthy and difficult, requiring the attention and resources of Australia’s trade negotiators, and risking compromising liberalisation potential and even souring of relations between Australia and partner countries. They can entrench a mentality of ‘tit-for-tat’ concession trading between parties rather than focussing on areas that offer mutual benefit with minimal costs, as the goal of comprehensiveness can be indiscriminately pursued by negotiators and governments, losing sight of the underlying economic benefits at stake.

One important consideration is that negotiations over sensitive sectors can significantly delay, or even preclude, the parties from concluding an agreement. It

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has been suggested, for instance, that Australia may be unable to successfully negotiate a comprehensive trade agreement with the European Union or Japan given sensitivities, particularly around the agricultural sectors, in both economies. In such circumstances, the benefits of reduced barriers in non-sensitive areas are also delayed (or even forgone). If reductions to barriers in non-sensitive areas make up a significant proportion of the likely benefits of an agreement, on balance, their delay (or loss) might outweigh any possible benefits from further reductions in barriers to sensitive sectors in the partner country. These drawbacks are particularly likely in the case of ‘single undertaking’ agreements, where agreements cannot be concluded until all topics are agreed to.

Reflecting such considerations, in its submission to the Mortimer review, the Australian Services Roundtable argued for the:

Cessation of automatic Australian priority to “comprehensive” bilateral negotiations covering Goods (Agriculture) as well as Services. (ASR 2008, p. 6)

On the other hand, the National Farmers’ Federation (sub. 13, p. 10) cautioned:

... sensitivities are not merely isolated to agriculture, but can include a variety of sectors such as automotives and services. .... There will always be temptations for Governments to omit these sensitive sectors in the realisation that doing so would make it much easier to finalise a deal. However, reform in these industries can also often be the most beneficial, with the potential to lead to significant price reductions, encourage new innovation, better management techniques and quicker adoption of best-practice production. Excluding these sectors from trade agreements can instead entrench the protection of these groups making it more difficult to achieve future reform of those industries.

The Department of Agriculture, Fisheries and Forestry (sub. 6, p. 4) stated:

As agriculture can be a difficult aspect of many trade agreement negotiations, it could be argued that it would be easier for Australia to aim for sector-specific agreements rather than the current comprehensive policy. The department has significant concerns about this proposal, recognising that it may leave agriculture out of most agreements indefinitely, to the detriment of a valuable export-focused sector. Such concern is justified as some trading partners have already attempted to marginalise or exclude agriculture from FTA negotiations. A shift to a sector-by-sector approach would only encourage narrow-focused agreements, creating an unfortunate precedent for Australia’s broader trade policy agenda, including at the multilateral level.

While noting the concerns expressed by the Federation and the Department are not without substance, in the Draft Report the Commission put forward the idea that the Australian Government should adopt a more flexible approach to the comprehensiveness of BRTAs it pursues. There were two aspects to the draft recommendation. First, that the government consider less comprehensive but still WTO-consistent agreements, such as separate agreements in goods or in services, in

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its initial consideration of the costs and benefits of its trade options. And second, that the government should make greater use of implementation schedules that rely on built-in agendas to promote reductions in barriers to trade and investment where negotiations prove to be very protracted and where reductions in barriers in non-sensitive areas make up a significant proportion of the likely benefits of a comprehensive agreement. In these circumstances, the Commission considered it could be appropriate to abandon the single-undertaking approach and to utilise a built-in agenda.

While the two options could in fact stand alone, they were essentially directed at the same objective: the earlier capture of ‘low-hanging fruit’ and the pursuit over the longer time frame of those elements that require more protracted negotiation.

In response to the draft recommendation, some participants expressed concerns regarding the spirit and the potential impact of this recommendation. For example, Professor Peter Lloyd suggested that the ‘spirit of both GATT Article XXIV and GATS Article V is that of comprehensiveness. Taken together, they imply (but not legally) that comprehensiveness across both sectors is desirable’ (sub. DR77, p. 1).

A number of organisations expressed concern that the draft recommendation would reduce the chance of attaining reform in sensitive sectors, particularly agriculture (box 13.4). In particular, DFAT (sub. DR98, pp. 7) stated:

A less-than-comprehensive approach risks reducing the negotiating leverage and the range of possible trade-offs that are critical to achieving a balanced outcome in FTA negotiations, including improved access in sensitive market sectors and products. It runs the risk of reducing the positive impact on domestic economic reform that an FTA can potentially provide. It could also signal, ahead of the start of negotiations, where Australian policymakers envisaged FTA partner governments would be unlikely to respond completely to Australian requests.

The Commission considers that, at least in part, some of the concerns expressed arose due to a misunderstanding of its recommendation. It is important to clarify that the Commission was not suggesting that the agriculture sector, or specific agricultural industries, be excluded from any negotiation covering goods-specific PTA. Rather, it suggested that the option of WTO-compliant goods-only or services-only agreements be considered, where appropriate, noting that potential benefits should not be foregone where they can be largely secured through a less comprehensive approach.

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**Box 13.4 Participants' comments on Draft Recommendation 2**

National Farmers' Federation (sub. DR85, p. 2):

From the NFF's perspective, this is the most concerning recommendation within the draft report, ... As previously stated, the NFF believes that all-inclusive trade agreements, whether they are bilateral or multilateral, must be Australia's bottom line.

Sheepmeat Council of Australia (sub. DR73, p. 2):

Trade liberalisation through international fora should remain an Australian Government priority. This can be achieved through negotiating comprehensive BRTAs and must be a high priority given the protracted and problematic nature of multilateral trade negotiations ...

Australian Sugar Industry Alliance Ltd (sub. DR93, p. 2)

In the bilateral trade arena comprehensiveness is similarly important. The Australia—US FTA is the only FTA either country has concluded that does not include ... sugar. In addition to delivering no new access for Australian sugar to the US market, the exclusion of sugar has been noticed by other countries, some of these are parties to FTA negotiations with Australia. This has increased the difficulty Australia faces securing improved market access in those negotiations for both sugar and other sensitive agricultural products.

Department of Agriculture, Forestry and Fisheries (sub. DR95, p. 2)

The department's view remains that the maximum benefits for Australian agriculture — and other sectors — will come from providing liberalisation across all parts of the economy.

In relation to the second element of the draft recommendation that there be greater use of implementation schedules that rely on built-in agendas to promote reductions in barriers to trade and investment, DFAT responded that this already occurs in Australia's BRTAs, noting that:

[Australia's FTAs] all contain various built-in agendas that allow for the continuing work to promote further liberalisation and reform over time, as well as the scope to move onto new areas in response to the needs of today's business community ... However, the scope to make use of built-in agendas should not be used as an excuse by the parties not to confront the difficult areas of reform upfront when the FTA is initially negotiated. (sub. DR98, pp. 7-8)

The Cattle Council echoed this concern, arguing that securing the non-contentious components immediately while settling on a 'working group' approach to advance more sensitive issues would 'effectively sideline agricultural market access discussions from the negotiation of BRTAs. This approach, if followed, would be a retrograde step in Australia's trade policy' (sub. DR97, p. 3).

While the Commission maintains that a more flexible approach to the scope of agreements could bring benefits in some instances, it has not retained this element of its recommendation in this final report. In part, this reflects the lack of further evidence following the Draft Report that would indicate that the gains on offer from a services-only agreement could not be achieved by pursuing a broader goods and

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services agreement. It is also possible that a policy of striking sector-specific agreements could alter other countries' approach towards Australia in negotiating trade agreements more broadly, including in multilateral fora. As pointed out in chapter 9, the gains from the inclusion of services in agreements will often take many years to realise, and probably does not constitute 'low-hanging fruit'. But the opportunities and challenges of each bilateral relationship do vary.

However, the Commission continues to consider that greater use of implementation schedules that rely on built-in agendas would be beneficial. This would retain all sectors in an agreement but progress reform through a staged approach.

The appropriate scope and negotiating approach to any future BRTA might pursue, and the merits of other options for obtaining reform to trade and investment barriers in partner countries, are matters to be considered in the revised approach to pre-negotiation assessments recommended in chapter 15.

### **13.3 Rules of origin**

Where PTAs are entered into, the question arises as to the appropriate design of associated rules of origin (RoO). As noted earlier, RoO are incorporated in PTAs to determine whether items of merchandise trade entering from the partner country qualify for preferential tariff treatment. That is, they restrict the availability of preferential entry to goods deemed to originate from the partner countries.<sup>1</sup>

The best-practice principles listed in section 13.1 do not provide much detailed guidance on the design of RoO, although they do suggest that any rules should not unduly raise barriers to trade. For example, the ADB principles simply state that 'rules of origin should be as low as possible and consistent', while the RIRDC principles state 'inherent to the formation of a PTA are rules of origin which can restrict trade and increase compliance costs. RoO should be minimised and simplified to minimise this cost'. The Commission considered the design of RoO more closely in its 2004 study of the RoO in the ANZCERTA (CER) with New Zealand.

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<sup>1</sup> Such rules are also applied to confer origin in services trade, but in these areas they are less onerous and contentious than in merchandise trade. RoO are also used in international trade for a variety of other purposes, including for trade statistics, to implement antidumping measures, to determine whether imported goods qualify for MFN treatment or for one-way tariff preferences, and for labelling and marking requirements. RoO also serve the purpose of assessing cumulation in BRTAs involving more than two parties.

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The principal justification used for RoO in PTAs is to avoid ‘trade deflection’ — that is, the utilisation of preferences by producers in non-partner countries by transshipping products through members of a PTA with the lowest tariff (see chapter 8). While trade deflection need not always be welfare-reducing<sup>2</sup>, the Commission has taken the view that there is a legitimate case for the use of RoO in this context.

To achieve this, RoO must require a degree of transformation of the product in the partner country that is sufficiently substantial to discourage the transshipment of the same product from third parties.<sup>3</sup> Equally, however, if the transformation required is unduly onerous, potential gains from trade are likely to be diminished. Among other things, as discussed in chapter 8, overly restrictive RoO can provide an incentive for firms to alter their production processes and use higher cost regional inputs in order to qualify for preferences.

With the objective of avoiding trade deflection in mind, in principle RoO in PTAs are only required if the value of the ‘margin of preference’ — the difference between the MFN tariff and the preferential tariff — is greater than the costs of transshipment. Where this is not the case, there is no incentive for parties in a third country to engage in transshipment to take advantage of the tariff preference. Thus, the application of RoO in such circumstances would not impact on trade deflection. However, it would still entail compliance costs and, depending on how the RoO are specified, risk necessitating adjustments to the production processes and input mixes of firms in the partner country.

On the other hand, where the margin of preference exceeds the costs of transshipment, appropriately designed RoO can discourage trade deflection. Designing RoO to achieve this objective is not easy, as the minimum level of transformation that is sufficiently substantial to avoid trade deflection will vary from product to product, as transport costs and margins of preference vary. Further, in designing RoO, a range of other considerations are relevant. These include the impacts of RoO on incentives to innovate, compliance costs, the costs to governments involved in negotiating RoO and the scope of different forms of RoO to be used for protectionist purposes.

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<sup>2</sup> Technically speaking, trade deflection need not always entail a welfare loss, as it is possible that in some cases there may be benefits to consumers of a transshipped product, in the form of greater consumer surplus associated with being able to access lower-priced imports, that will outweigh the additional costs entailed in transshipment.

<sup>3</sup> Goods designated as being ‘wholly obtained’ from the partner country automatically qualify for preferences, without a requirement for substantial transformation. Wholly obtained goods are typically natural resource-based goods which are deemed the produce of a single country or final goods which are manufactured in a party from such wholly-obtained inputs (sub. 53, p. 16).

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## *Evolution in Australia's approach to RoO*

The RoO in the 1983 CER agreement with New Zealand were based on a regional value of content (RVC) approach, with a requirement that the last process of manufacture take place in the exporting country. The originating materials and processing used in this last process were required to represent a minimum of 50 per cent of the ex-factory cost of the exported product. This same broad approach was used in Australia's PTA with Singapore, albeit with some modifications and a lower RVC requirement.

In its 2004 report, the Commission found that, given the maturity of the agreement and the low levels of tariff protection in each country, there should be no change to the RVC method then used for determining origin in CER, that had been in use since the agreement was established in 1983. In doing so, the Commission considered the merits of the product-specific CTC method but found that, while it potentially offered benefits such as lower compliance costs and increased certainty for business, it would also entail significant risks:

... a change to a CTC rule would be a significant move in the way Australian and New Zealand businesses and the Customs Service determine origin in the CER. There is considerable doubt about whether determination of what constitutes manufacture would be more rigorous than current procedures — some firms could be advantaged while others would be disadvantaged relative to their situation under current arrangements. Furthermore, there is considerable evidence that the CTC method is easily manipulated to provide protection to sectional interests in a non-transparent manner and concern among some participants about such an outcome. (PC 2004, pp. 151-152)

Since 2004, however, the Australian Government has adopted the CTC approach in most of its PTAs. According to DFAT, the catalyst for the change to the CTC approach was the negotiation of the AUSFTA, in conjunction with feedback from industry that reiterated that adoption of the approach would reduce a number of problems it saw under the RVC approach (box 13.5).

However, in the AANZFTA (with ASEAN and New Zealand, which took effect at the start of 2010), businesses have a choice of using either a CTC rule or a RVC rule for many products. (Likewise, following changes to the CER that took effect in 2007, businesses presently have the option of qualifying for preferences under either the pre-existing RVC-based RoO or under new CTC-based rules). According to DFAT, the key benefit of the approach in the AANZFTA is that it:

... marries the objectivity of the CTC approach – there is a single, clear rule for each tariff line – with ASEAN's greater familiarity and comfort with the value added approach. The agreement to provide a choice of ROO allows additional flexibility for exporters who may choose to export their goods under either test. (sub. 53, p. 19)

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### Box 13.5 The move to CTC-based rules of origin in Australia's PTAs

The ANZCERTA ROO, when it entered into force in 1983, was based on a value added approach with a requirement that the last process of manufacture take place in the exporting country. The originating materials and processing used in this last process were required to represent a minimum of 50 per cent of the ex-factory cost of the exported product.

This approach was retained in the SAFTA ROO [with] some modifications...

The catalyst for Australia's decision to change its approach on ROO was the commencement of FTA negotiations with the United States. The United States had previously concluded a number of FTAs – including the North American Free Trade Agreement (NAFTA) with Canada and Mexico and its Agreement with Singapore – using Product Specific ROO (PSR) mainly based on a CTC approach.

Furthermore, wide discussions with Australian industry in recent years had flagged some doubts about the capacity of the value added approach to meet the criteria for effective ROO. Some industry contacts had raised concerns about the lack of clarity in determining allowable and non-allowable costs under the value added approach. Importantly these calculations involved considerable compliance and administrative costs for business. The ex factory cost method also requires industry to obtain and keep records solely for the purpose of determining ROO. These records are a cost to industry as they are not required for the general running of their businesses.

Australian industry has expressed three main concerns about the value added approach. First, the value added test is the least certain method of calculating origin as it is highly susceptible to changes in the costs of non-originating materials. ... A second issue raised by industry was the constraints the value added approach placed on innovation. ... A third key concern raised by industry was the failure of the value added approach to take into consideration the concept of substantial transformation across industries.

During consultations with industry it became clear that CTC methodology would resolve many of the concerns identified with the value added approach. This led Australia to adopt PSR based on a CTC approach in AUSFTA. Australia also adopted PSRs based on a CTC approach in TAFTA. In many cases the required PSR are similar to those under AUSFTA.

Following the 2005 entry into force of both AUSFTA and TAFTA, further consultations have been held with industry to examine the application of the ROO. These consultations have confirmed industry support for the CTC-based approach and have resulted in this becoming Australia's preferred approach in FTAs.

In recent years Australia and New Zealand have re-negotiated the ROO in ANZCERTA to use PSR based on a CTC approach. This approach was also used in ACI-FTA.

*Source:* DFAT (sub 53, p. 19).

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### *Future approach to RoO*

The Commission has encountered a range of views during this and previous studies about the merits of different RoO. What is clear is that, although the CTC approach has now been adopted in most of Australia's agreements, there remain differences in the detailed rules in different agreements (chapter 6). While the use of product-specific rules can provide a simpler process for assessing origin and reduce costs for some producers, the Commission remains concerned that differences between agreements can add to costs and distort trade patterns. In its response to the Draft Report, DFAT noted that a regional work program had just begun that was seeking to improve the 'complementarity and coherence' of RoO in the region. (sub. DR98, p. 9).

DFAT also restated its preference for CTC-based rules:

... at this time, and based on our experience and advice provided by industry, DFAT believes that the CTC methodology for the most part provides the best means of achieving the outcome of an appropriate set of rules that are liberal and flexible in ensuring the application of the principle of substantial transformation. ... in most cases, CTC rules provide a simple and unambiguous test of origin, making alternative rules unnecessary. (sub. DR98, p. 9)

The Department of Innovation, Industry, Science and Research also supports the 'predominantly CTC-based approach to PSR, negotiated on a line-by-line basis, as the only methodology which will ensure robust processes of substantial transformation on each product within the Harmonised System' (sub. 94, p. 1).

However, in the Commission's view, the composite approach recently adopted in the AANZFTA offers clear advantages. It offers choice for exporters with different production methods and, depending on the RVC threshold adopted, may reduce the potential for the RoO to be used for protectionist purposes. The Commission's assessment is that this composite model should be adopted as a basis for RoO in future PTA negotiations.

In the Draft Report, the Commission also recommended that, in future PTA negotiations, Australia seek the inclusion of a waiver of RoO requirements to be applied where the difference between the preferential and MFN rates for a particular import are 5 percentage points or less. DFAT argued that the Commission had not provided supporting evidence or clearly specified a rationale for this recommendation. It continued:

Unless strong evidence could be assembled which provided a solid basis for concluding that the risk was low that the implementation of a waiver of the ROOs requirement would result in trade deflection and consequent welfare losses, DFAT could not support this recommendation. (sub. DR 98, p. 11)

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As noted earlier in this section, to avoid trade deflection, RoO in PTAs are required only if the value of the ‘margin of preference’ — the difference between the MFN tariff and the preferential tariff — is greater than the costs of transshipment. In its 2004 study of the RoO in the ANZCERTA (CER), the Commission drew on data on freight costs between Australia and New Zealand in supporting a waiver in cases where the difference in the countries MFN tariffs was 5 percentage point or less. The Commission found that such a waiver would ‘deliver broad-based gains and should reduce compliance costs significantly’ (PC 2004). Data for other trading partners suggests that average freight costs are typically higher than those for trans-Tasman trade.<sup>4</sup>

RECOMMENDATION 3

*The Australian Government should adopt the composite model for rules to determine origin in merchandise trade, as in AANZFTA, as the basis for rules of origin in any future preferential trade agreement. In adopting this model:*

- *a choice of Regional Value Content and Change in Tariff Classification rules for determining origin should be afforded for each item of merchandise;*
- *the least restrictive variant of each test should be adopted, consistent with preventing trade deflection; and*
- *Australia should seek a waiver to rules of origin requirements where the difference between the MFN tariff rates in the partner countries is 5 percentage points or less.*

## 13.4 Multilateralising provisions

As noted in chapter 6, differing preferences and trading rules across BRTAs can lead to a ‘noodle bowl’ effect that can raise the costs of trade relative to a consistent multilateral trading system. Given that the process of reform through the WTO has stagnated, at least temporarily, it may be possible to create new, consistent, trading rules through different means, to re-invigorate trade liberalising reform in the international trading system administered by the WTO.

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<sup>4</sup> Using detailed import clearance data from the Australian Bureau of Statistics, average freight costs for imports into Australia were estimated as the difference between the ‘free-on-board’ and ‘cost-insurance-freight’ values as a proportion of the customs value. Over the period 2002 to 2009, calculated average freight costs ranged from 10.6 per cent for imports from the United States to about 7.7 per cent for imports from Japan and New Zealand.

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BRTAs, in their various forms, represent one means of doing so. The following sections examine accession and ‘MFN’ clauses — two potential mechanisms for expanding the application of (or ‘multilateralising’) preferences and measures to reduce barriers to trade and investment beyond the original parties to a BRTA.

### **Accession clauses**

Broadly, an accession clause provides that other parties may join an agreement, by agreeing to implement the same reductions in barriers to trade and investment and abide by the same conditions and rules embodied in the accession agreement (and subject to approval by the original parties). This allows a BRTA to expand to cover additional nations on the same basis. Examples include the process for new members to join the European Union, subject to a pre-set range of conditions, or at the multilateral level, accession to the WTO.

While accession clauses have some in-principle appeal, there are practical difficulties with their application that may diminish some of their potential benefits. First, comprehensive BRTAs are negotiated across a wide range of sectors and issues between parties. When other parties seek to join a BRTA they effectively ‘free ride’ off the original negotiating process and the trade-offs that resulted from it. Given different sensitivities and trade profiles between nations, it may be the case that the original parties would not benefit from the accession of certain countries. In particular, negotiators would face pressures from interest groups in all the original parties, rather than just their own domestic interests. As Elek noted:

In practice, accession is likely to be limited to those who do not create serious new competition for the interests protected within existing agreements (either by exemptions or rules of origin). (sub. 44, p. 26)

As such, the economic benefits from the accession of new parties can be limited.

Second, the comprehensive nature of some BRTAs can make the accession process complicated and arduous. This may create an incentive for new parties to simply seek new agreements with each of the original parties, unless the benefits of joining the existing agreement are substantial. As such, accession clauses are more likely to be of use as part of larger regional agreements whose size is sufficient to be an incentive for other nations to take part. However, the Commission understands that, to date, there are no PTAs between major economies. Instead, there are a number of agreements existing around the ‘hubs’ of major economies, often through bilateral (rather than regional) agreements with other nations. While the reasons for this are complex, a contributing factor is the desire of major economies to negotiate agreements that suit each of them best, rather than agreeing to standards dictated by

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others. Although some regional agreements with major economies are under consideration (such as the TPP), the ‘track record’ to date casts doubt on the ability to truly multilateralise conditions of an agreement.

One way to reduce the complexity of acceding to agreements would be to allow accession to particular clauses, or subsets of agreements, for example in relation to particular topics. The Commission notes, however, that negotiating parties may take issue with such an approach, as it could unbalance the ‘negotiating calculus’ of a comprehensive agreement. As such, accession clauses are likely to be more effective when used in agreements that focus on particular sectors or topics, that allow for easier harmonisation of rules and up front consideration of the effect of additional parties joining an agreement (such agreements could essentially become critical mass agreements (CMAs), as discussed in chapter 12).

The Commission’s assessment is that while appealing in principle, accession clauses may only be of substantial benefit when used as part of larger regional agreements, or in single topic agreements such as CMAs.

FINDING 13.1

*No preferential trade agreements have been entered into between major trading blocs. While accession clauses are often seen as a means to multilateralise preferential agreements, little use has been made of them to date by either large or small countries.*

## **MFN clauses**

‘MFN’ clauses refer to provisions in BRTAs that seek to preserve at least equal treatment for the partner countries if one (or more) of them later negotiate more liberal preferences with other parties. In this way, they seek to imitate multilateral most-favoured-nation treatment (of course, in terms of preferential barriers to trade, the simplest way to grant MFN treatment to others would be to negotiate on a non-preferential basis).

Australia has such MFN clauses in two trade agreements, in relation to services and investment, but not goods:

AUSFTA and ACI–FTA [Chile] have a MFN provision, which requires Australia and its FTA partner to accord to each other’s service suppliers, investors and investments, treatment no less favourable than that it accords, in like circumstances, to service suppliers, investors and investments of a non–Party. This means, for example, that if either Party signs a new, more liberalising FTA, the benefits of that will flow automatically to the other Party. AUSFTA and ACI–FTA also include a ratchet mechanism for services and investment, which means that any liberalisation that a

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Party undertakes unilaterally with respect to certain listed measures will also be automatically locked in to the respective FTA. (DFAT, sub. 53, pp. 73–4)

The use of MFN clauses can act as an inbuilt ‘defensive reaction’ to existing trade agreements in countering any later trade diverting negotiations by partner countries. In doing so, they can be seen to support the multilateral trading system, by reducing the degree of preferential trade undertaken.

However, it is inappropriate to apply MFN clauses in BRTAs indiscriminately. First, they may be redundant where, due to existing multilateral agreements, areas of trade policy can only be changed on an MFN basis even if covered in a BRTA. Intellectual property (chapter 14) is one example of this, due to the MFN clause contained in the TRIPS agreement.

Second, there are some areas that do not easily lend themselves to MFN clauses, but rather to direct cooperation between governments to set (and ensure the enforcement of) mutually agreeable standards. One example of this is mutual recognition agreements (MRAs) surrounding the registration of service providers, where the governments involved must satisfy themselves of the standards of services regulation in each jurisdiction before allowing the freer movement of service providers. Automatically extending an MRA offered to one country to all trading partners could undermine the pursuit of valid regulatory objectives regarding, for example, health and safety.

One other notable concern with MFN clauses is that their use can add to policy ‘lock in’ (discussed in chapter 11) simply by increasing the number of countries that are stakeholders in a given trade barrier in Australia. Importantly, as noted in chapter 11, this can lock in the form of trade barrier as distinct from the level, potentially constraining policy makers in the future from liberalising a barrier with new regulatory approaches.<sup>5</sup>

The Commission notes that existing Australian practice preserves some flexibility. For example in relation to negative list agreements, Australia maintains the ability to modify measures subject to reservations, to the extent that they remain in

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<sup>5</sup> The Office of International Law (sub. DR83, p. 3) noted that it is the level of treatment accorded by a barrier, rather than the particular barrier itself, that is bound. As discussed in chapter 11, determining if a barrier that has changed in form (for example, from a monetary threshold to a sectoral focus) is in fact more favourable to particular partner countries or not is more difficult than, say, a tariff reduction. This could reduce the willingness of regulators to examine more fundamental changes in regulatory schemes that could be more beneficial than simple reductions in barriers within existing frameworks.

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conformity with the relevant obligations (Office of International Law, Attorney-General's Department, sub. DR83, p. 3).

As discussed in chapter 14, the Commission is concerned with a number of areas covered in some trade agreements that are traditionally areas of domestic policy. To the extent that the application of MFN clauses exacerbates concerns in these areas, further caution is warranted.

As noted in chapter 12, in relation to Australia's domestic barriers, reforms that are identified as beneficial should, in the Commission's view, be expedited on a unilateral basis, thus applying the same liberalised settings to all trading partners.

### **13.5 Providing trade-related assistance to other countries**

In the course of negotiations for existing BRTAs, particularly those involving developing countries, it is becoming commonplace for Australia to offer assistance to negotiating partners. Broadly, this can take two forms, trade facilitation and capacity building.

#### *Trade facilitation*

Trade facilitation measures are actions that lower the cost of trade such as improving physical or regulatory infrastructure to streamline the movement of goods through ports. As noted in chapter 8, improving trade facilitation was found to have a small but positive impact on trade flows, with a greater impact for non-preferential improvements.

Trade facilitation measures can be implemented through direct engagements between governments — for example, the exchange of expertise for customs processing — and does not necessarily need to be undertaken as part of a BRTA.

Nonetheless, the Commission's assessment is that, if a BRTA is determined to be beneficial, the offer of trade facilitation measures to partner countries that could stand to benefit can enhance the gains available from a given agreement (provided trade facilitation measures are at least as cost-effective as the inclusion of other provisions). As noted in chapter 8, the Commission considers this should be done on a non-preferential basis (that is, improving the procedures in a manner that improves access to all, not simply 'express' access to the goods or services of one country).

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FINDING 13.2

*Trade facilitation measures are an effective means of enhancing trade. Such measures can be included in a BRTA, but are most beneficial if undertaken on a non-preferential basis.*

### **Capacity building**

The provision of capacity building assistance to other, particularly developing, countries can have many benefits. Typically, capacity building is targeted at the good governance and institutions of recipient countries, and often takes the form of training for local officials, or the exchange of government officials with partner countries to improve the experience of both sides. Such forms of capacity building can improve domestic policy, and assist developing countries in the negotiation of bilateral, regional and multilateral trade agreements.

As discussed in chapter 12, the Commission considers that capacity building measures that aim to improve domestic transparency are of particular benefit. In the context of developing countries, a first step towards this would be to improve domestic analytical capacity. This could assist the countries in identifying valuable reforms for themselves, rather than ‘conceding’ to reforms advocated by developed countries in the course of trade negotiations (the Commission acknowledges that substantial aid may be required from developed nations to assist such mechanisms). Once the analytical capacity of the country in question has been developed, the outcomes from policy processes could be further improved by moves to increase domestic transparency.

Whether capacity building should be included as part of BRTAs is a separate question, as there are drawbacks to the use of BRTAs in this context. Offering capacity building as part of a BRTA with a developing nation can lead to perceptions of conflicts of interests, as attempts to train negotiators from ‘the other side’ or pursue capacity building in particular sectors can be seen to benefit the developed country more than the recipient. Such perceptions can arise even where the capacity-building is offered without any expectation of exchange. For example, in the context of the PACER Plus negotiations, a statement from Pacific civil society organisations, churches and trade unions contended that:

... a clear conflict of interest arises when [negotiation] training programmes like these are directed by Australia or [New Zealand]. It is extremely unusual for trade officials to improve their negotiating capacity by discussing their national issues and concerns with those they would then negotiate with! Trade officials from Pacific countries need independent and objective sources of information, training and capacity building in order to engage in trade negotiations with Australia and NZ. (2009, p. 6)

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These perceptions — whether justified or not — can be diminished where training is conducted at arm’s length from government. Moreover, AusAID argued that such training can have advantages for both parties:

... while it may seem counter-intuitive to train developing country partners in the technical aspects of trade negotiations, it would lead to a number of benefits for Australia, including:

- (i) a more efficient negotiating process for the trade agreement;
- (ii) achieving a more optimal outcome from the agreement (including broader, deeper and more immediate market opening);
- (iii) better implementation of the agreement which would lead to better access for Australian exporters; and
- (iv) building up general capacity of the developing country partner(s) to pursue trade agreements that are WTO consistent and supportive of multilateralism. (sub. 46, p. 10)

The Commission supports ongoing capacity building programs by the Australian Government as a central feature of our assistance to developing countries, particularly those in our region, and considers that these should continue to be pursued regardless of whether BRTAs with the assisted countries are also pursued. In particular, the Commission notes that these programs can be undertaken through direct provision of assistance, or by using development or economic cooperation agreements.

In the context of trade agreements, the Commission’s assessment is that the identification of partner countries should take account of the ability of the partner to accurately assess the relative costs and benefits of an agreement themselves. If it is deemed that the prospective partner country does not have the capabilities required in order to negotiate an agreement, the appropriate trade policy approach to that country should instead focus on broader economic capacity building (which would include institutional exchanges that can serve to highlight the potential benefits of trade liberalisation). Such capacity building should be directed at ensuring that the frameworks (in markets, government institutions, and physical infrastructure such as ports) in the country are developed to such a point that they are more able to take advantage of the potential gains from trade. Such factors should be assessed as part of any initial analysis of Australia’s trade policy approach to relevant developing countries (through, for example, the trade policy strategy process discussed in chapter 15).

If it is determined that negotiations should go ahead with a developing country partner, then they should proceed at a pace that takes account of the partner’s relative level of preparedness, as well as whether or not capacity building programs appropriate to the circumstances are in place. Of course, capacity building should be

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funded and delivered in a clearly unbiased manner, to minimise potential (or perceived) conflicts of interest. Further, any capacity building that is provided should be clearly de-linked from any obligation on the part of the developing country partner, either to negotiate an agreement or to negotiate the agreement according to a schedule dictated by Australia.

RECOMMENDATION 6

*If it is deemed that capacity building should be part of a trade agreement development process, the Australian Government should fund and deliver capacity-building programs in a manner that minimises potential (or perceived) conflicts of interest. Any such programs should not impose an obligation to negotiate a trade agreement.*

While such negotiation capacity building can be of benefit, some participants questioned its merit relative to more general capacity building:

... rather than offer assistance for enhanced negotiating capacity we should continue to support more general economic development through international agencies. Attempting to harness BRTAs for this task seems ill advised. This is especially true of the small and micro states of our region. (Greg Mahony, Public Policy Institute, Australian Catholic University, sub. DR78, p. 1)

Indeed, the Commission's assessment is that broader economic capacity building — directed at institutions, markets, infrastructure and domestic analysis capability — offers considerably greater benefits to recipient countries than negotiation-specific programs. In the context of broader Australian trade policy, and in a situation where the resources available for capacity building are limited, greater priority should be devoted to programs that have broader economic impact, rather than those conducted simply to facilitate the negotiation of trade agreements.

## 13.6 Summing up

A degree of variability is inevitable — and, indeed, desirable — in the design of BRTAs, not least because optimal design will vary in accordance with the nature of the economic relationship Australia has with a prospective partner. Nonetheless, some useful broad approaches to the design of future BRTAs can be drawn.

There would be merit in the Australian Government adopting a more flexible approach to the comprehensiveness of the BRTAs it pursues, particularly if negotiations are likely to be, or become, difficult or protracted, or if there are clear and significant gains available from securing early agreement on non-contentious areas.

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A composite model should be adopted as a basis for RoO in future PTA negotiations in order to reduce compliance costs for exporters and lessen the potential for RoO to be used for protectionist purposes.

Multilateralising provisions, such as accession clauses and MFN clauses, have some in-principle appeal, but there are some practical difficulties with their application. MFN clauses should avoid locking in any particular form or level of trade barrier, which could then constrain future liberalisation.

Trade related assistance to developing countries, such as capacity-building, should be funded and delivered transparently, and be de-linked from any obligation on behalf of the country concerned to negotiate an agreement with Australia.