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Productivity Commission

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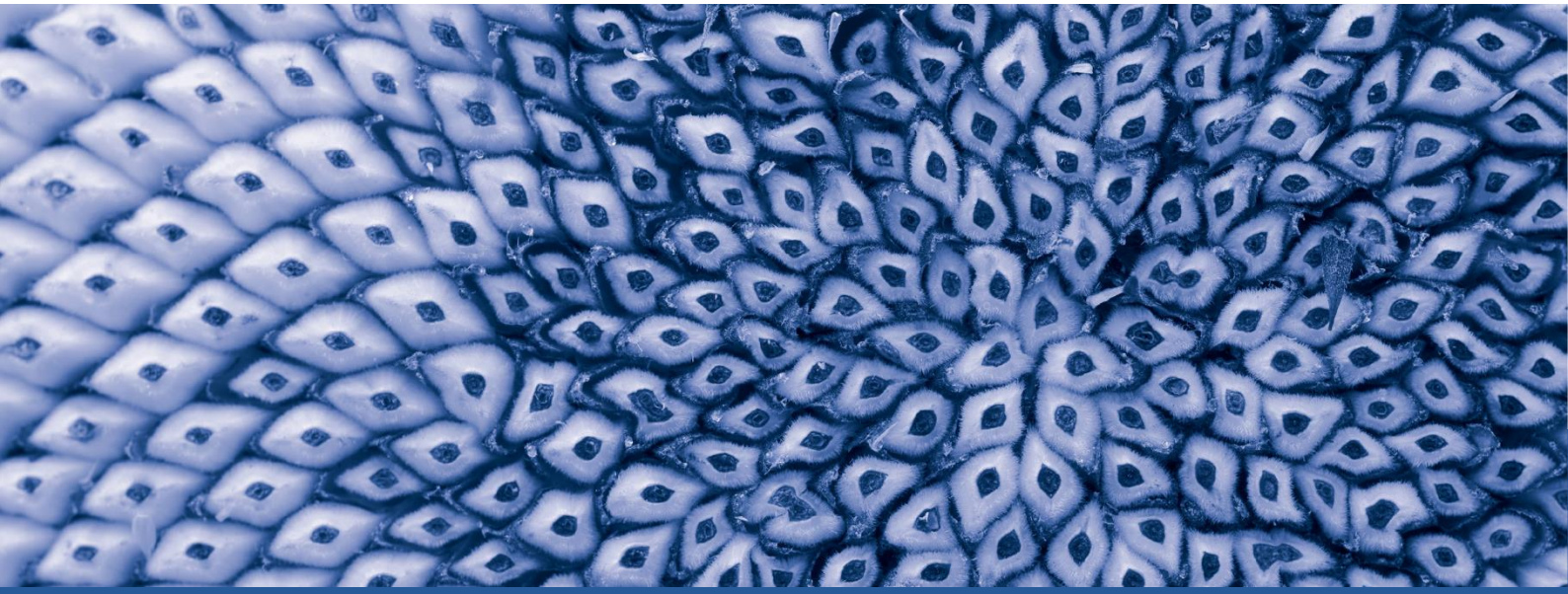

Inquiry into the Australian Government's approach to negotiating trade and investment agreements

Productivity Commission submission

The Productivity Commission acknowledges the Traditional Owners of Country throughout Australia and their continuing connection to land, waters and community. We pay our respects to their Cultures, Country and Elders past and present.

The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long-term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

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Introduction

The Productivity Commission (Commission) is pleased to make this submission to the Joint Standing Committee on Trade and Investment Growth.

The Commission is the Australian Government's independent research and advisory body on economic, social and environmental issues affecting the wellbeing of Australians. We contribute by providing quality, independent advice and information to governments, and on the communication of ideas and analysis.

The core function of the Commission is to conduct public inquiries at the request of the Australian Government on key policy or regulatory issues that affect Australia's economic performance and community wellbeing. In addition, we undertake research at the request of the Government and to support its annual reporting, performance monitoring and other responsibilities.

Terminology

The Committee's terms of reference refers to 'trade and investment agreements'.

Modern 'trade and investment agreements' are far broader and more comprehensive than what is needed for Australian exports of goods, services and investment to access foreign markets (referred to as 'market access') (discussed below).

Given this, coupled with the breadth of the issues included, modern trade agreements look much more like 'broad cooperation' agreements in which countries commit to solving a range of problems bilaterally or in small or more extended groups. This submission refers therefore to such broad cooperation agreements that have evolved from the more narrowly defined trade agreements. The submission also uses the term 'preferential agreement' to collectively refer to bilateral and/or plurilateral agreements.[1]

Trade and investment are vital to the Australian economy

International trade and investment are vitally important to the Australian economy. Barriers to trade and investment pose a risk to economic growth and living standards (PC 2017, p. 16). Exports accounted for over one-quarter of Australian gross domestic product in 2022-23 (exceeding $685 billion or 27% of GDP), with imports accounting for one-fifth ($547 billion or 22% of GDP) (ABS 5206.0).

Exports enable Australia to earn the foreign income that it needs to buy the goods and services that it does not produce or is less efficient (more expensive) at producing. Export industries also provide significant employment to Australians, enabling workers to earn higher incomes than otherwise.

Imports are essential to the health and vitality of the domestic economy and for the wellbeing of Australian consumers. Domestic producers use imported goods and services as inputs into Australian production, and imported capital goods are vital for Australia's future productive capacity. Australian households consume a wide range of imported goods and services, ranging from food, beverages clothing, medicines, motor vehicles, household and electrical equipment through to art, culture, movies, entertainment and games. Imports also provide additional competition to Australian producers, strengthening and deepening Australian markets and lowering the cost, and improving the quality, of Australian goods and services. This extra competition helps make Australian producers more efficient and internationally competitive, by lowering their

[1] Preferential trade agreements are often called 'free trade' agreements.

input costs and the costs of Australian producers that use their outputs as inputs into their own production. It also lowers costs to Australian consumers.

Trade enables Australians to enjoy a higher standard of living than they would have otherwise by enabling Australia to concentrate on those activities in which it has a competitive advantage. Allowing other countries to do the same also benefits Australian producers and consumers by providing them with a wider variety of goods and services or access to superior or cheaper goods and services. This allows Australia to use its scarce and valuable resources more effectively.

The broader context of the Committee's work

While trade and openness are key drivers of Australia's productivity and future prosperity, the Committee's work comes at a time of rising protectionism around the world (Robson 2023). The reasons for this include:

- An increase in mercantilist and protectionist sentiment over the last decade.
- Growing concerns about economic resilience and vulnerable supply chains, particularly in light of the COVID-19 pandemic.
- Growing geopolitical and geostrategic tensions, including Russia's invasion of Ukraine – but also in other parts of the world.
- The challenges posed by policy responses to climate change, including most notably the decarbonisation of the global economy and the global energy system in particular.
- Recent policy responses by major economies, which tend to provoke responses from other countries.

In addition, there are some broader economic realities that are relevant for the Committee's deliberations.

- Australia is now largely a services-based economy, and we need to prepare for a world in which those services are increasingly traded across borders (PC 2023a, p. 96).
- Most Australian assistance is now 'behind the border' in the form of tax concessions and spending (PC 2023b). Other countries are increasingly doing the same. In many cases, it may not immediately be obvious that these forms of intervention actually constitute a form of protectionism – sometimes policies have a mix of objectives and it is difficult to disentangle the protectionist element from other parts (PC 2022b).
- E-commerce, online work in less secure environments (such as employees' homes) and new data-intensive technologies such as artificial intelligence (AI), 5G, the Internet of Things (IoT) mean that privacy and the freedom of cross-border data flows are becoming increasingly important.
- Climate policy increasingly looms large over trade issues (PC 2023b, pp. 20–31) (and may be used to mask further moves towards protectionism – see PC (2022b)). Trade in certain kinds of capital goods and environmental goods and services may become more important as nations transition to net zero.

In this context, it is also worth noting that most imports of goods into Australia attract a zero tariff rate. Australia's tariff system raises little revenue relative to the compliance costs that it creates, and tariffs no longer protect domestic industry. The case for retaining tariffs as a bargaining chip, to be 'traded away' in future trade negotiations is weaker than ever.

Finally, Australia is also a prolific user of anti-dumping measures (including countervailing measures). These measures create unnecessary costs and the regime needs reform. They should progressively be dismantled and that any new measures are subjected to an economy-wide cost-benefit test.

Commission work on trade and investment policy

The Commission's work in analysing and assessing the impacts of Australian trade and investment policy is extensive (figure 1). Some studies are ex post assessments of the actual effects from trade agreements (such as PC (2010)), while others are ex ante assessments of the potential effects of particular policy options (such as PC (2017)). Other studies focus on specific aspects of these agreements, such as their 'rules of origin' (such as Crook and Gordon (2017)) and trade restrictiveness (such as PC (2005)).

Many of these studies are particularly relevant to the Joint Committee's terms of reference.

- The 2022 report on *The Nuisance Cost of Tariffs* focuses on the costs that the complexities of the tariff system, especially the complexity of the many agreements that affect Australian imports, and other restrictions on international trade impose on businesses that interact with them and on the rest of the Australian economy (PC 2022a).
- The 2017 report on *Rising Protectionism* looks into the threats and opportunities for Australia from changes in the international trade policy environment, including the potential effects of acceding to different trade agreements (PC 2017).
- The 2010 report on *Bilateral and Regional Trade Agreements* provides a detailed examination of several of Australia's international trade agreements, how they are negotiated, how they operate, their effects and areas to improve their effectiveness (PC 2010). While this report may be dated, its findings remain particularly relevant to the Joint Committee.

Figure 1 – The Commission's reports on trade and investment

Trade agreements	Rules of origin	Industry assistance/ compliance costs	Investment
***Rising Protectionism: challenges, threats and opportunities for Australia* (2017)**	***Rules of Origin: can the noodle bowl of trade agreements be untangled?* (2017)**	***Trade and Assistance Review* (annual)**	***Prudential Regulation of Investment in Australia's Export Industries* (2021)**
***Bilateral and Regional Trade Agreements* (2010)**	***The Restrictiveness of Rules of Origin in Preferential Trade Agreements* (2005)**	***Optimal Industry Policy* (2023)**	***Foreign Investment in Australia* (2020)**
	***Rules of Origin under the Australia-New Zealand Closer Economic Relations Trade Agreement* (2004)**	***The Nuisance Cost of Tariffs* (2022)**	
		***Future Ready? Australia and international trade in the post-pandemic global economy* (2022)**	
		***Supporting Australia's Exports and Attracting Investment* (2019)**	

Insights into aspects of the Committee's terms of reference

As mentioned above, modern trade and investment agreements go well beyond what is required to improve market access and include chapters and clauses that affect many other aspects of the Australian and partner economies. The Australia–United Kingdom Free Trade Agreement, for example, contains 32 chapters. In addition to chapters that relate explicitly to trade and investment, the agreement includes chapters on intellectual property, government procurement, competition policy and consumer protection, state-owned enterprises and designated monopolies, innovation, labour, environment, development, trade and gender equity, animal welfare and antimicrobial resistance. The Australia-United Kingdom Free Trade Agreement is not alone in this regard. The breadth of topics covered is a feature of modern trade and investment agreements.

The potential breadth of each future agreement raises a series of important questions that should be answered before proceeding to develop and negotiate an agreement.

The first question is what the purpose of the proposed agreement is. Trade agreements traditionally focused on increasing access to foreign markets for Australian businesses. Such agreements would then focus on reducing or eliminating barriers that restrict access. Broad cooperation agreements go well beyond what is required for market access. There may be legitimate reasons for countries entering into agreements to address those topics that form part of broad cooperation agreements. But the reasons for including them in a trade and investment agreement are often unclear, and it is unclear that a broad cooperation agreement is the best way of addressing many of these issues. If they are to be included in trade and investment agreements, the rationale for including such provisions should be clearly spelt out.

Once the purpose of a proposed agreement is clear, the next question should be to identify what we hope to achieve with the proposed agreement. What are its intended objectives and goals? Articulating these objectives and goals is important for developing a suitable framework to ensure that the negotiated agreement achieves them (point 'a' in the terms of reference).

The final question should be whether these goals are worth pursuing and, if so, whether they should be pursued through an international agreement (either through a trade or a broad cooperation agreement) or through some other means (such as through international standard setting bodies or another forum such as the OECD, or at the other end of the spectrum, through domestic policy or unilateral action).

The following sections address these questions.

Agreements should improve the wellbeing of Australians

Trade and investment are not goals in themselves. They are a means to an end, which is to improve the living standards of Australians. Accordingly, trade and investment agreements should not be negotiated to solely facilitate trade. They should be motivated by the fact that they are in the national interest and seek to improve the wellbeing of Australians (point 'f' in the terms of reference).

Agreements designed to contribute to the 'national interest' or the wellbeing of the Australian community points to the need for negotiation mandates to be defined through broad ranging consultation, seeking input from parts of the community who might not traditionally contribute to the process. This is especially important with the increased complexity and comprehensiveness of agreements that include clauses on a myriad of aspects of civil and economic life. Identifying what is in the national interest and what will improve the wellbeing of Australians is central to developing a mandate for each agreement. This requires the Government and the Department of Foreign Affairs and Trade (DFAT) to consult widely to identify what is in the national interest and what will improve the wellbeing of Australians (point 'c' in the terms of reference).

Wide consultation is also a way to identify the barriers that agreements may seek to reduce and help identify priorities. This will require actively seeking out relevant stakeholders and engaging in broad consultation rather than just listening to the loudest voices. The most appropriate stakeholders to consult will vary depending on what the agreement seeks to achieve, and the provisions being contemplated. But the expanding coverage of agreements means that the required consultations are likely to be even broader, and required to occur more often during the lengthy negotiation process.

It is important that the anticipated benefits from any proposed agreement outweigh the anticipated costs. That is, it is important that each agreement will result in an expected net benefit to Australia and for Australians. Producing an expected net benefit is a prerequisite for being in the national interest.

The reasons for including each provision should be sound

The reasons for including non-trade provisions in broad cooperation agreements should be sound and based on careful consideration. A detailed public inquiry could be undertaken:

- to identify the appropriateness of existing arrangements relating to these areas
- to consult widely with stakeholders
- to identify the most appropriate policy responses for remedying any impediments identified
- to identify how best to improve the effectiveness and efficiency of existing arrangements to improve the wellbeing of Australians.

This points again to the need for broad consultation mechanisms and critical analysis. The consequences of including inappropriate provisions in broad agreements can be high and potentially detrimental to what is in the national interest (point ‘f’ in the terms of reference).

It is not clear why the objectives being targeted by the non-trade provisions of broad cooperation agreements are best addressed through inclusion in these agreements, rather than through other means.

Including services raises many additional issues

Liberalising trade in goods is more straightforward than liberalising trade in services, and, hence, more amenable to inclusion in trade, investment and cooperation agreements. It is easier to identify, quantify and negotiate reductions in the barriers that adversely affect goods trade. These barriers typically take the form of tariffs and quantitative restrictions (such as quotas) that artificially restrict the flow of goods into a country and generally apply directly to the good being traded when it crosses the border (with potential flow-on effects to government revenue and users and consumers of these goods). These barriers impede access by foreign providers to domestic markets. While the negotiations themselves may not be easy, identifying what is required to improve market access for goods is relatively clear cut.

However, international trade in services is intrinsically very different from international trade in goods. International trade in services can occur through a number of different mechanisms (or ‘modes’ in the terminology of the World Trade Organization (WTO)):

- a producer in one country providing a service to a consumer in another country (referred to as cross border supply – mode 1)
- a producer providing a service to a consumer in the producer’s home country (referred to as consumption abroad – mode 2)
- a producer providing a service to a consumer in the consumer’s home country through a physical presence (foreign commercial presence – mode 3)
- a producer providing a service to a consumer in the consumer’s home country through the temporary movement of people (movement of natural persons – mode 4).

Cross-border supply of services is similar to the way in which trade in goods occurs. An example of cross-border trade in services would be when a consumer in one country engages a consultant in another country to prepare a report for them. This may or may not also involve the temporary movement of people (such as undertaking face-to-face consultations with the customer or site visits). The report crosses the border with a financial payment going in the opposite direction.

However, most international trade in services does not occur via cross-border trade. Mode 2 involves the consumer travelling to the producer's home country where the service is provided. Tourism is an example of mode 2. Australia exports tourism services when visitors from overseas spend money holidaying in Australia. Mode 3 involves the producer having a commercial presence in the foreign country via foreign direct investment. An example would be where the service is provided through a foreign subsidiary.

Modes 2, 3 and 4 involve delivering services directly into the domestic market (either of the producer or consumer). This makes it more difficult to identify and measure international trade in services compared to international trade in goods. It also makes it harder to identify the barriers to trade and what is the appropriate policy response.

Another distinguishing feature is that quality (whether actual or perceived) is often integral to the delivery of the service and, hence, to international trade in services. Many professions particularly in the areas of medicine, the law, taxation, financial services and engineering are regulated to protect consumers. Restrictions apply to both domestic and foreign businesses and people wishing to undertake such activities. Foreign businesses may be subject to additional requirements that domestic providers do not have to comply with (such as having their qualifications and competencies officially recognised or having to sit additional examinations to demonstrate their proficiency). There may or may not be sound reasons for the additional requirements for foreign providers (such as requiring a commercial presence so that consumers can pursue legal action against the provider in the event of tort).

These and other factors make the regulation of services less straightforward than for goods. As they also apply to domestic consumers, it is important that these regulations are set appropriately, reflecting local societal values without engendering onerous costs. Determining this requires a thorough examination of the issues and the effects of regulations, and identifying the benefits, costs and alternatives to achieving the policy objectives that gave rise to the regulation in the first place. This will generally involve identifying and consulting with a much broader range of stakeholders than for goods, and assessing what is in the national interest is more complicated and involves balancing competing trade-offs. Doing this takes time and expertise. An example of the complexities involved and of the expertise required is: what are the most appropriate arrangements for protecting intellectual property and how long these protections should operate for. Decisions on what is the appropriate way to regulate intellectual property will have important implications for the Australian economy and for Australians. What is in Australia's national interest may not necessarily align with what is in other countries' interests.

Other policy responses will often be more effective

Australia could unilaterally address many of the provisions in broad cooperation agreements through appropriately considered and targeted domestic policy. The pursuit of objectives related to gender equality, for example, do not need to be included in a bilateral international agreement, but could instead be progressed independently by appropriate policies. At the other extreme, securing compliance with certain international standards may be best achieved through multilateral fora, rather than via a series of bilateral or multilateral trade agreements.

Arrangements should be consistent across agreements

Given the number of preferential trade and broad cooperation agreements in place and given their breadth, it is important that the provisions are as consistent as possible across agreements to reduce the cost of complying with and administering these agreements.

Government policies play an influential role in determining the environment in which trade and investment occur

Australian and overseas government policies shape the environments in which international trade and investment occur. Some policies apply specifically to international trade and investment (such as the application of tariffs and quantitative restrictions on imports and restrictions on foreign ownership). Other policies apply indirectly by affecting domestic economic activity and market conditions (such as the type and level of domestic taxation and regulation). These policies influence the decisions of producers and consumers in Australia and overseas about what to produce and what to consume and from where to source these goods and services. In short, domestic policies have the potential to affect the incentives that Australian and overseas producers and consumers face, with the consequence that the policies may alter the decisions that would have been made (such as from where to source a particular good or service and its price) all the way through to potentially choking off trade and investment entirely. These government policies may have material consequences for Australian living standards if the implications of the policies being put in place, both in Australia and overseas, have not been properly thought through.

As international trade in goods involves physically moving goods across international borders, the barriers to international trade in goods often arise at the border where the goods enter a country. Many goods are subject to tariffs that increase their cost, thereby artificially reducing their competitiveness compared to locally produced goods. Quantitative restrictions such as quotas may also restrict the amount of trade that can occur. Imports may be subjected to customs, quarantine and other clearance processes, which, if excessive, increase the costs of trade unduly. Imported goods will also need to meet the same requirements for sale as domestically produced goods (such as meeting packaging, labelling and product safety standards). Export restrictions may constrain or prevent international trade in some goods (such as weapons or sensitive technologies).

Barriers to international trade in services and investment often arise from domestic policies that affect the extent to which foreign providers can participate in domestic markets (including those that prevent them from doing so). Barriers often arise from inconsistencies in the treatment afforded to foreign firms compared to the treatment afforded to domestic providers (referred to as ‘national treatment’). A particularly important barrier for trade in many services is where the qualifications and accreditation earned in one country are not recognised in the partner country, even though the services being provided and their quality are ostensibly the same. This affords an element of protection to domestic service providers. Mutal recognition, national treatment and the ability of key personnel to move between regions are important for international trade in many services.

Barriers to international trade in services and investment frequently arise well beyond the border and are often also important for the functioning of the domestic economy (services now account for over 80% of Australian economic activity). While they will have important implications for international trade in some products and services such as pharmaceuticals, movies and innovation, the rules governing intellectual property have important implications for Australian businesses and consumers in the domestic market. The risks from including inappropriate conditions in such agreements are particularly high.

Australia's approach to formulating trade and investment policy has evolved over time

Australia's trade and investment policies have evolved over time. These changes have evolved with Australia's economic development. Understanding these changes and why they occurred conveys important lessons for formulating future trade and investment agreements, and therefore the required negotiation mandates.

Australia has always relied on foreign capital

The Australian economy has always relied on foreign investment to augment the domestic capital stock and to facilitate Australian production. Initially, this capital came primarily from the United Kingdom; now significant investment originates from the United States, the European Union, Japan, Hong Kong, Singapore, Canada, New Zealand and Korea. Foreign investment in Australia totalled almost $4.6 trillion in 2022 (ABS 5352.0).

Over time, investment by Australians overseas has increased to include many of the economies that invest in Australia (such as the United States, the United Kingdom, New Zealand, the European Union, Japan, Canada, Hong Kong and Singapore). Australian outward investment in 2022 totalled $3.7 trillion (ABS 5352.0).

This means that, in level terms, foreign direct investment in Australia exceeds Australian investment abroad.

After an initial focus on exports, Australia shifted to import replacement

The initial focus of the Australian colonies was on survival, with the development of domestic agricultural production being central to this. The development of pastoral industries led to the development of the wool industry, enabling Australia to export fine wool to Britain. The discovery of gold in the mid nineteenth century led to the development of the mining industry that gave rise to mineral exports. Australia was the world's richest nation in terms of GDP per person at Federation on the back of these exports (Banks 2003).

As the world industrialised during the early twentieth century, Australia followed suit. The focus of Australian trade policy shifted towards developing domestic industries to replace imported manufactured goods. Tariffs were levied on imported goods to make Australian manufactured goods more competitive in supplying the domestic market.

The Colony of New South Wales first introduced tariffs on imported alcoholic beverages in 1800 to raise revenue. Tariffs were applied to tobacco in 1818. The other colonies followed suit when they were established. These tariffs became an important source of revenue for the colonies.

The focus from tariffs as a source of revenue shifted in 1866 when Victoria broadened the range of imports subject to tariffs to include most manufactured goods to provide employment for miners. Most colonies other than New South Wales followed suit. This marked the start of using tariffs to protect domestic producers from competition from imported goods.

The consequence of this was that Australian producers that used imported inputs and Australian consumers faced higher prices for these goods. The resulting higher production costs meant that Australian manufacturers were high cost, inefficient and not competitive in world markets, thereby limiting their ability to sell into world markets, many of which were significantly bigger than the Australian domestic market.

Tariff rates and industry assistance steadily increased to shield Australian producers from import competition (Banks 2003).

Australia then undertook unilateral reform

The direction of trade policy changed again in the 1970s, 1980s and 1990s, as Australia began to better understand the adverse effects of this protection on the competitiveness of Australian firms and the cost to Australian consumers. Recognising that the existing tariff structure was inefficient, inequitable and against the national interest, the Whitlam Government unilaterally cut Australian tariffs by 25% across the board in 1973. This started a series of reforms aimed at making the Australian economy more internationally competitive, including the establishment of the Industries Assistance Commission, the precursor of the PC, in January 1974 (Banks 2003). This resulted in a shift in focus away from import replacement to becoming more export-orientated. A key feature of these reforms is that they extended well beyond trade policy to include domestic reform as well. Another key feature was that Australia undertook these reforms unilaterally as they were in the national interest and not because other countries agreed to reform their economies.

Australia pursued multilateral efforts to reform international trade

Australia has always been a keen supporter of the international rules-based global trading system. It has also been a strong supporter of efforts to reform and modernise these rules. Recognising the distortionary effects that selective trade barriers can have on trade, Australia has a long track record in advocating for a non-discriminatory multilateral approach to trade policy whereby developed countries are treated equally with concessions for developing countries.

Australia resorted to the use of preferential agreements

The breakdown of the Doha round of multilateral trade negotiations in November 2011 and the inability/failure to revive/conclude multilateral negotiations led to fundamental changes in the way that the international trading rules were set.

Prior to Doha, multilateral rules that applied to all countries that were members of the WTO governed international trade, with limited use of bilateral trading agreements between signatory countries (initially pairs of countries). The 1983 Australia-New Zealand Closer Economic Relations Trade Agreement was an exception to this, as an early example of a relatively comprehensive agreement that went beyond the multilateral agreements on trade in goods.

After the breakdown of the Doha Round, there was a proliferation of, at first, bilateral, and then plurilateral, trading agreements that sought to circumvent the failure of the multilateral round to advance trade reform. These agreements involved commitments between the signatories to reduce barriers to trade, and sometimes investment, in specific agreed areas.

Each preferential trade agreement differs in terms of:

- the sectors and products included
- the concessions made
- the period over which these commitments are phased in
- the rules that determine which exports from each country are subject to the preferential arrangements in the agreement (referred to as ‘rules of origin’).

Rules of origin are intended to prevent trade from third countries being re-routed through one of the signatories to benefit from the preferential arrangements negotiated (discussed below).

As these arrangements vary between agreements, the proliferation of preferential trade agreements has given rise to fragmented and piecemeal rules that govern international trade. These arrangements vary depending on the good and service and the country concerned. The resulting ad hoc and piecemeal arrangements impose substantial compliance costs on businesses that seek to utilise these agreements.

Preferential trade agreements are practical workarounds to the impasse on multilateral reform. Given their fragmented and piecemeal nature, they are inferior to multilateral reform and involve compliance costs. They are generally viewed as being better than no reform, but it is important to avoid preferential agreements from being barriers to multilateral agreements.

One consequence of the rise of preferential trade agreements is that disputes are handled between member countries according to the provisions within the agreement rather than through the WTO's dispute-settlement mechanism, with the result that the decisions only bind the signatories to that agreement and not all WTO members.

Australian agreements have become broader and more complex

As mentioned, Australia's trade agreements have broadened their focus over time. Our early agreements focused on removing tariff and non-tariff barriers (such as quotas) to international trade in goods. Subsequent agreements included barriers to trade in services, including the temporary movement of people, and then to include impediments to international investment. Recent agreements, such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, include a raft of additional provisions that cover areas such as digital trade, health, the environment, labour, and anti-corruption.

Preferential agreements are now central to international trade and investment

Australia is currently a signatory to 18 preferential trade agreements involving 30 economies (DFAT 2023).[2] Many of these economies are signatories to multiple agreements with Australia (including, but not limited to, New Zealand, Singapore, Malaysia, Indonesia, Thailand, Japan and Vietnam). They accounted for 81% of Australian goods trade in 2021-22 (85% of Australian exports and 75% of imports).[3]

The scope for future gains is limited

Trade agreements benefit many Australian exporters by, over time, lowering tariffs and relaxing (or removing) other forms of protection that foreign governments levy on our exports. This confers a price advantage to Australian exports and should increase Australian export volumes, which may occur at the expense of exports from countries that are not party to the agreement. Australian reductions in tariffs and other restrictions lower the cost of goods imported from the partner country to Australian businesses and consumers. The resulting cost savings also benefit Australian exporters.

[2] The 30 economies include Hong Kong and China but not Nauru, which has signed but not ratified Pacific Agreement on Closer Economic Relations (PACER) Plus to which Australia is a signatory. The 18 agreements do not include the preferential arrangements that Australia affords some developing countries, such as Papua New Guinea, that are not reciprocated.
[3] Not all trade between Australia and these economies is covered by the 18 preferential trade agreements. Goods trade accounted for 90% of measured Australian exports and 84% of measured Australian imports in 2021-22 (ABS 5302.0).

Trade agreements have resulted in some appreciable reductions in tariff barriers faced by Australian suppliers in partner countries, notwithstanding some carve outs or long phase-in periods for tariff reductions (or quota increases) (PC 2010).[4]

However, the potential for similar gains arising from future trade agreements will decline as the number of agreements to which Australia is a signatory increase and as more of Australia's trade is covered by such agreements.

Preferential agreements can have a material effect on trade flows

Tariff preferences in trade agreements have the potential to 'significantly increase trade flows between partner countries, although some of this increase is typically offset by trade diversion from other countries' (PC 2010, p. XX). The Commission went on to find that the 'increase in national income from preferential agreements is likely to be modest'. The Commission received little evidence from business to indicate that bilateral agreements to date have provided substantial commercial benefits. This may be because the main factors that influence the decisions to do business in other countries lie outside the scope of these agreements.

The primary costs of trade agreements arise from their complexity

The primary costs of Australia's tariff system arise from its complexity rather than from the distortions caused to economic activity (PC 2022a, p. 2). These costs reflect the concessional and preferential nature of Australia's tariff system.

Given that they are so small, both in level and product coverage, tariffs protect very few Australian producers. Distortions from reallocating labour and capital toward relatively inefficient businesses are much smaller compared to when tariffs were more prevalent: some tariffs are applied to imports that do not compete with domestic products, the tariff rate is low, and tariffs are applied to a small number of imports.

The main effect of the current tariff system is to increase the cost of inputs to businesses that use imports and eventually increase consumer prices. Although the cost of the tariffs themselves might be small in aggregate, they add to the costs of the imports that they apply to, and there are costs to businesses from complying with the system, such as identifying whether they qualify for any concessions or for a preference under a preferential trade agreement. In accessing a preference, businesses incur an average cost of 0.9–2.8% of the value of the imports to which the preference was applied to avoid paying the tariff of 5% of the value of imports. This includes the costs to foreign exporters of meeting the local content requirements necessary to qualify for the preference, which are largely passed through to Australian businesses and consumers. In some cases, businesses do not access a preference either because they are unaware of its existence or because the cost of accessing it is too high. Tariffs also enable Australian businesses that compete with imports to increase the prices that they charge Australian consumers.

As the number of concessions and the number of preferential trade agreements increase, the costs of the system increase and the amount of revenue decreases, making each dollar collected more expensive to collect. The implementation of agreements with the United Kingdom, India and the European Union were estimated to reduce revenues from $1.5 billion currently to $579–664 million, raising system costs to $1.41–4.81 per dollar of revenue collected (PC 2022a, p. 2).

[4] An increase in a quota enables more imports to enter a country and, as such, constitutes a lowering of barriers to international trade.

Much of this complexity arises from the rules of origin that are central to the operation of preferential agreements

The preferential treatment of trade between signatory countries requires rules of origin to determine which goods are from signatory countries and, hence, eligible to access the provisions under the agreement and which ones are not. These rules are intended to stop exporters in countries, other than partners to a preferential trade agreement, from availing themselves of the preferences negotiated in the agreement. Goods partly manufactured in a partner country (using inputs from non-partner countries) are only eligible for preferential tariff treatment if the local manufacturing has sufficiently transformed the non-partner inputs. The rules of origin in the agreement sets out the criteria for what constitutes sufficient transformation. These arrangements involve a lot of complexity and additional cost (box 1).

Box 1 – Trade agreements and rules of origin

Rules of origin set out the criteria for accessing the provisions in each preferential trade agreement. Goods partly manufactured in a partner country (using inputs from non-partner countries) are only eligible for preferential tariff treatment if the local manufacturing has sufficiently transformed the non-partner inputs.

While the historical reason for prescribing substantial production transformation tests was to prevent firms in countries outside the agreement taking advantage of the agreement by transhipment, they involve a lot of complexity and additional cost. They also distort firm behaviour, which gets compounded with multiple agreements. Moreover, the rationale for 'strong' transformation rules, to dissuade (re-package and run) transhipment, has lost currency for Australia, given the low rates of tariffs and higher share of trade now covered by preferential trade agreements.

Rules of origin have become a pernicious barrier to trade for Australian business. Their inherent protectionism is little known – well disguised in their daunting yet mind numbingly dull complexity. Rules of origin are transformation tests (often requiring a local value-added threshold be met) to earn tariff and quota preferences under preferential trade agreements. They are a non-tariff barrier. The more stringent the transformation test, the greater protection afforded and higher the import prices for consumers.

Australia's preferential trade agreements contain rules of origin that can differ widely between agreements, creating a messy 'noodle bowl' that is hard for many Australian exporters and importers to navigate and raises the cost for those that do.

Rules of origin are insidious as they afford an impression of trade concessions, but instead their complexity and restrictiveness substantively erode the purported positive trade impacts of the preferential trade agreement. One study estimated that rules of origin (across 149 countries) reduced the trade creation effects of preferential trade agreements by around two thirds.

The costs of rules of origin (which also include business uncertainty and trade concession erosion) will only worsen in a world of fragmented global value-added chains and preferential trade agreement proliferation.

Preferential trade agreements will not deliver on their 'advertised' trade benefits if future regional agreements do not reduce rules of origin stringency and work toward removing them altogether – untangling the 'noodle bowl' thus far created. Removing rules of origin that limit broader liberalisation

Box 1 – Trade agreements and rules of origin

may allow preferential trade agreements to become stepping stones for multilateral trade liberalisation, rather than the stumbling blocks they are today. The most effective remediation is unilateral (most favoured nation) tariff liberalisation. This would make importing simpler and less costly and assist Australian exporters through lower input costs.

In summary, rules of origin 'make accessing the benefits of trade agreements about as easy as eating a bowl of noodles with only one chopstick'.

Source: Crook and Gordon (2017).

Rules of origin are discriminatory. They provide an incentive for producers to purchase inputs from suppliers in member countries rather than from other, possibly lower-cost, sources. The additional costs can outweigh the gains from more liberal trading arrangements (PC 2004).

The low level of Australian tariffs means that the rules of origin in each agreement impose significant compliance costs on businesses to secure a minimal reduction in the tariff rate that Australia levies on their imports. This points to the costs of such arrangements outweighing the potential benefits for business. Including the costs incurred by government in administering these complex arrangements further weakens the case for them.

The proliferation of preferential agreements creates inconsistencies across agreements

The proliferation of preferential agreements creates inconsistencies across agreements. The rules of origin, for example, can differ widely between agreements, creating a messy 'noodle bowl' that is hard for many Australian exporters and importers to navigate and raises the cost for those that do' (Crook and Gordon 2017).

The compliance costs associated with preferential trade agreements are compounded with multiple agreements owing to inconsistencies across agreements.

Given this, it is important to ensure that these agreements are effective and in the national interest

Agreements should produce a net benefit

The focus of broad cooperation and trade and investment agreements should be on what is in the national interest (point 'g' in the terms of reference), *not* just on the potential trade and investment implications. While trade and investment form an important part of what is in Australia's national interest and for improving the wellbeing of Australians, other considerations such as the cost to business of complying with the proposed arrangements and the cost to government of administering these arrangements should also be taken into consideration. Any wider costs should also be factored in (such as impacts on other producers and consumers).

The decision to enter into a broad cooperation or a trade agreement should reflect an expected net overall benefit to the entire Australian community rather than one that reflects narrow commercial interests.

Broad country coverage is often, but not always, desirable

It is not clear that plurilateral agreements are superior to bilateral agreements.

On one hand, the inclusion of more countries in plurilateral agreements provides access to a larger combined market for Australian businesses and consumers. The inclusion of more trade and economic activity is likely to reduce the adverse distortionary effects on international trade and investment flows. The rules of origin in plurilateral agreements will reduce compliance and administration costs compared to a series of independent bilateral agreements among the same countries. Having fewer agreements will also make it easier for businesses to understand and navigate.

However, on the other hand, plurilateral agreements run the risk of being weaker than bilateral agreements to accommodate the views and interests of the additional countries. Where the additional countries are relatively small, the costs of doing so might outweigh the benefits from increased market access.

A broader country coverage would be preferable to a narrower coverage when the resulting agreement moves Australia and the other countries closer to a world of multilateral reform.

Broader sectoral coverage is often, but not always, desirable

The arguments applying to broad versus narrow sectoral coverage are like those concerning the breadth of country coverage. Differences in the way services are traded internationally generally give rise to sector-specific commitments in international agreements. The temporary movement of people, for example, is more important for international trade in many services than for goods that can be shipped across borders. The inclusion of additional areas in agreements has the potential to produce wider benefits but runs the risk of resulting in weaker agreements to accommodate the broader sectoral coverage.

Favourable treatment (carve outs) afforded to some economic activities but not others encourage unproductive and undesirable rent seeking behaviour. This is likely to be more of an issue where the activities are similar in nature (such as different types of agricultural commodities or manufactured products). These carve outs should be avoided wherever possible.

Not all objectives should be included in trade and investment agreements

The shift to broader agreements that include provisions that target social and ethical objectives raises the very real risk of introducing new barriers to trade and investment. Linking trade and investment agreements to countries adopting 'appropriate' practices in the areas of labour, environmental, cultural and human rights can affect and target 'process and production methods' (PPMs). Such provisions are often justified on the grounds that they relate to 'the potential generation of negative externalities in the form of unforeseen or ignored impacts' (Read 2005, p. 240).

The inclusion of these broader non-trade objectives in trade and investment agreements is a contentious area of international trade and investment law. While PPMs can legally be included in certain circumstances and subject to them meeting certain conditions (Read 2005), including such provisions in trade and investment agreements is often not the best or most effective way of pursuing the desired policy objectives. More conventional means are often more effective, such as through diplomacy, other (that is, non-trade)

agreements or through fora such as, for issues relating to labour standards and working conditions, the International Labour Organization.

It is important to note that trade and investment have historically played important roles in economic development, which, in turn, has raised living and environmental standards in the economies concerned (examples include Japan, Singapore, Malaysia, Korea, Thailand, Hong Kong and China). But including broader issues within trade and investment agreements risks diverting the focus away from trade and investment and may well be counterproductive by stifling the economic development that would, in due course, bring about improvements in labour and environmental standards. There is also a real risk that such measures may amount to protectionism by stealth.

Agreements should avoid unnecessary complexity

It goes without saying that trade and investment agreements should avoid unnecessary complexity and seek to minimise compliance and administration costs. Complex agreements are difficult to understand and administer. Unnecessary costs are an impost on Australian businesses and consumers without any commensurate benefit. These costs will be lower when arrangements are as simple as possible and broad brushed rather than product or sector specific. The detrimental effects of compliance and administration costs can easily outweigh the expected gain to businesses and consumers from the lower tariff rates that flow from these agreements, such that they may not produce a net overall benefit.

Reforming the rules of origin is central to reducing complexity

Reform of the rules of origin is needed. Preferential trade agreements will not deliver on their ‘advertised’ trade benefits if future regional agreements do not reduce rules of origin stringency and work toward removing them altogether (Crook and Gordon 2017). Removing rules of origin that limit broader liberalisation may allow preferential trade agreements to become stepping stones for multilateral trade liberalisation, rather than the stumbling blocks they are today.

The most effective remediation to untangling the ‘noodle bowl’ created thus far by rules of origin is unilateral (most favoured nation) tariff liberalisation. This would make importing simpler and less costly and assist Australian exporters through lower input costs. The Commission has argued that there is no case against unilateral action, including that retaining tariffs as negotiating coin is weak given the low level of remaining tariffs and the costs they impose on importers and the broader Australian economy (PC 2010, pp. 214–216). Moreover, holding out for reciprocity would erode the wellbeing of Australians and deny the dynamic benefits of open markets.

Scope exists to improve foreign investment in Australia

In reviewing the policy framework that governs foreign investment in Australia, the Commission (PC 2020) identified improvements that could be made, including:

- The national interest test lacks clarity around how it is interpreted from case to case. Tighter policy guidance and excluding risks from the test that can be mitigated through national regulations (such as competition) would lower compliance costs and lift investor certainty.
- Attaching conditions to foreign investment approvals provides only a limited means to mitigate risks. National laws and regulations, together with purpose-built and adequately-resourced regulators (such as the Australian Competition and Consumer Commission, or the Critical Infrastructure Centre), where available, should be preferred.

The Commission went on to recommend the publication of reasons for decisions to block proposals, greater certainty around timelines, and aligning application fees with the actual cost of administering the screening regime would increase transparency, enhance predictability and lower the costs of the screening regime.

Agreements should be reviewed periodically

Agreements should be reviewed periodically to ensure that they remain relevant, continue to serve the national interest and that the provisions negotiated are operating as intended. Dispute resolution procedures seek to ensure that each country honours the commitments they make in each agreement. There is no guarantee that this remains the case. Dispute resolution provisions should be reviewed to ensure that they are effective and efficient. Provisions that relate to trade in services and investment can easily be rendered ineffective by the existence of other barriers that lie outside the agreement that can stifle trade or investment and undermine the effectiveness of the provisions negotiated. The provisions in the agreements may need to be broadened to include these barriers if the desired objectives are to be achieved.

Preferential agreements should support and be consistent with multilateral reform

Preferential agreements can be stepping stones

In its 2017 report on protectionism, the Commission argued that Australia should continue to work towards freer markets and support a better functioning rules-based trade system, by:

- prioritising regional agreements that allow, or work directly towards, most favoured nation treatment
- promoting the greater use of plurilateral sector-specific agreements negotiated in the context of the WTO
- pursuing only those agreements where there is a strong case that a clear net benefit to Australia will result
- broadening participation in negotiations to parties capable of offering critical assessment, not just parties seeking an advantage or protecting a constituency
- adopting better consultation processes in negotiating agreements, including widening stakeholder group access to draft treaty text on a confidential basis during the negotiation and
- strengthening Australia's reputation as an attractive destination for international investors through more consistent, transparent and predictable foreign investment approval processes while preserving our vital national security interests.

It went on to find that 'scope exists to extend concessions made in preferential trade agreements to other trading partners, and to address the many non-tariff measures that add to the cost of doing business across borders' (PC 2017, p. 89).

A plurilateral approach to trade negotiation can bring many of the benefits of multilateral negotiation and may be a stepping stone to multilateral liberalisation. Australia should continue to invest effort in the development of plurilateral or sector specific agreements, especially those that allow most favoured nation treatment and that are consistent with other WTO principles (PC 2017, p. 94).

Preferential trade agreements should be used sparingly

Preferential trade agreements are an option for reducing barriers to trade and investment in partner countries. They should only be pursued if a strong case can be made that there is a net benefit and in situations where broader agreements are unlikely to be reached. Agreements that adopt the principle of most

favoured nation or cumulation (treatment of inputs from any partner country as local content) have been shown to generate higher benefits.

The fact that most Australian trade is already covered by preferential trade agreements severely weakens the case for negotiating further agreements, particularly as the agreements in place already cover all of Australia's major trading partners outside the European Union. Australia should have already gained the bulk of the benefits from increased competition and lower prices. This points to, at best, significant diminishing returns from negotiating further agreements, especially considering that any benefit from increasing the coverage of imports can be gained from unilateral action.

Unilateral action is often a better option

Unilateral action avoids many of the costs from trade agreements

Many of the trade and investment reforms contained in preferential agreements are worth pursuing, as they are in the national interest and improve the wellbeing of Australians. The Commission noted in its 2017 *Rising Protectionism* report that 'Australia could proceed in this sense unilaterally, as most of the benefits, especially from lower non-tariff measures, do not depend on our trading partners taking similar actions' (PC 2017).

Unilateral action avoids all of the compliance and administration costs that accompany preferential trade agreements. Another 2022 Commission study found that nearly 90% of imports into Australia were duty free, with the 5% tariff on the remaining 10% of imports raising $1.5 billion in import duty (0.3 % of Australian Government revenue). It went on to find that compliance, administration and other costs associated with tariffs ranged from $0.9–2.4 billion (PC 2022a, p. 49). These estimates point to the net effect of tariffs being small, with the direction unclear — ranging from a small potential benefit of $0.6 billion to a net cost of $0.9 billion. The relatively high compliance costs reflect the effects of rules of origin. This means that the net cost of unilateral action will, in the worst case, be small. There would also be relatively few Australian industries and firms that compete with imports that would be adversely affected.

The destination is more important than the route

The terms of reference focus on the process by which Australia develops trade and investment agreements and on the ways that this can be improved.

While the focus on process is important, the Committee should not lose sight of the fact that it is the content of the agreements and their subsequent effects that are more important for Australia and for Australians than the route taken to formulate these agreements. In its report on *Rising Protectionism*, the Commission concluded that:

> Resisting protectionism and continuing to work towards freer markets, while making trade work for all by minimising adjustment costs and ensuring the benefits are widely shared, is the best path for Australia. Higher living standards depend on it. (PC 2017)

The focus of Australia's trade and investment agreements should clearly be on the destination of delivering higher living standards for Australians. The process by which this is achieved requires careful analysis and broad ranging consultation to avoid the process and the outcome being overly influenced by sectional interests.

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