



Australian Government
Productivity Commission

The future of the
world trading system

Theme chapter to
Productivity Commission
Trade and Assistance
Review 2017-18

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This document only contains the theme chapter of the *Trade and Assistance Review 2017-18*. Page numbers reflect the numbering from the full report.

The full report is available from <https://www.pc.gov.au>

3 The future of the world trading system

Key points

- The world trading system is under greater strain than at any time since the 1930s.
- Most prominently, the United States has levied tariffs on steel and aluminium imports, under the cover of national security grounds, as well as Chinese and Mexican imports more generally, and it has blocked appointments to the WTO's dispute settlement Appellate Body. China has reciprocated with tariffs of its own, and a cloud hangs over trading relations between the world's three largest trading economies (China and the EU with the United States).
- These strains come on top of broader, longer-standing factors constraining the WTO. There is a fundamental lack of consensus among members on a range of issues, and discontent in parts of the community with the world trading system and globalisation more generally. While these forces do not, at present, constitute an existential threat to the world trading system, its authority and credibility are at risk.
- These forces have overshadowed recent less widely known successes. The average tariff rate has continued to fall, agricultural export subsidies have been abolished, customs processes are being redesigned to facilitate trade, a government procurement agreement has been negotiated and the dispute resolution system has worked remarkably effectively.
- Nonetheless, Australia cannot afford to take for granted that continued progress will be made given some of the deep seated problems besetting the world trading system. Equally, resurrecting trade barriers is not a solution to the forces testing the support for open markets.
- The path forward lies with improving the system we have. This involves both measures that Australia can take alone and measures Australia could pursue in cooperation with others.
- The single most important policy setting for Australia in the face of mounting troubles in the world trading system is to keep our own borders open to trade and investment and to continue working towards freer markets.
 - There is ample scope for the Australian Government to remove 'nuisance' tariffs, lower non-tariff barriers, simplify rules of origin and avoid anti-dumping duties.
 - Better consultation and engagement with the community on prospective trade agreements and on the rationale for free trade would also foster public confidence in open markets.
- Australia should also continue to work with other countries to build consensus on how to resolve long-standing and escalating challenges facing the WTO.
 - There is a need to reinvigorate the negotiation function of the WTO, including plurilateral, sectoral and regional agreements that allow, or work towards 'most favoured nation' treatment and resolving the deadlock on 'special and differential treatment'.
 - There is also a need to strengthen compliance with notification procedures and review and refresh the rules to handle issues relating, inter alia, to state owned enterprises, regulatory cooperation, digital trade and intellectual property.
- It is encouraging that Australia and other countries are striving within the WTO and in other fora to enable the world trading system to move forward. The importance of strengthening in an even-handed manner the rules-based system governing international trade, which has underpinned the growth in world trade, boosted living standards and prevented a relapse into protectionism for the past 70 years should not be underestimated.

The world trading system is part of the multilateral economic order that the United States has led and championed since the end of the Second World War. It is a rules-based, not results-based, system based on the principles of non-discrimination, transparency and reciprocity. The norms are codified and pervade global, regional and bilateral agreements and country-level policies.

The system provides predictability and mechanisms to avert or resolve trade disputes and gives all nations and businesses regardless of their size the confidence that success in international trade depends on the merits and competitiveness of the goods and services they provide, not their political clout. It has proven effective in progressively lowering trade barriers, which has been a source of economic growth, lifted living standards and contributed to poverty reduction within and across nations.

In recent years, however, the world trading system has come under greater strain than at any time since the 1930s. Most prominently, the United States has levied tariffs on steel and aluminium imports, under the cover of national security grounds, and on US\$250 billion of imports from China. It has used its significant economic power to renegotiate bilateral and regional agreements with Korea, Mexico and Canada and, more recently, it has announced tariffs on imports from Mexico in an attempt to force greater surveillance of the US border. It has also blocked appointments to the World Trade Organisation's (WTO) dispute settlement Appellate Body. China has reciprocated with tariffs of its own, and a cloud hangs over trading relations between the EU and the United States.

These current trade tensions come on top of a longer standing and broader phenomenon. There is a fundamental lack of consensus among members on a range of issues that is preventing the WTO from moving forward. And in parts of the community there is discontent with the world trading system and globalisation more generally. While these forces do not, at present, constitute an existential threat to the world trading system, its authority and credibility are taking a hiding.

It begs the question: what does the future hold if the United States and others further disengage from the rules-based order? To shed light on this question and to highlight what is at stake, this review outlines the key components and features of the world trading system and what it has achieved. It then considers the challenges facing the system in general and the WTO in particular, concluding that the path forward has to lie with improving the system we have. The final section identifies some areas where Australia can take action alone, as well as in cooperation with other countries to reinvigorate the world trading system.

3.1 The world trading system: what is it and what has it achieved?

Key features of the trading system

The modern global trading system originated with the 1947 General Agreement on Tariffs and Trade (GATT) and formed part of a new post-war international economic order. It laid down

the principles and rules governing trade between nations and was designed to avoid a repeat of the protectionist policies of the 1930s that contributed to the depth of the Great Depression.

The GATT, and later the WTO, arrangements centre around two principles: transparency and non-discrimination. The principle of non-discrimination applies both at the border and behind the border. With respect to non-discrimination at the border, member states commit to provide each other '*Most Favoured Nation*' (MFN) treatment: the best general tariff rate you provide to anyone, you must provide to everyone.

Non-discrimination behind the border commits member states to the notion of *National Treatment*. It affords the same treatment to foreign nationals and goods as for a country's own nationals and goods, requiring no less favourable treatment once they have passed the border. The system allows some exceptions to the non-discrimination principle (for example, safeguards and anti-dumping), but seeks to contain them with strictures on their application.

Reciprocity is another principle embedded in the world trading system's norms. Nations that remove or lower barriers to trade can expect other nations to do the same. Again, multiple exemptions exist. The most notable allows developing economies to delay implementation of agreements to lower barriers to trade and in some circumstances to maintain them indefinitely. Moreover, reciprocity can operate in both directions. A country that is aggrieved, for instance, by another member state engaging in a practice or policy that effectively undoes the gains from a previous agreement, can raise a complaint and may be allowed to retaliate.

The simple principles of non-discrimination and reciprocity have far-reaching implications. They allow small and medium-sized countries like Australia to engage with other countries on equal grounds, providing access to markets on terms that they most likely could not have negotiated bilaterally. The MFN rule, for example, has allowed Australia to benefit automatically from trade deals negotiated between others. And the notion of reciprocity linked our own cuts in tariffs to cuts in tariffs abroad, playing off the interests of firms seeking protection against those of exporters seeking to expand their markets. Each successive round of tariff cuts strengthened further the economic importance of exporters and weakened that of protectionists. Baldwin described it as a 'Juggernaut' building political economy momentum for the next round of cuts (Baldwin 2016).

The world trading system did not have a permanent body until the WTO was established in 1995. Its three main roles are to:

- oversee a system of monitoring and reporting on trade and trade-related policy developments
- serve as a forum to negotiate reductions in barriers to trade
- hear and settle trade disputes.

The trading system also encompasses bilateral and regional trade agreements (which are notified to the WTO). These agreements often embody the norms of the multilateral system, and in more recent years, go beyond it, to cover new issues, such as the principles that

surround digital trade and data flows. They also have limitations due to the potential for trade diversion, costly rules of origin and may preserve many of the most distorting tariff peaks. Australia has signed 11 bilateral and regional trade agreements covering 67 per cent of our trade; with negotiations underway that could increase this share to around 80 per cent.

A third level of the global trading system encompasses the trade policy decisions that countries take unilaterally (provided they are consistent with the principle of non-discrimination). Australia has played a prominent and leading role at this level of the world trading system. A country's own barriers to trade generally have a more distorting effect on the allocation of its resources and on incentives to be productive and innovative than the trade barriers of other countries. Being among the first countries to recognise this, much of Australia's liberalisation has been unilateral, undertaken voluntarily, rather than in return for reciprocal concessions from other countries.

What has the world trade system achieved?

The world trading system's set of multilaterally agreed rules and disciplines has provided the framework for lowering tariffs and other restrictive trade measures, and keeping them low. Successive rounds of negotiations led to a process of multilateral liberalisation (except in agriculture, which was not on the negotiating table), expanded the set of rules to include agreements on services (GATS), intellectual property rights (TRIPS), foreign investment (TRIMS) and upgraded the dispute settlement system.

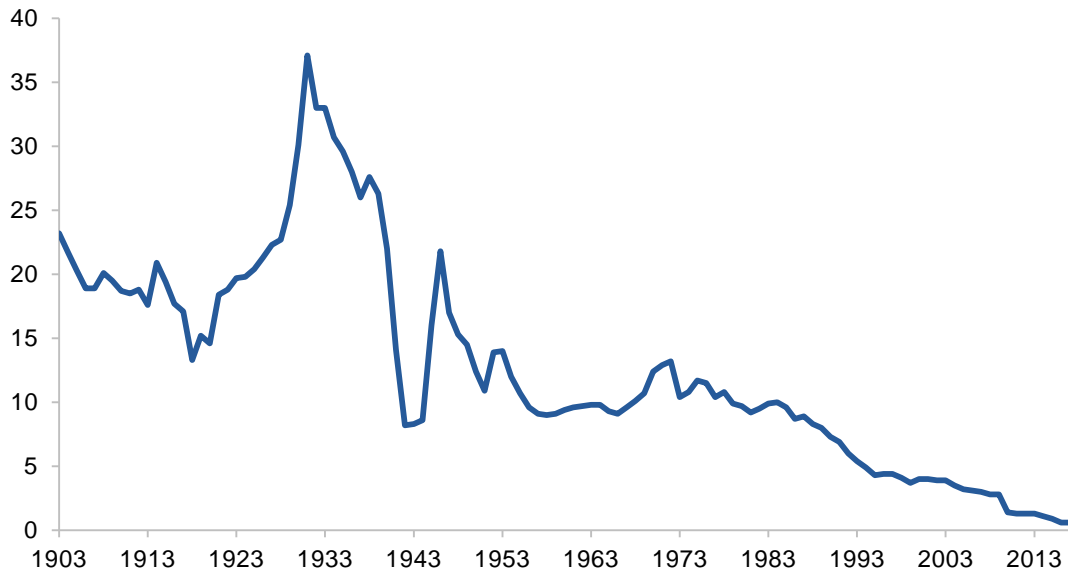
Since the trading system's inception, Australia's (and others') tariff rates have steadily declined to average less than 1 per cent (figure 3.1), and zero for a large share of imports. Over the same period, the number of states participating in the WTO has grown to 164 members (a further 22 are seeking to join it), representing 98 per cent of world trade. By many measures, it has been a remarkable success. As Baldwin put it:

'WTO is a smash hit by the standards of international organisations. It presides over a rule[s]-based trading system based on norms that are almost universally accepted and respected. Disputes are adjudicated by an international court whose rulings are almost universally implemented despite a lack of enforcement powers. Its membership is almost universal and it makes decisions by consensus. Most importantly it achieved its mission: the establishment of an open and rules-based trading system'. (Baldwin 2010, p. 8)

The share of trade in global production has risen steadily (figure 3.2), and with that more closely integrated Australia's economy with its trading partners. Australian consumers see the benefits each day in terms of wider choices and lower prices. Supermarket shelves, for example, are stocked with Californian oranges, Italian kiwi fruit and — thanks to a WTO ruling against Australian import restrictions — even New Zealand apples. The prices of cars, clothing, footwear and most electronic goods have fallen in real terms over the past 30 years, boosting household purchasing power.

Figure 3.1 **Australia's average tariff is now close to zero^a**

Per cent of import value

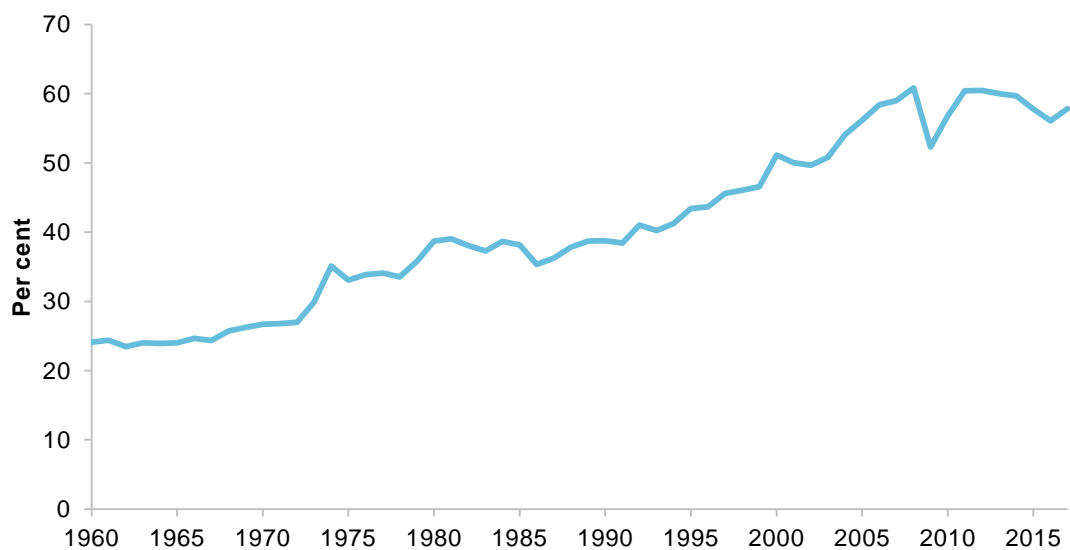


^a Includes excise 2003-04 to 2009-10. Excludes excise 2010-11 to 2017-18

Sources: : 1903-04 to 2004-05 (Lloyd (2008), table 5, columns 3 and 4); 2005-06 to 2017-18 (Commission estimates).

Figure 3.2 **Global trade integration has steadily increased**

Exports plus imports of goods and services as a share of GDP



Source: World Bank.

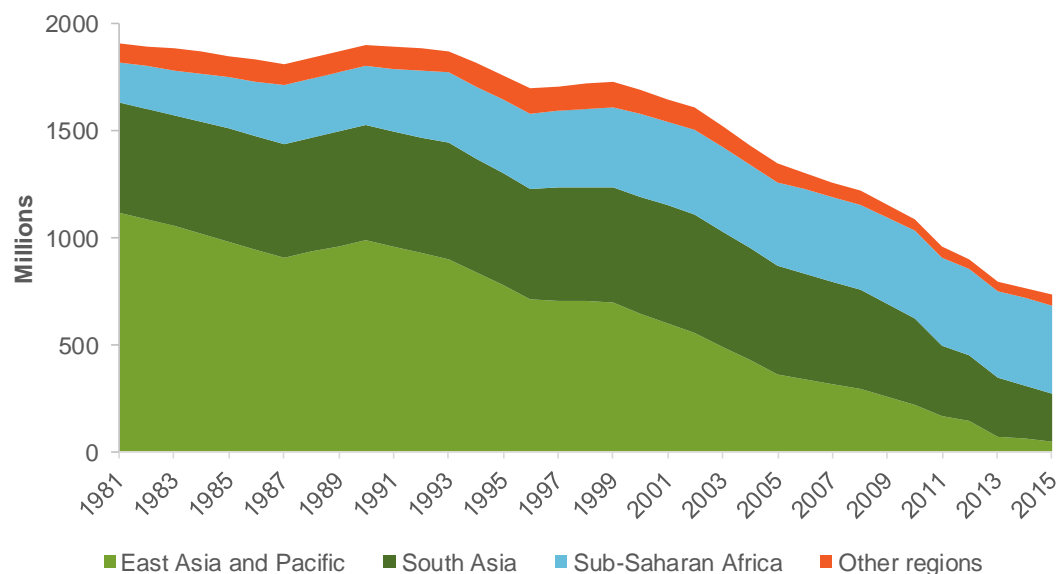
Australian businesses have also benefited. Lower tariffs and other trade-restrictive measures mean lower input costs for many businesses. For example, every business that uses a car – from trades’ people, taxi operators to driving schools and many others – has benefited from the large reduction in tariffs and quotas over the past few decades. Exporting businesses have been some of largest beneficiaries, stemming from both lower input costs and a lower Australian dollar (as high tariffs act to prop up the exchange rate). Successful Australian firms have enjoyed higher productivity growth and higher wages. Growth in trade with China alone may have raised Australian incomes by as much as 2 per cent (Ahn and Duval 2017).

The process of global integration (together with other microeconomic reforms) has been a powerful force driving Australia’s sustained economic performance, as Australian businesses have increasingly come under pressure to compete with foreign suppliers. While this can be disruptive for individual businesses, the weight of evidence shows that competitive pressures spur innovation (Soames, Brunner and Talgaswatta 2011), transform work practices (Holmes and Schmitz 2010) and improve management practices (Bloom and van Reenen 2010). For Australia as a whole, income growth has been substantial and the gains broadly shared across the community (PC 2018a).

Integration has also changed the structure of the Australian economy. The boom in coal and iron ore prices, driven by demand from China, saw a large increase in mining investment and expansion of these exports. Education has also grown to be our third largest export industry. On the other hand, disruption in manufacturing has continued to reduce its share of the overall economy, a process that has included the prominent closure of the car assembly industry, and closure of some heavy manufacturing facilities such as in aluminium and petroleum refining industries.

In many developing and emerging-market economies the effects of global integration have been more rapid and even more profound. Trade creates employment in export-facing manufacturing and services, which helps facilitate the movement of people out of often low-productivity agriculture. It rewards investment in education and allows workers to climb up the skill ladder. The World Bank estimates that over the past quarter-century, more than a billion people have lifted themselves out of poverty, in many cases by seizing the opportunities trade has created (World Bank 2018; figure 3.3). The largest gains have been in Asia, including impressive economic growth in ASEAN countries such as Indonesia, Thailand and Vietnam.

Figure 3.3 More than a billion people lifted out of extreme poverty
 Number of people earning less than US \$1.90 PPP per day



Source: Commission estimates based on World Bank Poverty and Equity Database.

3.2 The challenges facing the world trading system

Despite the world trading system's strengths and many accomplishments, it has come under increasing strain over the past few decades, and is facing multiple challenges that extend to its core, the WTO.

No broad multilateral agreement has been concluded since 1994, the body of rules and procedures of the organisation has not kept pace with the changing nature of trade - notably the rise of global supply chains and digital trade - and the timely compliance with transparency procedures is slipping. Moreover, the use of tariffs and other protectionist measures has lifted since the global financial crisis and there are clear risks that the trend towards more protectionist policies could accelerate.

It is unclear how these forces will influence countries' trade policies. However, developments to date suggest the maintenance of the status quo is unlikely. Some fear major backsliding on protection and a breakdown of the rules-based multilateral system in favour of 'managed' trade. Others think change will be at the margin and aimed at bridging the divides on the specific issues at the source of the troubles with the world trading system.

A descent towards managed trade?

Donald Trump's presidential campaign and his electoral victory in 2016 foreshadowed a fundamental shift in the United States' trade policy. He stated that trade deficits cost American jobs, especially in the manufacturing sector, and are largely the result of the unfair trade practices of other countries (Trump 2017a).

His election on the back of a promise to 'put America first' and 'bring back manufacturing jobs' was coupled with promises of measures that would be a departure from US openness and leadership in the international trading system. In his inaugural address, Trump declared:

Every decision on trade ... will be made to benefit American workers and families. We must protect our borders from the ravages of other countries making our products, stealing our companies, and destroying our jobs ... We will bring back our jobs. We will bring back our borders. We will bring back our wealth. And we will bring back our dreams (Trump 2017b).

His words were followed through with decisions that left few doubting his bravado. Three days after his inauguration he withdrew the United States from the completed, but yet to be ratified Trans-Pacific Partnership agreement. A similar, but less publicised fate met the Transatlantic Trade and Investment Partnership negotiations. Then the United States levied tariffs on steel and aluminium imports from most steel producing countries (except Australia) on national security grounds and imposed further tariffs on imports from China, citing intellectual property concerns. The President also threatened higher tariffs on motor vehicle imports and initiated a renegotiation of trade agreements with Canada, Mexico and Korea, menacing to withdraw completely if they were not concluded to his satisfaction.

This change of course in US trade policy in part reflects long-standing frustration held by successive US administrations (and some other countries) with the inability to reach consensus within the WTO on how to address some fundamental and protracted issues facing the world trading system (discussed below).

Nonetheless, the US actions were met with responses and have created uncertainty about future trade relations, which in itself is costly. China reciprocated with tariffs of its own and many countries are challenging in the WTO the decision to levy tariffs on steel and aluminium. Meanwhile, appointments to the WTO's dispute settlement Appellate Body remain blocked by the United States and a cloud hangs over the bilateral trading relations between the world's three largest trading economies (China and the EU with the United States).

Some commentators fear these developments set a dangerous precedent and risk the United States repudiating the rules-based trading system in favour of managed trade, where strength replaces rules as the basis for trade relations (Bown and Irwin 2018, Kirchner 2018). It is partially manifest in US demands for China to buy more US exports in an effort to reduce the bilateral trade deficit. And last year South Korea agreed to limit its annual steel shipments to the United States to 70 per cent of its average deliveries over the previous three years.

Managed trade can manifest in various guises, including voluntary export restraint agreements targeting specific industries, local content rules and stipulating the conditions of

labour deployed in foreign production (for example, a minimum wage level). The latter requirement was introduced in the recently negotiated US-Mexico-Canada Agreement that replaced NAFTA. Moreover, often agreements set vague targets, such as ‘levelling the playing field’ or ‘trading fairly’ that increase the risk of disputes at a later stage. Managed trade agreements implicitly reject the idea that trade is mutually beneficial.

Voluntary export restraints have been used in specific sectors on several occasions, without displacing the rules-based trading system. Prominent examples include the Multi-Fibre Arrangement (MFA) which limited textile trade from developing to developed economies between 1974 and 2004, Japan reducing the number of its cars exported to the United States in the early 1990s, and the 1986 Semiconductor Arrangement between Japan and the United States (box 3.1).

Box 3.1 Unintended consequences of managing semiconductor trade

In the 1970s the United States dominated the world market in semiconductors. By the 1980s, however, Japanese producers were steadily gaining market share, accounting for around 90 per cent of US sales for some types of semiconductor.

Bowing to pressure from the United States, Japan in 1986 agreed to limit its exports of semiconductors to America. The Arrangement followed complaints from the US semiconductor industry that it faced unfair competition from Japanese firms and needed temporary protection.

The Arrangement stipulated, *inter alia*, that Japanese producers set the price at which they sell chips in conjunction with the US government; regulated sales by Japanese semiconductor firms in third countries and promoted the sales of US made chips in Japan.

Not surprisingly, semiconductor imports from Japan fell and prices rose. This in turn hurt the competitiveness of US-made computers. Since Japanese computer producers (and those in other countries) were able to buy semiconductors for less than their US competitors could, the Arrangement made it possible for Japan (and others) to compete more effectively in the US computer market. While some jobs were created in the US semiconductor industry, many more were lost in the US computer industry.

The Arrangement was renewed in 1991 and expired in 1996, following an agreement among WTO members in 1995 to no longer use voluntary export restraints.

Sources: Denzau (1988), Johnson (1991).

These examples of managed trade schemes have typically been short lived, and they create losses in the countries that seek to manage trade, as well as among their trading partners and third countries. On the latter, for example, the plan for China to buy more agricultural products from the United States may mean they buy less from Australia. They also disrupt existing business ties, compel companies to search for new suppliers and ultimately result in competitive disadvantage for more industries than they favour. The higher costs flow through to consumers as higher prices and lower living standards.

The poor past experience with instances of managed trade and the pronouncements from President Trump that he would withdraw from the WTO if ‘they don’t shape up’

(Micklethwait et al. 2018, cited by Bown and Irwin 2018) has prompted some to contemplate how the world trading system would look with a widespread shift to managed trade.

Bown and Irwin (2018) argue that such a move would free the United States from its obligation to apply MFN tariffs on imports from other WTO members. They then outline an extreme scenario where all negotiated tariff reductions since the first trade agreement was reached under the Reciprocal Trade Agreements Act of 1934 are rescinded (US preferential trade agreements negotiated outside this Act would be unaffected). This would imply a return to the Smoot-Hawley tariff.

The Commission simulated a scenario approximating this extreme case. It entails the United States unilaterally increasing tariffs about ten-fold to 1930s levels while retaining the trade agreements with Australia, Canada, Mexico and Korea. These actions would generate an ‘economic own goal’, with US living standards falling by almost $\frac{3}{4}$ per cent and large declines in both imports and exports. Other countries that did not retain trade preferences would also be adversely affected. These impacts are based on the assumption that other countries do not retaliate. Scenarios where countries retaliate involve much greater economic costs (PC 2017a).

Of course, simulations of this kind are highly stylised and unable to capture the many complexities in a country’s trading relations. What they do, however, is reinforce the conclusion that a descent towards managed trade would be detrimental to every player in the global economy.

Troubles at the core of the trading system

While a radical reshaping of the world trading system towards managed trade is an unlikely scenario, there are enduring concerns at the core of the world trading system that pose equal or even greater risks to the future of that system. They reflect a more general dissatisfaction with the system and relate to some longstanding issues in each of the three areas of WTO responsibility: monitoring; negotiations; and dispute settlement. There are also geo-strategic forces at play.

The system itself, however, is not broken and remains the foundation of global trade policy. In fact, the WTO has secured a number of less widely known successes in recent years (box 3.2).

Box 3.2 WTO progress towards freer markets

The focus on current tensions in the world trading system has masked the WTO's successes concluding trade agreements on smaller agendas in the past few years. Some of these successes are of high direct importance to Australia, including:

- The plurilateral Revised Government Procurement Agreement of 2014 (in force for Australia since May 2019), which aims to give reciprocal access to foreign tenders in participating member countries.
- Conclusion of the plurilateral Expanded Information Technology Agreement in 2015 which eliminates tariffs on 201 information technology products.
- The 2015 Ministerial Decision on abolishing agricultural export subsidies.
- The Trade Facilitation Agreement which entered into force in February 2017 and will result in customs processes being redesigned to better facilitate trade.
- Negotiations for a plurilateral agreement on international electronic commerce.

Australia has also played a role in progressing regional trade agreements, which over time may positively influence the shape of future WTO negotiations. For example:

- The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) entered into force for Australia in December 2018.
- Seven chapters of the proposed Regional Comprehensive Economic Partnership (RCEP) have been agreed.

Monitoring is partial and is not timely

The WTO requires all members to report on changes in policies affecting trade and investment, in line with their commitments made on accession. The notification system is a valued transparency measure that allows every member state to engage in dialogue with other members. It helps businesses to navigate their way through regulations abroad, and when it works well, it restrains countries from applying new trade-distorting measures and defuses potential disputes.

However, in order for the notification system to work well, it requires timely notification and open discussion of the issues in good faith. On this point, there is broad agreement that member states' compliance with their notification requirements is falling short. In October 2018, nearly half of the 164 WTO members had not yet lodged their subsidy notifications that were due in 2017 and about a third had still to deliver their notifications due in 2013 (WTO 2018). As a result, many countries' trade practices remain opaque, making it difficult to monitor compliance with WTO rules and seek their enforcement.

Some members also consider that monitoring is not covering all of the issues it should and the information that is provided is underutilised and incomplete. A prominent example is where state-owned enterprises are the actors granting subsidies (through state-owned banks granting low interest loans, for instance). They play a substantial role in the Chinese economy, accounting for around 14 per cent of employment (Asia Society 2019), and are

dominant in industries such as energy, transport equipment and banking. Concerns have also been raised around Chinese technology and intellectual property acquisition practices.

Trade negotiations have stumbled

Whereas the GATT saw successive rounds of wide-spread tariff cutting, trade negotiations at the WTO have not proceeded as successfully. While there has been important progress on trade facilitation and agricultural export subsidies, the Doha Round launched at the 2001 WTO ministerial council, with a comprehensive, single undertaking (binding all members) agenda and particularly focussed on developing countries, is now moribund.

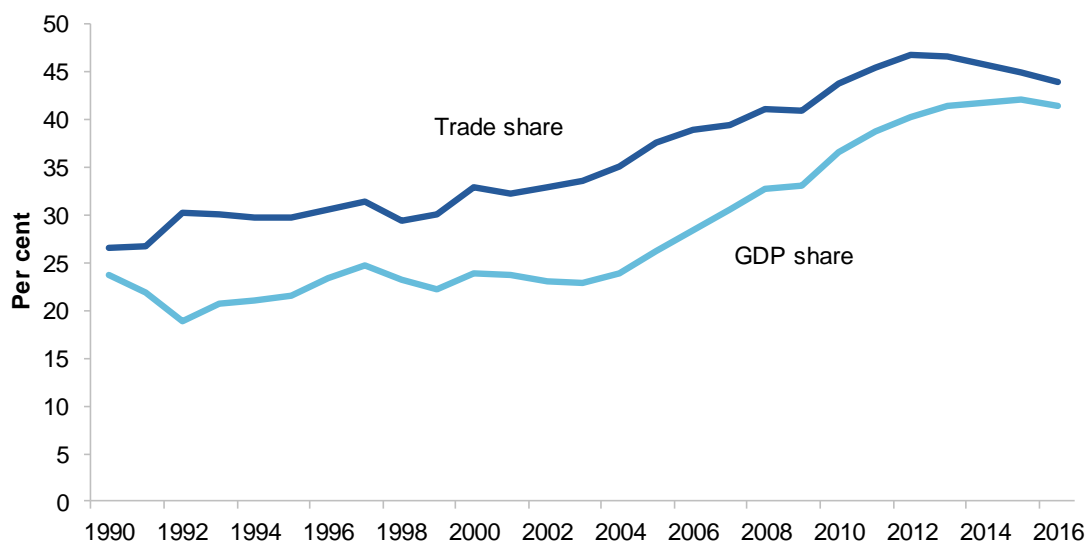
Negotiations stumbled for many reasons. The ‘juggernaut’ dynamic of previous rounds has arguably become a victim of its own success. With most tariffs having reached low single digit levels, the prospect of further reductions in applied rates is relatively less attractive. Exporting businesses are therefore less active in calling for the removal of trade restrictions at the border. Agriculture is the major exception to low tariffs, but here building a coalition of reform-minded members to counter opposition to free trade in agriculture remains exceptionally difficult. Tackling non-tariff barriers and barriers to services trade is also a prospective area for agreement, but as deals may be seen to encroach on national sovereignty, it has proved a lot harder to establish the sufficient consensus needed to finalise a deal.

The shifting composition of WTO members towards developing economies also makes it difficult to reach a deal across a broad trade agenda. Since the last successful multilateral negotiation was launched in 1986 (Uruguay Round), more than 70 developing nations have joined. New members with different preferences make coalitions of developing countries against granting access to their own market more likely. But the real leverage to stall negotiations stems from developing countries benefitting from ‘special and differential treatment’ under the WTO.

‘Special and differential treatment’ can include weaker requirements for market access and longer timetables for implementing agreements, as well as help with building capacity to carry out WTO work, handle disputes and implement technical standards. It means developing countries can benefit from WTO agreements that lower trade restrictions without reciprocating. At the same time, the WTO’s consensus principle has given developing nation coalitions more blocking power by virtue of their large number.

While most WTO members accept a degree of differential treatment, the issue is that countries self-identify as ‘developing’; there are no established mechanisms for ‘graduation’ to ‘developed’ status. This has been a slow burner issue for the WTO, as for many years after the creation of the rules-based trading system developing country markets were limited in size. But this has changed over the past two decades. The developing country share of world output has doubled since the finalisation of the Uruguay Round and its share of global trade has also risen sharply (figure 3.4). A failure to reach consensus on how to resolve this issue will diminish the cohesion of the WTO and hold up its ability to move forward.

Figure 3.4 **A rising share of developing countries in world GDP and trade**
Share of world gross domestic product



Source: IMF World Economic Outlook, October 2018.

The dispute resolution mechanism is under threat

The WTO provides a system to settle disputes on behalf of any member claiming to be harmed by policies of another in violation of a treaty obligation. The process facilitates consultation between the parties, adjudication by panels consisting of representatives of other members and, if necessary, an Appellate Body.

The arrangements work well, playing an effective role in defusing tensions and avoiding tit-for-tat cycles of retaliation. A recent prominent example was the rare earths dispute (box 3.2). More broadly, there have been nearly 600 cases heard, with most adverse findings resulting in countries bringing their measures into conformity (Reich 2017, WTO 2019a). The WTO system stands in contrast to various dispute settlement arrangements under preferential trade agreements, which are perceived to offer less certainty, do not have established processes and secretariats and have not built the same jurisprudence base.

Notwithstanding high regard for the WTO's dispute settlement system, the Appellate Body has been a focus of recent criticism. The United States has raised a number of procedural concerns (such as the body's disregard for the agreed 90-day deadline for appeals), objections to the way the system operates (such as the body issuing advisory opinions beyond those necessary to resolve disputes, consideration of cases de novo, and a view that previous reports should be taken as precedents), and substantive concerns with the body's interpretation of WTO agreements in a manner they argue goes beyond the rights and

obligations that were negotiated by members. There is a fundamental lack of consensus among members on these matters.

Against this background, the US government has steadfastly refused to confirm new appointments to the Appellate Body. It remains unclear what change the US Administration would need to see to unblock appointments. If a solution to the standoff is not found soon, the Appellate Body will cease to operate by the end of this year, when the terms of the two incumbents expire.

Box 3.2 The rare earths dispute brought to the WTO

Political tensions flare up from time to time and sometimes spill over into trade policy. Following a territorial dispute with Japan and the arrest of a Chinese fishing captain, China banned exports of rare earth metals to Japan. This case was resolved after Japan, the United States and Europe took action against China in the WTO and China accepted the ruling against it.

The case is a good example of the dispute resolution system in action. The case involved Chinese export duties and quotas, together with restrictions on who can export molybdenum and tungsten.

China argued that the restrictions were related to the conservation of its exhaustible natural resources, and necessary to reduce pollution caused by mining. The complainants argued that the restrictions were designed to provide Chinese industry with protected access to the materials. For some of these materials, China is a dominant global supplier and export restrictions severely affect the operations of foreign manufacturers.

Both the initial panel and the Appellate Body found that the restrictions were in breach of China's WTO obligations.

Sources: Bradsher (2010), WTO (2015).

3.3 A path forward

With the commitment to free trade by some of our trading partners now in doubt and multilateralism itself under challenge, Australia can no longer afford to take for granted the effective functioning of the world trading system. Equally, resurrecting trade barriers is not a solution to the forces testing the continued support for open markets. The path forward has to lie with improving the system we have.

This review, however, is not the place to enter the debate about details of specific reform proposals to the WTO. Suffice to say that many consultations and proposals, including by Australia, are being put forward within the WTO and in other fora. Instead we apply a broader lens, outlining an approach that could help achieve better outcomes for Australians (and others) and foster public confidence in open market policies. It involves both measures that Australia can take alone and measures Australia could pursue in cooperation with others.

What can Australia do alone?

The single most important policy setting for Australia in the face of mounting troubles in the world trading system is to keep our own borders open to trade and investment and to continue working towards freer markets. Australia has successfully pursued this direction in the past.

Three specific areas that would move Australia in this direction and send out a clear and strong message of support for the rules-based trading system are worthy of consideration. They are to: lower remaining trade barriers; periodically review the design and adequacy of foreign investment screening processes; and bolster government efforts to explain how and why the community benefits from trade liberalisation.

At the same time, governments should pursue broader policies that strengthen the economy's resilience and the workforce's adaptability to technological changes, and that create an environment that spreads the benefits of globalisation more inclusively. These companion policies are discussed in PC (2017a).

Ample scope to lower Australia's own trade barriers

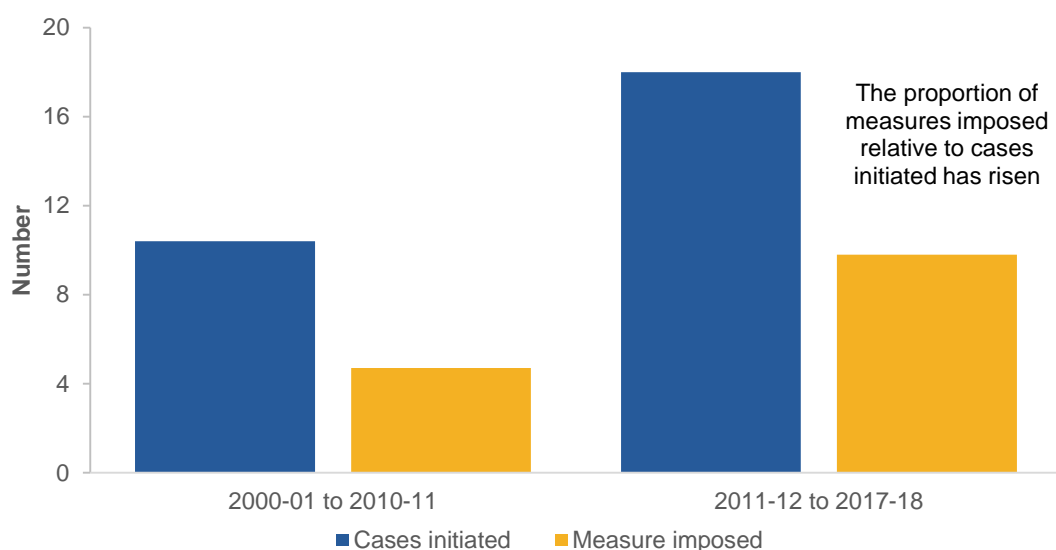
Notwithstanding Australia's much lower levels of assistance than in the past, ample scope remains to reduce obstacles to trade. Over 11 per cent of our imports in 2017-18 attracted an MFN tariff rate of 5 per cent, and over the past decade Australia has intensified its use of anti-dumping duties (figure 3.5). Furthermore, there is still less than full take-up of preferential trade agreement tariff preferences for imports into Australia, in part due to the compliance costs of satisfying the rules of origin (RoO) (Crook and Gordon 2017).

It is open to the Australian Government to remove trade restrictions and to avoid introducing new measures. One option would be to start with the many non-tariff barriers that lie behind the border. They take the form of domestic laws, regulations and practices and can particularly act to restrict trade in services. For example, burdensome licensing requirements in sectors such as architectural and engineering services can increase administrative costs on foreign companies or prevent them from practicing in Australia. Since many of these measures are the domain of state governments, the Council of Australian Governments (COAG) could be the body that initiates a process to identify, remodel or remove trade-restricting non-tariff barriers.

Another approach is to extend tariff and other concessions made in preferential trade agreements to other trading partners — that is, make them non-discriminatory or 'most favoured nation'. If achievable, this would remove the costs associated with complex RoOs on Australian imports, as they would effectively become redundant. A step further would be to remove 'nuisance' tariffs altogether.

Commission analysis has shown that a country gains most of all from reducing its *own* trade barriers, especially non-tariff barriers, regardless of what other countries do (box 3.3 and PC 2010).

Figure 3.5 Australia has intensified its recourse to anti-dumping duties
Anti-dumping activities before and after legislative changes in 2011



Source: Commission calculations.

Box 3.3 The benefits from unilateral liberalisation mostly accrue to the country itself

To illustrate the size of the benefits and their country distribution from unilateral trade liberalisation the Commission simulated a scenario where Australia removes all tariffs and reduces non-tariff barriers and regulatory barriers to services trade on an MFN basis.^a

The impact of this change is positive, boosting global economic activity by about US\$13.8 billion. Australia accrues about 85 per cent of this global increase in economic activity, equivalent to a 0.9 per cent increase in Australia's GDP. Measures of Australia's real income and purchasing power also rise.

The improvement in welfare reflects the more efficient allocation of resource allocation and the lower prices that flow from competition from foreign sources.

Removing non-tariff barriers generally improves welfare, independent of their impacts on trade. While they do not depend on trading partners taking similar action, it might be easier to implement such changes as part of a concerted regional effort.

To illustrate, a second simulation examined the effects of Australia and like-minded countries (RCEP for illustrative purposes) together removing all tariffs and decreasing non-tariff barriers and regulatory barriers to services trade on an MFN basis. In this case, RCEP countries benefit, like Australia, with higher economic activity and welfare. Moreover, the higher level of economic activity in RCEP countries boosts Australia's trade with the region, lifting Australia's overall gain by the equivalent of a further ½ per cent of our GDP (US\$6.2 billion).

^a For details about the model and the mechanisms driving the simulation, refer to PC (2017b).

Sources: Productivity Commission estimates; PC (2017a); PC (2017b).

It is noteworthy that according to Global Trade Alert, anti-dumping cases have been the single largest source of new trade restrictive measures introduced by Australia since 2009, despite their poor justification (PC 2016b). This in part reflects a series of legislative and administrative changes between 2011 and 2015 that made it easier for parties to make an anti-dumping case and more likely that duties would be granted, and at higher levels and stay in place longer (PC 2016b, table B.2). While anti-dumping duties are WTO-consistent and overall small in value when compared with general tariffs, their incidence is highly concentrated on a few firms. This makes their impact on the economy particularly harmful. They should be avoided.

The prevalence of global supply chains strengthens the case for unilateral action. Some links in the chain provide services, others provide goods, but they *all* contribute to the production of the final product. The ability to participate in global supply chains depends on being able to competitively source foreign inputs; foreign inputs are a complement to domestic value added in exports rather than a substitute for them. Regarding tariffs and market access as negotiating coin to be used in exchange for access to a partner's market or protection for domestic producers misses the point of global supply chains and is self-defeating.

Effective FDI screening

Foreign investment is also critical as a way into a global supply chain — as direct investment is often essential to trade — and leads to other benefits like technology diffusion. At the same time, some direct investments can pose a risk to national security or impose costs. Recognising these costs and benefits, Australia's foreign investment policy regime aims to prevent foreign direct investments (FDI) that are not in the national interest. It is not designed to provide protectionist measures to benefit Australian industries, but may have unintended consequences that do so.

Barriers to foreign investment are hard to measure on a consistent basis, due to the myriad ways a government might discriminate against foreign investors. There may be outright limits in specific sectors on equity ownership by foreigners, greater conditionality attached to regulatory approvals, or poor review processes that can act to stop a potential cross-border investment from even proceeding to the approval stage. In recent years, heightened national security concerns connected with critical infrastructure have led the Australian Government to add further foreign investment scrutiny by establishing the Critical Infrastructure Centre in 2017.

The theme chapter in last year's *Review* looked at the trade and investment implications of national security measures. It identified the 'very little visibility of the costs created by national security measures' (PC 2018b, p. 43). Consistent, transparent and predictable foreign investment processes, which also preserve our vital national security interests, matter for our reputation as an attractive destination for international investors. The Commission will be looking at FDI patterns and its policy implications in next year's *Review*.

Stronger engagement with the community

Some of the community disenchantment with the world trading system stems from within Australia. Past work of the Commission highlighted how bilateral agreements had not delivered the expected benefits in terms of increased trade or earned the broad support of the community (PC 2010). While market access under more recent trade agreements has expanded significantly, public misconceptions about the benefits and costs of such agreements continue to abound.

Higher quality consultation processes with the community would help to achieve better outcomes from our trade and investment agreements. Confidentiality agreements could be used to enable formal consultation on draft treaty text with stakeholder bodies during the negotiation process.

Similarly, once a draft agreement is completed, it could be exposed to public scrutiny before it is signed. These consultation practices would build a better appreciation of the choices and their respective pros and cons, combat perceptions that secrecy during negotiations leads to sub-optimal outcomes for some members of the community and foster public confidence in open markets.

More generally, governments need to recognise that the case for open markets cannot be taken for granted. Better engagement with the community around the rationale for free trade and clearer communication about policies to manage the costs of adjustment, and to support a more inclusive sharing of the benefits from open markets is needed to build community acceptance for open markets. Without this acceptance, it will prove very difficult for governments to continue implementing trade and investment liberalisation policies.

For engagement to be meaningful, however, it must not just focus on the positive news stories. It needs to better explain how, and why, the community overall benefits from trade liberalisation, while recognising there will sometimes be members of the community who lose out. At the same time, the community needs to understand what is at stake if tariffs and other barriers to trade are reinstated. The Commission's 2017 *Rising Protectionism* study included empirical analysis of the effects on Australian households of a global trade war. Two other recent notable examples of outreach by the Australian Government are the Department of Foreign Affairs and Trade's 2018 publication, *Benefits of trade and investment*, and work by the Department of Industry, Innovation and Science (Tuhin and Swanepoel 2017) that illustrated that exporters are more productive and pay higher wages than firms focused solely on the domestic market.

What can Australia do in co-operation with others?

Discontent with the world trading system and globalisation more generally is a broad phenomenon across parts of communities. While Australia can do a lot on its own, it should also continue to work with our international partners to address the existing shortcomings and tackle the new issues facing the world trading system. This is an ongoing task, but the current circumstances make it imperative to act decisively now.

Australia is well placed to make the case, and be a champion for change. Traditionally, we have punched above our weight at the WTO and we have a reputation as an honest broker. Australia initiated the Cairns Group of exporters that secured the ‘tariffication’ of agricultural quotas during the Uruguay Round. More recently our work with other like-minded countries helped to reach an agreement that commits members to remove agricultural export subsidies, and currently we are playing a leading role in the negotiation of an e-commerce plurilateral agreement at the WTO.

Efforts of this kind have typically been led by a small number of countries, but delivered improved outcomes for all. While it helps if some large economic powers are part of the process, it is not essential for it to work. They succeed because they build the case for reform through the careful and impartial compilation of the evidence, assessing the options and, through this process, gradually coalescing member states to support and adopt change.

While this approach to building consensus can be slow and does not always work, it is preferable to the alternative of managed trade blocs, or alliance structures that lack transparency or dispense with, and sometimes undermine, the well-accepted principles that underpin the rules-based trading system.

Australia will be best served by continuing to work with like-minded countries in efforts to build a new consensus on how to improve the world trading system through meetings of trade ministers, the G20 and other regional groups. For example, reform-minded trade ministers met in Ottawa last October (box 3.4) and set out some broad areas where collaboration could likely lead to tangible improvements. Less obvious to the public is the ongoing effort in Geneva by Australian officials and other WTO members’ representatives to develop and build support for reform proposals.

Using this as a starting point, the Commission sees two prospective areas for fruitful collaboration that would help to improve the functioning of the world trading system. First of all, pursue opportunities to reinvigorate the negotiation function of the WTO. Second, take stock of how well the existing agreements and notification procedures are performing to identify prospective areas for improvement, and how to get there.

Box 3.4 **The Ottawa ministerial on WTO reform**

With the WTO facing a number of challenges that are putting the world trading system under stress, in October 2018 Canada convened trade ministers from 12 WTO members, including Australia, that are committed to supporting and strengthening the multilateral trading system.

The purpose of the meeting was to initiate a dialogue aimed at identifying concrete actions to enhance and improve the WTO. The ministers' communiqué included five main messages. They:

- stressed the indispensable role the WTO plays in facilitating and safeguarding trade
- underscored the dispute settlement system as a central pillar of the WTO. It ensures rights and obligations are enforceable. They acknowledged that concerns have been raised about the system and are willing to discuss ways to safeguard and strengthen the system
- emphasised the need to reinvigorate the negotiating function. In particular, the need to conclude negotiations on fisheries in 2019, with an intent to strengthen disciplines on subsidies that contribute to over-fishing
- highlighted the need to address modern economic and trade issues and tackle unfinished business to ensure the relevance of the WTO
- recognised the poor record of compliance with notification obligations, which play a central role in ensuring WTO members understand the policy actions taken by their partners in a timely manner and called for a strengthening of the monitoring and transparency of members' trade policies.

The full text of the communiqué can be accessed here: <https://www.canada.ca/en/global-affairs/news/2018/10/joint-communiqué-of-the-ottawa-ministerial-on-wto-reform.html>.

Reinvigorate the WTO negotiation function

Well-designed trade agreements enable more businesses and people to participate in and benefit from the expanded opportunities they offer. The largest prospective benefits come from agreements negotiated with an extensive group of economies on a multilateral basis. However, on the multilateral front, the Doha Round of negotiations has come to a standstill and this situation is unlikely to change.

The failure of the Doha Round has acted like a litmus test for the broader malaise in the global trading system, and overshadowed the WTO's less widely known successes. Several multilateral and plurilateral agreements (that bind all members) on less comprehensive agendas have been concluded (box 3.2), average tariff rates have continued to fall, as countries implement earlier commitments, and (notwithstanding procedural concerns raised by the United States) the WTO's dispute resolution system works remarkably well, commanding very high rates of compliance with rulings and defusing stoushes that might otherwise degenerate into broader political conflicts.

These accomplishments in the WTO, and the Trans-Pacific Partnership regional agreement that developed outside of it (despite the United States withdrawing its support), suggest plurilateral agreements negotiated between subsets of WTO members are a means to reach a consensus on further liberalisation and to update rules that have not kept pace with technological and other changes in the trading environment (for example, digital trade).

Plurilateral agreements can be inclusive or exclusive (box 3.5). The inclusive (or critical mass) variety has less restrictive trade preference arrangements, and exclusive agreements negotiated under the auspices of the WTO offer some benefits. In particular, they provide a pathway through which non-participant countries can subsequently opt to accede to a completed agreement.

Box 3.5 **Types of WTO sector-specific agreements**

There are two main types of sector-specific agreements.

- *Inclusive* (or critical mass) agreements are negotiated on a most favoured nation (MFN) basis and typically come into effect when signatories account for 90 per cent or more of world trade in the product area in question. The Information Technology Agreement is an example, and illustrates the potential for plurilateral agreements to act as a stepping stone to multilateral liberalisation. Partners to the original agreement, concluded in 1996, numbered 29. Over time, the number of participants has increased to 82, accounting for 97 per cent of world trade in information technology products (WTO 2017, p. 2).
- *Exclusive* agreements are negotiated on a non-MFN basis. Benefits are restricted to participants, which may make them easier to negotiate. The Agreement on Government Procurement is an example.

Source: Draper and Dube (2013).

Australia has invariably been a participant in plurilateral and sector-specific negotiations and should continue to work with like-minded WTO members in the negotiation of such agreements, especially those that allow most favoured nation treatment. This approach can bring many of the benefits of liberalisation and act as a stepping stone to multilateral liberalisation. Importantly, they also provide flexibility, promoting some momentum for the willing to move forward together.

Towards a better rules-based trade system

The WTO has failed to keep pace with the changing nature of trade, notably the rise of sophisticated global supply chains and digital trade. In response, many members are negotiating on a bilateral basis to make progress where they are able. Australia has been a player in this trend, and now has eleven preferential trade agreements in force (and a further four agreed, but yet to enter into force), the more recent ones with provisions covering areas like regulatory co-operation, standards and government procurement.

The combination of an inadequate commitment to WTO processes and a lack of a consensus on the rules needed to handle new issues is undermining its authority and status at the centre of the world trading system. Indications of this are highlighted by US grievances about Chinese state owned enterprises allegedly having an unfair competitive advantage. Other member states cite their dispassion with the agreement on trade-related aspects of intellectual property rights (TRIPs), and yet others take exception with the ability of a member to self-declare as a developing economy and thereby lower their level of commitment (section 3.2).

These issues invariably are not breaches of WTO accession commitments, but reflect an apparent inability of the members to engage and resolve in good faith these and other matters as they arise. Nor are they straightforward, raising tricky conceptual issues relating to competitive neutrality, trade secrets and transparency. In short, there is an ongoing need for a balanced and informed debate among members on how to reinvigorate the whole trading system.

In this regard, Australia in collaboration with other member states could exert some influence and play a proactive role by putting forward proposals for discussion outside the formal bargaining processes of the WTO (but not necessarily outside the WTO), to help bridge the impasses facing the world trading system. Specifically:

- We have experience operating an independent competitive neutrality complaints mechanism over unfair competition from significant government business activities or state-owned enterprises. A model of a similar kind could be examined, as part of a broader dialogue on competition issues, for its feasibility within the WTO architecture. Another example lies with Australia's mutual recognition arrangements that allow different regulatory arrangements without impeding trade unnecessarily.
- As noted earlier, we have experience dismantling trade barriers of our own accord. We could lead, or sponsor through international agencies, technical assistance work in developing countries to promote awareness of domestic gains from unilateral liberalisation, and to share our experience and expertise with the tools of analysis, such as effective rates of assistance, that supported the case for open markets.
- We could initiate a process to develop and build consensus on a framework for classifying economies and when they transition to a developed economy status. This would help to bolster the integrity of the WTO's 'special and differential' treatment provisions. There is also scope to orchestrate a dialogue on how to incorporate into WTO agreements the advances made in agreements negotiated outside the WTO fold, such as with digital trade and standards.
- We could pursue at the WTO the long overdue cause of reviewing existing WTO agreements. Review provisions in the TRIPs Agreement (Article 71.1), for example, provide a mechanism to initiate an international dialogue on IP reform every two years; it has never been used.

The Commission recognises that initiating such processes is much easier said than done. Moreover, if advanced within a negotiating environment, it entails risks of backsliding, as once an agreement is reopened all aspects of it are 'on the table'. However, the importance of strengthening in an even-handed manner the rules-based system governing international trade, which has underpinned the growth in world trade and prevented a relapse into protectionism for the past 70 years, cannot be underestimated. As Christine Lagarde, Managing Director of the IMF put it:

'we need to reform the global trade system to make it even better, fairer, and stronger for all nations and all people. That means fixing the system, together, not tearing it apart.'
(Lagarde 2018, p. 2)