1. Introduction

Sisira Jayasuriya and Gary Magee

Preferential trading agreements (PTAs) – often misleadingly called Free trade agreements (FTAs) – have been proliferating at an accelerating pace in recent years (given the wide usage of the latter, both terms are used in this volume). In July 2007 there were 380 agreements that had been notified to the World Trade Organization (WTO) (not all had been notified) and it is expected that there will be some 400 in operation by 2010.1 Almost every WTO member is also a member of one or more PTAs. There are PTAs comprising developed countries, developing countries, North–South combinations, near neighbours and distant members, and most countries appear to be either involved in (or preparing for) PTA negotiations. Those who have caught the PTA fever now include several countries that have in the past been staunch supporters of multilateralism, eschewing PTAs as a diversion from the difficult but ultimately productive path of deep and meaningful non-discriminatory trade liberalization through the General Agreement on Tariffs and Trade (GATT)/WTO process.

Australia is a notable example. Though it has had a long-standing close bilateral relationship with New Zealand – culminating in the Australia–New Zealand Closer Economic Relations (CER) agreement – until quite recently it was firmly committed to multilateralism as the way to achieve freer trade. In regional fora such as APEC, Australia espoused the so-called open regionalism which was basically a mechanism that aimed to extend any regional trade liberalization to non-members, thereby linking any regional liberalization to the wider goal of broader non-discriminatory liberalization. However, all that has changed in the last few years. In addition to the CER agreement with New Zealand, Australia has signed three PTAs since 2003, starting with the Australia–Singapore FTA, followed by the Australia–Thailand FTA and the Australia–US FTA which came into effect in 2005. By early 2008, it was involved in substantive negotiations or scoping/feasibility studies for several other PTAs, including PTAs with China, India, ASEAN (as a grouping) and New Zealand, Chile, the Gulf Cooperation Council, Japan, Korea, Indonesia and Malaysia.
Australia’s enthusiastic embrace of PTAs only confirms what has become quite evident in recent years at the global level. Despite protestations to the contrary, there is a clear shift in emphasis by most major countries away from the WTO multilateral process towards PTAs and this has, in turn, led other smaller countries to follow suit, partly to ensure that they are not ‘cut out’ of the benefits of membership in discriminatory PTAs. But the perceived economic benefits from membership of these exclusionary clubs are only one factor, sometimes not even the main factor, in the accelerated drive to sign (often criss-crossing) PTAs. Not surprisingly, governments generally emphasize the positive aspects of PTAs because political and strategic imperatives underpin many of the agreements. The successful conclusion of an FTA – however limited its scope is – often comes to be seen as the test of the strength of the political relationship between the parties, with political implications for the government leaders who had committed themselves to achieving it. Further, FTA negotiations are naturally the focus of interest for potentially affected parties; these include, in particular, relatively small (and well organized) groups of producers/suppliers who stand to gain substantially from expanded market access to the foreign market or to lose a great deal from import competition from foreign exporters. This political context places both severe constraints and strong pressures on negotiators to achieve a successful outcome in the form of an agreement that can claim to be a source of major benefits while protecting vital areas of national interest from foreign competitors. But what constitutes a desirable PTA? How can PTA negotiators deliver a successful outcome?

It is now common in political fora to discuss the PTA as a potential vehicle for achieving significant reductions in barriers to trade, not only in goods but also in services and other areas (particularly in the sense of enhancing free movement of capital – investment liberalization). But ever since Jacob Viner (1950) pointed out that, in principle, the net (static) welfare effect of a PTA is ambiguous because a PTA has the potential for both trade creation and trade diversion, economists have recognized that discriminatory trade liberalization is not necessarily welfare improving. Trade creation occurs if the PTA leads to closer aligning of domestic prices with international prices inducing production shifts from a high cost partner to a low cost partner or from welfare-increasing consumption increases in response to such price changes. On the other hand, trade diversion occurs if production shifts from a low cost non-partner country to a higher cost partner. The overall benefit then depends on which of these dominate. In theory, it is possible to set up a PTA that will (largely) eliminate trade diversion (thus ensuring that welfare would be enhanced) by suitable adjustments to the overall structure of tariffs with non-members.
This has spawned intense controversy and debate about the desirability of PTAs and the nature of the link between PTAs and multilateral liberalization: are PTAs ‘building blocks’ (facilitators) or ‘stumbling blocks’ (obstacles) to the achievement of global trade liberalization? Those who see PTAs as building blocks highlight the weaknesses of the WTO, the difficulties of achieving agreements in multilateral trade negotiations and the ease with which groups of like-minded countries can agree among themselves to advance the liberalization process faster and in greater depth. In political economy terms, sometimes it is argued that even limited and partial liberalization can strengthen support for wider and deeper liberalization. On the other hand, opponents point to the ‘spaghetti bowl’ effect of overlapping and criss-crossing PTAs that lead to the limited scope of PTAs due to avoidance of ‘sensitive sectors’, costly administrative complexities produced by a multiplicity of trade regulations and procedures (differential tariffs, technical standards, rules of origin, and so on) and the possibility of competing trade blocs. The literature on this topic is already vast and rapidly expanding but the issues remain intensely contentious; the economics profession itself has become quite polarized.

Nevertheless, there seems to be a general consensus emerging that ideally PTAs should aim to be broad in terms of sectoral coverage, stronger than standard WTO commitments (WTO-plus) and more extensive in terms of ‘behind the border’ – internal market-liberalization permitting deeper economic integration. Sally (2008, pp. 126–7) summarizes the key features of a desirable PTA as follows:

For PTAs to make economic sense, they should have comprehensive sectoral coverage, be consistent with relevant WTO provisions [in Article XXIV GATT and Article V GATTS – General Agreement on Trade in Services] and preferably go beyond both WTO commitments and applied practice at home. In other words, they should involve genuine and tangible, not bogus, liberalisation. There should be strong provisions for non-border regulatory cooperation, especially to improve transparency in domestic laws and regulations in order to facilitate market access and boost competition. Rules of Origin [ROO] requirements must be as simple, generous and harmonised as possible to minimise trade diversion and red tape. Strong, clean ‘WTO-plus’ PTAs should reinforce domestic economic and institutional reforms to remove market distortions and extend competition. Finally, non-preferential [MFN] tariffs should be low in order to minimise any trade diversion resulting from PTAs.

Though official statements are full of lofty words proclaiming a commitment to achieve such deep and comprehensive agreements, actual PTA negotiations typically take place within a framework that most economists would consider to be fundamentally flawed. It is a framework rooted in strong mercantilist ethos. The starting point of the negotiating
(bargaining) process is that gains from trade accrue only to the exporter; hence by reducing ‘our’ trade barriers and providing them access to ‘our’ market we are granting the ‘other side’ a favour. This is a ‘concession’ that in turn demands a quid pro quo concession from the other side in the form of a reciprocal offer of greater market access for our exporters. This particular stance adopted by negotiators is rationalized in several ways. A common political economy rationale is based on the view that reciprocity facilitates domestic acceptance of ‘concessions’ to the foreigners, while other justifications are based on bargaining tactics with game-theoretic underpinnings. However, it is widely observed that the interests of domestic consumers are typically downplayed, if not ignored altogether in these negotiations; even when they are recognized, producer interests typically dominate. Resistance to liberalization almost invariably comes from strong producer groups who find it easier to exercise political clout and constrain governments in PTA negotiations than in multilateral negotiations. This is perhaps not surprising: if governments were genuinely committed to consumer welfare there would be no need to follow a PTA (or even a multilateral) route; consumer benefits from cheaper imports can be easily gained by unilateral liberalization. It is also not surprising that many PTAs, driven by political motives and negotiated under severe domestic lobby group pressures and constraints, are weak, partial and ineffective (if not actually harmful) in terms of achieving trade liberalization and market integration.

Though the gains from multilateralism may be greater and the costs of the shift towards PTAs may prove to be high, the reality of PTAs makes it imperative that analysts give careful consideration to how better PTAs can be negotiated. This, for example, is a challenge that official negotiators cannot avoid. The particular domestic political economy constraints and the relative bargaining power of the negotiating partners are certainly key factors that influence the final shape of agreements. For negotiators, an appreciation of the implications of adopting different technical options can nevertheless be quite helpful in attempting to enhance the scope and value of a PTA and to minimize any negative impacts within the given political constraints. But, while there is a growing literature on the implications of specific aspects of PTAs, such as the impact of complex rules of origin, the literature that can be used as a general guide in addressing the concrete negotiating issues involved is relatively sparse.

Our aim in this volume is primarily to contribute to this task of presenting useful guidelines for negotiating better PTAs. We do not undertake or present an in-depth benefit–cost assessment of an Australia–China PTA, though there is some discussion about the potential gains from certain liberalization measures. The contributing authors are international trade
experts from the twin disciplines of economics and law who focus on the issues of interest in PTA negotiations in the wider context of the Australia–China economic relationship. China and Australia are relative newcomers to PTAs, though they both appear to be racing to make up for lost time. They are natural trading partners with strong complementarities whose economic links have strengthened enormously in recent years. China – whose industrialization and rapid growth has made it the driving force in generating the global commodity boom – is now the main trading partner of resource and land (agriculture) rich Australia. The two countries seem ideal candidates for a deep and comprehensive PTA. Even analysts sceptical of the desirability of Australia’s FTAs with countries such as the USA, Thailand and Singapore, have been generally favourably disposed towards a PTA with China. From China’s point of view, the need for reliable and secure resource supplies seems to make it a very attractive proposition. But the negotiations have not proved easy and have exposed differences over a wide range of issues. We believe that this quite protracted and difficult negotiation process between Australia and China for a Free Trade Agreement – a PTA – provides a very handy and illustrative case study to look at several key issues and areas of interest to all those involved in negotiating PTAs.

The structure of this book is as follows. Section I comprises, in addition to this chapter, two other chapters. In Chapter 2, Russell Hillberry presents a review of recent ex post analysis of the empirical experience of FTAs, with some discussion of implications for FTA design. On the basis of this review, he suggests that regional agreements containing multiple countries are the best alternative to unilateral/multilateral reforms, while interlocking bilateral agreements are best avoided. Further, governments should seek to harmonize policy commitments across past, current and future PTAs. Though the availability of applied (computable) general equilibrium models have popularized ex ante assessments of PTAs, he points out that both the proliferation of preferential trade agreements and their broadening policy scope make it substantially more difficult for economists to quantify the economic impacts of the agreements. As a result, a greater burden is placed on policy makers’ judgement. Hillberry emphasizes the importance of unilateral liberalization and that PTAs should not be treated as substitutes for domestic policy reforms. Chapter 3 is a special contribution by a Chinese economist, Professor Dashu Wang from Peking University, who is actively involved in China’s FTA negotiations, providing a Chinese perspective and emphasizing the political context in which these negotiations take place. China has strong political objectives in pursuing PTAs; in particular, it aims to challenge US supremacy in Asia.
and Japan’s position as the dominant economic power, and wants to avoid being outmanoeuvred by Japan in the Asian region.

Section II comprises Chapters 4–7, which are focused on the sector-specific issues in manufacturing, agriculture, services and resources. Neville Norman in his survey of the Australian manufacturing sector issues in Chapter 4 explains why the potential threat of Chinese import competition continues to make this a sensitive area. In agriculture, where Australia has a clear comparative advantage in most products, Donald MacLaren (Chapter 5) argues that while there are barriers constraining Australian agricultural exports into China, there may be little that Australia can offer China in return for enhanced market access into China; thus any bargaining on this will need to offer incentives for China in other sectors. Further, the kinds of reforms that can improve market access for Australia in agriculture will require ‘behind-the-border’ reforms in China, and these are difficult to achieve on a preferential basis and hence unlikely to be successfully negotiated in a bilateral PTA. This introduces both the importance of non-border reforms and the difficulties associated with achieving them in PTAs.

Philippa Dee and Christopher Findlay in Chapter 6 look at the services sector issues. This is where existing links are weakest, though there has been significant growth in areas such as travel and education. They point out that China has so far been unwilling to include services provisions in its PTAs at all, or has been unwilling to go beyond its existing WTO accession commitments. This is an area where the issue of ‘behind-the-border’ regulatory reforms is most acutely posed with the previously mentioned problems related to bilateral negotiations. Australia is seeking a first mover advantage for its services in China, or in some cases a second mover advantage (behind Hong Kong and Macao). Dee and Findlay argue that the consequences of any preferential access for Australian suppliers will depend partly on whether supply conditions from the Australian end are competitive. In particular, in this context they highlight the implications of an aspect of PTA negotiations that is not often recognized: the ‘client focus’ of trade officials that sees them happy to negotiate on behalf of individual services suppliers, rather than necessarily ensuring open entry for all suppliers from the country. If supply conditions in Australia are not competitive, selected Australian producers may capture greater rents with no benefit to Chinese users. They suggest that an Australia–China free trade agreement will do nothing to further the cause of domestic regulatory reform in China. Indeed, it may even create a subset of Australian services suppliers earning rents in China, who then have an interest in opposing further regulatory reform.

The resources sector, as Yinhua Mai and Philip Adams point out in Chapter 7, is perhaps the most critical from a bilateral viewpoint. It is
where natural complementarities are strongest. They see significant gains from an FTA which liberalizes further border trade liberalization in this sector, but fuller gains can accrue if this is accompanied by investment liberalization. But this is likely to be a more difficult area of negotiation than relaxing border protection. Foreign ownership in the resources sector is a sensitive topic. The implementation of investment facilitation measures is also likely to be more difficult than the removal of tariffs on the resource products, because it involves institutional and legislative changes.

Section III comprises five chapters that address key technical issues that arise in choosing rules and institutional designs in the design of successful PTAs: intellectual property, rules of origin, business law and enforcement, trade remedies and dispute settlement procedures and PTA compliance with the WTO. Each chapter surveys the basic issues, main alternatives and an evaluation based on both theory and international experience, taking into account the particular legal, institutional and political circumstances facing the negotiating partners. The discussions illustrate how these general principles in each case are applied to the concrete circumstances of an Australia–China agreement.

In Chapter 8, Kimberlee Weatherall raises the issue of intellectual property (IP) in the context of China and Australia, where domestic regulatory regimes are very different (and, in China’s case, also changing very rapidly). This is an area where bilateral agreements that raise standards are almost bound to become multilateralized. Though cooperation or dispute settlement provisions would not legally be required to be extended to other WTO members, they would nevertheless be seen as precedents. Hence, any agreement would be seen as having a much wider impact and not confined to the two negotiating partners. Given the relatively weak bargaining power of Australia, getting a completely satisfactory agreement would be difficult. On the other hand, this is an area where China would need to move forward in any case. Weatherall discusses various options and proposes a combination of defensive, cooperation, and dispute settlement approaches incorporating a dynamic element. The issues and options are clearly of relevance for any PTA where partners have significantly different IP regimes, as would typically be the case when negotiations are between a developing and developed country.

Peter Lloyd and Donald MacLaren address issues related to rules of origin (ROOs) in Chapter 9. ROOs are one of the most critical technical issues in any PTA. With increasing product fragmentation, almost no good is wholly produced in one country and, unless clear guidelines are laid down to establish eligibility for trade preferences under a PTA, the system becomes costly and unworkable, and preferences are largely eroded. While there is a general consensus that simple, ‘generous’ ROOs are essential if
a PTA is to achieve true liberalization in goods trade, choosing between
different options is not a simple task. It is recognized that all ROO systems
are necessarily trade restrictive to some extent in order to prevent trade
deflection. However, Lloyd and MacLaren argue that most ROO systems
are much more trade restrictive than they need to be. They describe and
analyse the advantages and disadvantages of major ROO systems and
specific characteristics, and explain how a system can be chosen in order
to minimize trade restrictiveness and, as far as possible, other untoward
effects on the costs of compliance, uncertainty and the pattern of trade.

Mechanisms for enforcement of agreements and dispute resolution (DS)
procedures are important to any well-designed agreement. In Chapter
10, Jeff Waincymer addresses legal issues related to business law and
enforcement involving both trade and investment in the context of PTAs.
In Chapter 11 Martin Richardson focuses on economic aspects of trade
remedies and dispute settlement procedures. Waincymer reviews the wide
variety of systems and approaches in existing PTAs which range from near
informal procedures for dispute resolution to tightly specified procedures.
There is tension between advocates of a legalist approach and those who
prefer international organizations to behave in a more pragmatic manner.
There are trade-offs involved in practice and compromises are almost
unavoidable. However, arguably, moving to a more legalist approach may
help resist domestic protectionist pressures. Richardson presents a trench-
ant and fundamental critique of the underlying rationale for most so-called
trade remedies, arguing that ideally the complete abolition of administered
protection in a PTA would be the most desirable outcome. However, as
many may consider such an approach too drastic, he proposes alternative
procedures that are simple, WTO consistent and impose lower efficiency
costs.

In the final chapter, Andrew Mitchell and Nicolas Lockhart take up
the issue of how a PTA can ensure broad compliance with relevant WTO
provisions. They point out that, in legal terms, the coexistence of the WTO
and PTAs among WTO members creates a complex system of competing
international rights and obligations. Of course this is a tension that has
been present from the very inception of GATT when PTAs were allowed
to operate in violation of the fundamental most-favoured nation (MFN)
principle of non-discrimination. For PTAs to comply with WTO rules they
must fall within one of the exceptions valid under WTO law; hence, each
WTO member must ensure that any PTA to which it is a party complies
with the conditions of the relevant WTO exception. Unfortunately, as
Mitchell and Lockhart point out, the proliferation of PTAs has created
a situation where no one is willing to challenge the legality of any PTA,
so that there is de facto acceptance of any type of PTA, thus increasing
the likelihood that PTAs may increasingly undermine the fundamental principles of WTO and the rules-based multilateral trading system.

NOTES

1. Information from the WTO website: www.wto.org.
2. The literature on this subject is quite large; a good introduction to the issues, debates and the literature can be found in World Bank (2005) and Schott (2004). Sally (2008) provides an excellent discussion of the key issues and the related political economy considerations. See also, Hoekman and Winters (2007).

REFERENCES