

‘Managing’ Agriculture in the US – Australia FTA

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1 Why do we need to ‘manage’ agriculture?

The best of all possible worlds for Australian and most United States agricultural industries would be one in which global markets are moving quickly and progressively to open markets based on free trade. But we’ve little hope of that happening any time soon. The past 23 years have seen only one agreement on global trade liberalization — the Uruguay Round agreements reached in the early 1990s. A Free Trade Agreement (FTA) between Australia and the United States will create a major new region of free trade in agriculture behind barriers that are already low by world standards. If managed well, and particularly if opened up to other participants in due course, an interim agreement on an FTA will help us bring about the sort of global trading environment that both the United States and Australia would like to have.

There is ample historical precedent for the use of regional trade agreements as part of a ‘squeeze play’ at crucial points in multilateral negotiation, particularly on agriculture.¹ An announcement by Australia and the United States in the closing phases of the Doha Round of WTO negotiations that they intended to achieve the bilateral elimination of barriers to all trade between them, creating a free-trade area comparable in size to the expanded European Union, would have a strong motivating effect on exporters elsewhere — particularly in Europe — who would like to share in the benefits of open markets, or at least not lose any ground as a result of the deal. The happy consequence of accelerating the program of multilateral liberalization is that it would make the bilateral agreement easier to implement because it would mean an earlier and higher boost to world prices: it may even open up opportunities to expand the coverage of the free-trade region.

Although both countries are expected to benefit from a free trade agreement between them, the evidence of the economic models suggests that there will be sharp differences in the composition of gains. The analysis shows that almost 60% of the

¹During the last phase of the Uruguay Round, even before it took office, the Clinton administration was threatening to turn its attention to NAFTA and the APEC regional agenda. The squeeze has come from the other side as well. For the past 40 years, the EC has repeatedly played the geo-strategic card of European integration to frustrate and delay multilateral progress toward the liberalization of global agricultural markets. In a 1997 paper for the Australian Center for American Studies (“*Australia, the United States and Free Trade*” Sydney 1997), I argued that a free trade agreement with the United States could be used to help revive the flagging APEC program

\$US1.2 bn direct benefits for Australia are likely to be found in additional exports of just two agricultural products (dairy and sugar). The benefits to the United States are similarly concentrated — just three product groups (TCF, motor vehicles and 'other manufacturing) comprise almost 75% of the U.S. benefits of \$US1.8 bn.²

The imbalance in agricultural exports, rather than the imbalance in manufactures exports, is likely to be the focus of political attention because the U.S. industries concerned enjoy very high levels of import protection. Unlike the Australian textile and PMV sectors, the dairy and sugar industries in the United States have avoided adjustment to international prices and market pressures for more than three decades. In order to 'manage' this political problem, proponents of an FTA will need to bring some perspective to the bilateral discussion of an FTA: the gap between U.S. and Australian agricultural prices will shrink over the next decade, reducing the impact of Australian exports on U.S. markets as the FTA is implemented. We may also have to 'manage' threats to the agreement from devices that may be proposed to overcome the agricultural trade 'problem'.

Although the idea of an FTA holds attractions for both Australia and the United States, there is no compelling reason for the USA to enter into a negotiation with Australia, much less reach agreement with us unless we sell the US leadership, in government and in industry, on the idea. An important marketing message is that an FTA is about liberalizing 'substantially all trade' and not just trade in agriculture. Australia will make the biggest export gains in agriculture but the United States will be the biggest beneficiary of the FTA: the value of its sales to Australia under an FTA will be greater than the value of Australian sales to the United States and the U.S.A will see the biggest dollar increment in economic welfare.

²Center for International Economics, "*Economic impacts of an Australia–United States Free Trade Area*", Canberra, June 2001

A summary of the argument

- (a) Although it seems to offer a 'bonanza' to Australian producers, the prospect of large increases in exports of some agricultural products poses a threat to key U.S. agricultural lobbies
- The 'management' of this issue depends on managing the expectations and fears prompted by the apparent size of the 'price-gap' between Australian and U.S. production
- (b) The 'price-gap' on which the economic models focus is not a good indicator of where the two industries will be at the end of the 'interim agreement' to implement an FTA
- The world will change during the period of the 'interim agreement' in ways that are likely to reduce both the 'bonanza' for Australian producers and the 'threats' to U.S. producers.
- (c) Although a more realistic evaluation of future agricultural trading conditions may seem to reduce the value of an FTA, it remains a valuable opportunity
- the interim agreement leading to an FTA is one of the best ways to 'manage' future directions in global agricultural trade policies
 - The current models under-estimate the potential for Australian agricultural exports to the U.S.: even if we discount the size of future 'price-gaps'
- (d) An important part of the negotiating strategy will be to resist any attempt to 'manage' the agriculture problem by
- Excluding agricultural sectors from liberalization
 - Postponing their liberalization beyond the dates for other sectors in the interim agreement
 - 'Back-loading' tariff cuts or using 'claw-back' safeguards that jeopardize the 'lock-in' of liberalization

2 The price gap

The gains from trade — as David Ricardo observed — don't depend on a difference in price between two trading partners. But the gains that Australia is said to make in the proposed FTA do: they depend on there being a 'price gap' between the supported/protected US price and the Australian or world-market price for certain commodities.

In its study for the Department of Foreign Affairs and Trade³, CIE said that 60% of the \$US1.2bn annual gains were likely from just two agricultural products (dairy, sugar). The reason that the gains from access to markets in those two products are so large is that there are significant economic 'rents' available, in addition to the standard gains from trade, as a result of the 'price gap' between the high US price and the world market price that is the benchmark in most Australian export markets. For example, the typical wholesale price of refined sugar in the USA is \$US0.23/lb while the Australian FOB price adjusted for transport costs to the US East Coast is about \$US13 c/lb. US dairy commodity prices at the wholesale level are typically 40% – 60% higher than the prices on world markets.

These rents — the super-profits from un-restricted access on a discriminatory basis to a protected market — loom large in the eyes of both Australian commodity producers (as a 'bonanza') and in the eyes of protected US producers of sugar, dairy, livestock etc (as a 'threat').⁴

- Australian dairy exports to the USA are expected to rise by 354% or about \$US260 million (1999 base)
- Australian sugar exports to the USA are expected to rise by 2550% or about \$US442 million

3 Preliminary skirmishes

Claims about the opportunities and threats for agricultural producers in an FTA have already prompted rumblings of opposition in the United States,⁵ easy skepti-

³Center for International Economics, op cit.

⁴In fact, these estimates may be too small: see the Appendix

⁵Including an extraordinary claim by the US National Milk Producers' Federation that an FTA would put Australia, and New Zealand, in "moral danger":

cism about the inclusion of agriculture in any agreement,⁶ and a more subtle attack on the project which argues that a multilateral approach is a better way to go about liberalizing agriculture because the incentives don't work out the right way in a bilateral context.⁷ Even the official pronouncements acknowledge "the need in particular to work on agricultural issues"⁸ in studying the idea of an FTA.

Observing these early engagements, a political 'issues manager' will be tempted to avoid or postpone conflicts that might derail progress. But are either of these options available in an FTA?

3.1 An 'interim agreement' for an FTA

It's important to be clear what we're talking about: the mooted negotiation of what Article XXIV of the GATT calls an 'interim agreement necessary for the formation of a free trade area'⁹ between Australia and the United States.

A free trade area is defined by the GATT in this way:

"(b) A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive

"NMPF has written to the Bush Administration in opposition to a proposed free trade agreement with Australia. . . 'A potential free trade agreement with Australia will certainly eliminate any hope to further discipline dairy trade within the World Trade Organization,'" NMPF wrote. 'By obtaining unlimited access to the vital U.S. dairy market, Australia and its partner New Zealand will simply forgo any efforts to open additional markets around the world, including the E.U., Canada and Japan. Despite expected protests to the contrary, Australia and New Zealand will turn their efforts to oppose harmonization of Tariff Rate Quotas around the world so they can profit from import quota rents in the United States.'" While NMPF supports granting the Administration Trade Promotion authority, and reducing trade-distorting subsidies, the letter said that a potential FTA with Australia would only be a 'distraction from the truly important trade challenge' of completing another round of World Trade Organization talks."

National Milk Producers' Federation (Newsletter Sept 3, 2001. Vol 59 No. 18)

⁶See "Leave it out: a farm-free trade agreement", Australian Financial Review, June 21, 2002

⁷Garnaut, R "An Australia-United States Free Trade Agreement" *Australian Journal of International Affairs*, Vol. 56, No. 1, pp. 123 - 141, 2002

⁸Statement of Ambassador Zoellick to the U.S. Senate Finance Committee on Trade Objectives for 2002, 6 February, 2002.

⁹Article XXIV: 5 of GATT

regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories.”¹⁰

There’s a big difference between implementing an FTA and implementing an ‘interim agreement’ leading to an FTA. The difference is about 10 years: the period that the WTO “*Understanding on Article XXIV*” specifies as a “reasonable length of time” for the completion of the program of trade liberalization leading to an FTA¹¹. The provisions of Paragraph 5(c) of Article XXIV make it clear that the implementation period should form part of a rationed plan for achieving “free trade”

“(c) any interim agreement referred to in sub-paragraphs (a) and (b) shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time.”

The apparent purpose of this provision is to assure the other Members of WTO that the discriminatory import preferences being put in place really are steps toward a full FTA and not merely a way of circumventing the obligations of Article I of the GATT. The WTO Working Party established for the purpose examines the ‘interim agreement’ plan and reports on it to the WTO Council on Trade in Goods, making recommendations for its amendment or acceptance.

3.2 Is there a ‘legal loophole’ for agriculture?

Under certain conditions, the WTO rules may allow the parties to an FTA to omit specific provisions on agriculture from the interim agreement. But I don’t think these grounds are available in the case of Australia and the United States.

‘Substantially all the trade...’ The meaning of this term in paragraph 8 of Article XXIV may be debatable: the interpretation of the word ‘substantial’ elsewhere in the GATT is “not insubstantial.” Does the phrase in Article XXIV

¹⁰ Article XXIV: 8(b) of GATT

¹¹ “Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994” paragraph 3

therefore mean that there is no need to eliminate barriers on the ‘insubstantial’ trades? That may be one way to construe the meaning: it is possible that Japan and Singapore could appeal to this phrase as the justification for their omission of agriculture from their planned “New Age Partnership” agreement. But it won’t help in the case of an FTA between Australia and the United States. None of the trades between Australia and the United States in the highly protected products is ‘insubstantial’: the U.S. is Australia’s largest market for beef, our fifth largest sugar market and the eighth largest market for dairy products. Any agreement that covered ‘substantially all the trade’ would necessarily include trade in these agricultural products.

Table 1: Australian exports of dairy, meat, sugar to the United States (2000)

(\$US '000)	
Meats	840,007 ¹²
Dairy	57,212
Sugars	10,567

Exceptions The exceptions in listed in paragraph 8 of GATT Article XXIV (see page 9) preserve some exceptions to GATT principles embodied in Part II of the GATT. The exceptions under GATT Articles XI - XIII are the most interesting from the point of view of agricultural trade because they concern quantitative barriers on imports that are (exceptionally) permitted under GATT where necessary to maintain a domestic supply-control program. These exceptions appear to be the basis on which some FTA’s implemented under the GATT omitted the liberalization of certain agricultural products. For example, the Canada-US Free Trade Agreement (1988) omitted dairy, poultry and eggs from full tariff elimination (an omission extended into Canada’s NAFTA agreement with Mexico) on the basis that these products are the subject of supply-control programs in Canada. But the United States’ tariff quotas for for dairy, sugar and beef are not designed to complement domestic supply control programs. The U.S. support programs are in the form of target prices and loan-rates. The United States did not attempt to argue in the case of its agreements with Canada or Mexico that any of its products should benefit from the exceptions listed in Article XXIV, and it

¹²Source: United Nations trade database

seems unlikely that it would start to do so now.

3.3 Could liberalization be postponed?

Would it be possible to adopt a longer time-frame in the interim agreement for the liberalization of highly protected sectors? Could we argue that a ‘reasonable length of time’ for the liberalization of dairy and sugar should be 20 years, for example?

In principle the parties could propose a longer implementation period, but it would be dangerous to do so. The WTO *Understanding on Article XXIV* says:

“8. In regard to interim agreements, the working party may in its report make appropriate recommendations on the proposed time-frame and on measures required to complete the formation of the customs union or free-trade area. It may if necessary provide for further review of the agreement.”

If you’re familiar with the language of WTO agreements, you’ll recognize the concept of a “reasonable” period of time.¹³ In principle it could be a rubbery length: there’s no lesser limit in the Understanding and there seems to be no reason why a longer implementation period might not also be considered ‘reasonable’ in particular circumstances. It seems that it would be up to the parties to an interim agreement to convince the members of the Working Party examining the interim agreement to make such a recommendation to the Council.

But an extension of time for the elimination of barriers to agricultural trade, beyond the normal 10 year period of an interim agreement would pose a serious “red face test” for Australia and the United States. Each is arguing for an accelerated timetable for partial liberalization of agricultural trade barriers in the WTO negotiations: six years from 2004. It would be reasonable for them to argue that the 10 year period of an interim agreement is an appropriate for *elimination* of barriers.

¹³It occurs, for example, in the *Understanding on Dispute Settlement* where it guides the period for implementing a disputes decision. There is now detailed jurisprudence on its use in that context: implementation panels and arbitrators have shown very little inclination to extend the ‘reasonable period’ for implementation of a disputes decision beyond the 15 months mentioned in the *Understanding*.

But, in light of their WTO proposals, it may be harder to convince a WTO Working Party on an FTA — which is certain to include the EU and Japan — that an extension to twice the proposed period for the elimination of export subsidies in the Doha round is justified for the bilateral elimination of tariff barriers.

In practice, liberalization of one or two agricultural sectors is likely to pose adjustment pressures that governments will want to spread out over a maximum period. This implies that full liberalization of the sectors will not be achieved until 10 years after an agreement is reached on an FTA in, say, late 2004.

4 Managing expectations

The two questions most frequently asked about the FTA proposals are

1. Is there ‘enough in it’ for the United States to liberalize its dairy, sugar and beef markets, even on a discriminatory basis?
2. Is an FTA compatible with, or possibly a danger to, Australia’s (or the United States’) multilateral agricultural liberalization objectives?

These questions do not call for answers in the form of simple facts (or calculations or ‘models’): they each ask about an *evaluation* of the deal. The first asks whether the returns to the U.S. will *seem* big enough to sell the U.S. political leadership and the opinion leaders in the agricultural lobbies on the deal. The second asks whether a discriminatory agreement can complement a multilateral goal.

Obtaining a ‘yes’ answer to both questions depends on managing the expectations and fears of industries and governments on each side of the Pacific. Specifically it depends on

- Whether you focus only on the agricultural aspects of the proposed agreement or whether you consider the balance of benefits in the FTA agreement as a whole
- What you think the agriculture aspects of the deal will really cost the U.S.

- Whether you focus on an FTA in isolation from the global trading regime, or whether you imagine a future global trading regime for agriculture that we reach by choosing a path that includes, among other things, an interim agreement on an FTA between Australia and the U.S.A.

4.1 It's not an agreement about agriculture

The benefits of the FTA are in two parts: direct economic gains and indirect benefits due to the incentive effect that the FTA will have for other trading partners.

A basic contribution to the management The direct economic gains are already detailed in the CIE report. The United States is the largest beneficiary in terms of export dollars (\$US1.8 bn versus \$US1.2bn) and in terms of economic welfare. CIE estimates the net present value of the twenty-year income stream from the FTA is \$US15.5 billion for Australia and \$US16.9 billion for the United States.

Spread over all sectors covered in the CIE analysis, **both countries** are net export winners: the U.S. is expected to gain substantially in manufactures and services markets: according to the CIE results, U.S. exports of motor vehicles and parts to Australia could rise by 46.6 per cent and exports of metal products could rise by 25.2 per cent.¹⁴

The indirect benefits due to the incentive effect on multilateral trade regimes will be examined in more detail in Section 5 on page 19.

4.2 What will the FTA 'cost' U.S. agriculture?

The value of any agreement is a balance of the benefits against the costs.

The economic reality is that even discriminatory trade liberalization in favor of Australia in products such as dairy, sugar and beef will deliver an unambiguous 'win' for the U.S. economy. But the calculation of 'costs' in the political economy of protection is based on a mercantilist balance-sheet: bigger net imports are a loss, not a win. In these terms, the costs of the FTA for the United States, appear to be concentrated in the high-protection agriculture industries of dairy and sugar. U.S. producers, naturally, focus on the large price-gap (see page 7) as the indicator

¹⁴Center for International Economics, op. cit., pp viii – ix

of these costs. But the price-gap is a very poor guide to the impact of Australian imports in, say, 2014 for two reasons.

1. First, the price gap then will not be as big as it looks now, in any of the products identified in the CIE study
2. Second, other market factors will moderate the impact of low-priced imports from Australia.

The impact of imports from Australia is not likely, in any case, to be a significant factor in the adjustment pressures facing U.S. farmers over the next decade: as a brief review of the adjustment pressures over the last decade indicates.

4.2.1 The price-gap will shrink

The size of the gap between U.S. and world market prices for agricultural commodities such as sugar, dairy or beef depends on both the level of U.S. prices and world prices. In the next decade it is very likely that the price gap between world prices and U.S. prices for dairy and sugar will shrink as domestic prices fall in the United States and as world market prices rise.

In other words, the gap between U.S. and world market prices on which the prospects of a ‘bonanza’ for Australian producers in the US market is likely to erode and may even disappear in the next decade. From the point of view of U.S. producers, a smaller price-gap means that imports will represent a much smaller threat to their share of the domestic market and to their current prices than they may seem to do today.

Domestic prices likely to fall The support programs for both dairy and sugar that were extended in the 2002 U.S. farm bill (‘Freedom to Farm’ Act) are based on target prices supported by recourse loans (sugar) and government stock purchases (dairy).

Dairy prices The long-term outlook for U.S. dairy prices — holding all other things constant — is an overall fall of about 15 - 20% from the price levels included in the CIE models. The Farm Bill’s extension of the milk target

¹⁵Farm Security and Rural Investment Act of 2002: Preliminary FAPRI Analysis. May 6, 2002

Table 2: Projected change in U.S. milk price and gross milk returns (¢/cwt)

	(changes relative to a December 2001 baseline)										
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	02-11 avg. ¹⁵
All-milk price	-0.12	-0.22	-0.33	-0.41	-0.16	-0.16	-0.17	-0.13	-0.09	-0.06	-0.18
Gross milk returns	0.38	0.31	0.21	0.11	-0.16	-0.16	-0.17	-0.13	-0.09	-0.06	0.02

price (set at \$US9.9 per cwt for milk used for making cheese) cannot sustain U.S. dairy product prices at the record levels of 1998/99 when the U.S. all-milk price reached a record \$US 15.40 per hundredweight. It had fallen to just over \$US11 per hundredweight by 2002 and is projected to continue to fall through 2005 — in part *because* of the provisions of the Farm Bill — before recovering to a long-run level of about \$US 13 per cwt.¹⁶ The continuing fall in prices out to 2005 is due in part to the major innovation for dairy in the 2002 farm bill: a three-year deficiency payment to dairy farmers that subsidizes their gross returns from milk without supporting prices. If, as the U.S. dairy industry expects, the deficiency payment is extended from 2005 the outlook may be for even steeper price falls through the rest of the decade as the payments keep sub-economic farms in business.

Table 3: Projected New York spot prices for sugar (\$US/tonne)

Year	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10	10/11 ¹⁷
Dollars	407	406	401	396	392	388	383	379	375	371	368

Sugar prices The 2002 farm bill made only one change in the Sugar support program: it removed a penalty of 1¢ per pound for sugar entered into government recourse-loan stocks. The penalty, introduced in the 1998 farm bill, was intended to maintain the budget neutrality of the government stock operations. Sugar production grew rapidly, however, and stocks increased. The removal of the penalty will potentially restore some production incentive leading to further pressures on the U.S. domestic price (and on government stocks). FAPRI projects a New York spot price slide of about 10% from the levels of 2001.

Possibly the most important change that will take place for the U.S. sugar industry will be the completion of the interim agreement with Mexico im-

¹⁶These projections are based on outlook data published by the US Food and Agricultural Policy Research Institute (FAPRI). They should be treated with caution since they assume nothing about future policy changes.

¹⁷FAPRI: U.S. and World Agricultural Outlook 2001

plementing NAFTA: by 2008, the Mexican sugar industry will enjoy full, free-trade access to the USA. This will certainly mean softer prices in the United States and more importantly, in the view of the Australian sugar industry, it will mean a restructuring of the US sugar market.

World prices likely to rise The other side of the price-gap is the world price. The outlook for world market prices for Australian food exports over the next decade is reasonably strong. Market expansion due to liberalization of trade barriers and demographic growth on top of cuts in export subsidies and progress in trade facilitation promises a rise in the world-market prices for key agricultural commodities: including dairy, sugar and beef.

1. The prospective elimination – or at least further dramatic reduction – of agricultural export subsidies will result in higher world prices, at least initially, making the world market more attractive for some Australian and US export industries and less threatening to protected industries in the United States.
2. Progressive cuts to agricultural tariffs — more significant than those agreed in the Uruguay Round — and the expansion of tariff quotas will see the accessible world market for several commodities that are important to both developed and developing countries grow rapidly (by historical standards). This, too, is likely to mean higher prices for both exporters and some unprotected importers but much lower prices for consumers in highly protected markets whose demand is likely to increase, offsetting the impact of reduced protection on producers in those markets.
3. The geographic location of import demand for temperate agricultural products will focus more tightly on the Asian continent as incomes in South and East Asia rise. The value of peri-urban land in China, India, Indo-China and South East Asia being used today for agricultural production will continue to climb and the land will be converted to higher-value, non-agricultural use. Australia's natural advantages as a source of large scale, low-cost commodity supply on a reliable basis will be even more valuable to food manufacturers targeting Asian markets.

4.2.2 Other pressures on U.S. agriculture more important

The “cost” of the FTA to U.S. (and Australian) firms is the cost of adjustment to new conditions of production and competition. These adjustment pressures due to the FTA are likely to be small when seen in the context of the adjustment pressures that the U.S. farm sector has faced in the past decade and is likely to face in the future. Even a brief review of the last decade of US agricultural history shows that the scale of changes that take place without any policy intervention – and may in fact be partly immune to policy interventions – is very large. No change that takes place as a result of reductions in trade barriers is ever likely to match it.

In the past 10 years, United States agriculture has seen both the peaks and the troughs of prosperity. The level of farm income support spending is one indicator: it has fallen from its highest ever level, to an historical low and has climbed back again to a peak in the course of the last decade.¹⁸

Despite recently reaching a level equal to half of net farm incomes, support programs in the USA have not protected the US farm sector from fundamental structural changes. In fact, support for output prices does little to address the main drivers of structural change in the U.S.A., which seem to be input prices and improvements in productivity.¹⁹ For example, in the period 1990 – 2000 the U.S. dairy herd shrunk by almost 8% as the average output per cow rose by 2.4% per year due to better breeding and nutrition. These productivity changes have been

¹⁸The United States’ Commodity Credit Corporation’s (CCC) net outlays averaged \$US15 billion yearly during the 1980s, peaking at \$US26 billion in 1986. By the 1990s, improved market conditions, plus program reductions mandated by various farm and budget laws, had reduced CCC annual outlays to an average of about \$US10 billion between 1990 and 1995. The 1996 farm law targeted even lower spending, at an annual average of less than \$US6 billion. However, declines in export markets during the second half of the 1990s – due for the most part to the strength of the US dollar – cut farm incomes sharply. From an all-time low in early 1995, the US dollar rose by a trade-weighted average of 40-50 percent in real terms against the currencies of its trading partners by 2001. The loss of trade competitiveness not only drove up the cost of the support programs authorized by the 1996 farm law (particularly marketing loans and loan deficiency payments), but also led Congress to escalate the level of ‘one-off’ payments between 1998 and 2000. Approximately \$US25 billion in emergency assistance was approved, of which \$US17 billion was in response to falling commodity prices (the rest was natural disaster aid). In calendar 2000, direct farm payments reached a total of \$US24 billion ? a figure representing over one-half of net farm income for the year.

¹⁹Evenson, R.E. and Huffman, W.B. “Long-Run Structural and Productivity Change in U.S. Agriculture: Effects of Prices and Policies” Economic Growth Center, Yale University, 1997

associated with massive change in farm numbers and size: the U.S. Farm Bureau estimates that the number of dairy farms fell by almost 20% over the period 1990 - 1996.²⁰

By the late 1990s, about 157,000 large commercial operations with annual agricultural sales averaging about \$US900,000, accounted for 8% of all U.S. farms but more than 70% of all farm sales. According to USDA, most of the United States' two million farms are primarily part-time, where operators rely on off-farm earnings for most of their income. Farm residents now account for less than 2% of the general U.S. population

4.2.3 The impact of Australian imports will be small

The CIE analysis concluded that, even at the level of the current price gap, the impact of Australian exports to the United States under conditions of bilateral free trade would be small. The **only significant effect** they found was a 1.5% cut in U.S. sugar production as lower priced Australian imports displaced domestic output.²¹

Factors that will moderate the adjustment pressures due to the FTA include:

Other opportunities Many Australian commodity sales are already made at prices above the benchmark 'spot' world market price further reducing the 'gap' to U.S. prices and the incentive to divert product into the U.S. market. Forward (contract) sales, sales into markets 'protected' by remaining country quotas or by advantageous freight rates, or sales made on the basis of established relationships offer better than world market returns to Australian agricultural commodity exporters, and are likely to continue to do so even after the FTA is implemented.

The level of sale will moderate the market impact of Australian exports to the United States. It is likely, given the high degree of competitive production in each country, that Australian exports will compete mostly on price. This suggests that commodity products will predominate and that most Australian exports will find their markets at the wholesale level. Price competitiveness

²⁰Farm Bureau press release "Number of U.S. dairy farms falls 5 percent" accessed at <http://www.fb.com/news/nr/nr96/nr1101.html> on 12 August, 2002

²¹Op cit., Table 4.6 p. 41

at this level will have a modest impact on final prices in the United States because most final prices reflect many other input costs: including, particularly, the costs of domestically supplied services.

A U.S. ‘face’ will be found on much of the Australian product that enters the US market after the implementation of the FTA. It is very likely that in areas where the price gap presents a valuable commercial opportunity, US investors will integrate wholly or partially owned Australian production operations into US production.

The ‘border’ will moderate the impact of Australian exports. The FTA between Australia and the USA will be unusual because the two participating countries are so far apart. Put another way, they have a much wider (and wetter) border than is typical for regional agreements, where the participating countries are normally contiguous. Economists have been aware for at least a decade that borders appear to create resistance to trade, even when there are no formal customs barriers or language issues across the border. In a recent re-assessment of the evidence comparing, researchers found that national borders reduce trade between the US and Canada by about 44% (and trade among other industrialized countries by about 30%) compared with the volumes of similar trade among Canadian Provinces or among US States.²². It’s likely that the Pacific Ocean will have at least as great an effect.

5 Effects on future global trade regimes

Australian businesses and farm leaders have reacted positively to the proposals for an FTA. The strongest concerns have been expressed by economic analysts who argue that the project represents a diversion from established multilateral approaches to trade liberalization and could expose Australia to moral harm (by weakening our resolve to achieve global liberalization). They argue that an FTA could also reduce economic welfare in Australia (by artificially diverting consumer choice to U.S. products that enjoy preferential tariff treatment).²³

²²Anderson, James E and van Wincoop, E “Gravity with Gravitas: A Solution to the Border Puzzle”, NBER Working Paper No.w8079, January 2001

²³Garnaut, Op. cit. contains the most detailed criticism along these lines.

But the warnings about potential trade diversion and the danger of losing our focus on the multilateral liberalization of markets for agriculture (or services) simply don't stand up.

5.1 There's no danger of trade diversion

'Diversion' refers to the possibility that a tariff preference will create a consumer incentive that does not correspond to the choices that a consumer would make in the absence of restrictions on imports from any source. The estimation of the danger of trade diversion is frequently a difficult exercise in counter-factual modeling. The potential economic loss is a function of the margin of preference created by an FTA and of the revealed 'comparative advantage' of the producers that benefit from the diversion. The larger the margin of preference or the smaller the revealed comparative advantage of the producers who profit from 'diverted' demand, the greater the harm caused by the trade diversion.

In the case of Australia and the United States, the dangers of trade diversion are small or non-existent. The margins of preference for United States exports to Australia will be very small or zero because agricultural tariffs are very small or zero in Australia. There are much bigger potential preference margins for some Australian agricultural exports to the United States — depending on the level of U.S. tariffs when the FTA is implemented — for products such as sugar, dairy and beef. But Australia is among the lowest cost sources of these products in the world: so the potential for U.S. consumers to be misled by the tariff preference into making a choice they would not have made in the absence of restrictions on imports from any source seems negligible.

5.2 An FTA could complement global liberalization

It's difficult to treat seriously the argument from 'moral danger' which has now been offered by critics of the FTA proposal on either side of the Pacific (see page 7). The United States and Australian governments have put the multilateral liberalization at the top of their foreign policy agendas for decades and there is no reason whatever to doubt that this is how their preferences will be ordered throughout the period of an 'interim agreement'. Farmers and food manufacturers in both countries have much greater opportunities available to them in global markets than in

bilateral sales and in both countries the farm sector is progressively more dependent on access to global markets. Furthermore, the Australian government has guaranteed that it will make sufficient resources available to undertake both negotiations (the ‘interim agreement’ on an FTA and the multilateral negotiations) simultaneously. Again, there is no reason to ‘second guess’ this assurance.²⁴

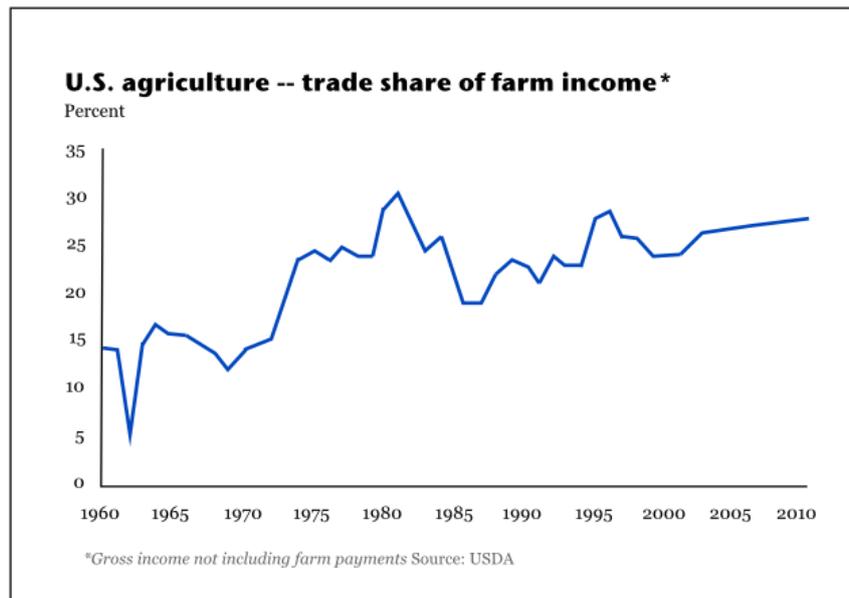


Figure 1: Agricultural exports’ share of US production growing

An FTA that includes the full bilateral elimination of agricultural export barriers could offer an important *strategic* advantage to Australia and the United States in the multilateral negotiations because experience suggests (see page 4) that the two countries will be able to use the ‘interim agreement’ to leverage their proposals for progress in the multilateral negotiations on a wide range of issues including agriculture, services, trade facilitation, competition policy, investment policies.

The United States and Australia may find it doubly helpful to have this opportunity because 2004 is also likely to see the formal accession of a group of eight Eastern European countries to the European Union. Given the EU’s likely preoccupation

²⁴The incentives operating on the major commodity groups — including beef, dairy and sugar — to achieve multilateral liberalization are so much greater than those for achieving bilateral liberalization that the industry organizations are likely to hold the government to this assurance.

with the enlargement, the proposed FTA not only offers the United States and Australia some ‘insurance’ against a modest outcome in the multilateral negotiations but also a means of sharpening European interest in a more ambitious global outcome.

CIE estimates that the FTA will have “barely noticeable” aggregate trade effects on other countries.²⁵ But, at the time of the announcement of an interim agreement, such rational calculation is not likely to be uppermost in the minds of export industries in other countries. The willingness of two significant economies to tackle the elimination of barriers on a discriminatory basis across the Pacific will challenge other economies, particularly in the Pacific region and in Latin America, to seek similarly open access to markets in the new free-trade area. The incentive would be increased if the United States and Australia were to offer at the time of the announcement to include other markets in the free-trade area — as long as they were able to meet the terms of membership — for example, at the end of the period of implementation of the Doha round agreements i.e. in the second half of the period of the ‘interim agreement’ leading to the FTA.

The economic size of the new free-trade area between Australia and the United States will be **comparable to the expanded Europe** with an aggregate GDP (1998 dollars) of about \$US8.3 trillion *versus* \$US8.6 trillion.²⁶ The creation of such a significant new region of free trade in goods and services — with the potential for deeper integration in investment, trade facilitation etc — could further unsettle the political economy of protection in Europe, Japan and India and elsewhere, disturbing the balance between protected sectors and the less protected, import-competing sectors that pay the price for protection in higher input costs and lost export opportunities.

6 Will hidden protection erode the benefits?

Ross Garnaut points out in his criticism of the US-Australia free trade agreement project²⁷, that the CIE Report embodies some simplifying assumptions that the

²⁵Table 4.8 of the CIE Report

²⁶World Bank World Development Indicators (2000)

²⁷Op. cit.

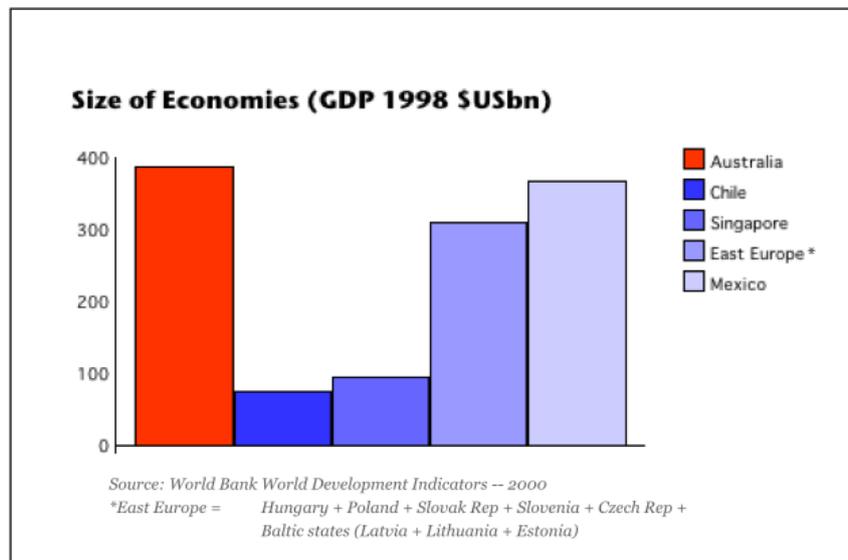


Figure 2: Australia is a significant partner in an FTA

client (the Department of Foreign Affairs and Trade) imposed on the analysts. Professor Garnaut identifies two of these assumptions as important potential problems with the estimates of growth in agricultural exports:

1. transaction costs are not taken into account— including costs associated with fulfilling rules of origin requirements and the cost of restructuring transport patterns
2. the model ignores US agricultural support programs, which are assumed to continue unchanged

Although I agree that the results in the CIE report might be more interesting if these factors were taken into account, I don't think that these issues will materially affect the interim agreement as it applies to agricultural exports.

6.1 Transaction costs will be small

The transaction costs are not likely to be large in relation to the increases in the value of exports of the three commodities that make up the bulk of the increase.

‘Origin’ is not a big issue in commodities such as sugar and beef – although certification of origin will probably be required as it is today (on Health Certificates). In the case of processed foods, such as dairy, where it is possible to use a variety of ingredients from different sources, origin is conceivably an issue and the possibility exists that the US side might want to apply onerous rules of origin for protectionist purposes.²⁸ It will be important to keep the origin rules as straightforward as possible. But given that the value-adding transformation processes for most food products tend to be located together — in contrast to, for example, value adding processes in the garment industry which are subject to burdensome rules of origin in NAFTA — and the comparative advantage of Australian producers across many categories of food ingredients, it is difficult to imagine that origin certification will become a major burden for food manufacturers.

Nor can I see any significant costs arising from the restructuring of transport patterns. There is every reason to believe that liner cargo volumes will respond smoothly to the increasing outward cargo demand as export flows are diverted from lower value markets to the USA and as the volume of Australian production grows. The market for liner cargo between Australia and the USA is well developed and outward cargoes are not particularly difficult to place — despite, or because of the operations of a sanctioned ‘cartel’ in the market. Of course we would expect any increase in demand to have a price effect: particularly if the demand growth were rapid or unexpected. But this is not likely to be the case: over an implementation period of 10 years, the rate of growth in demand is likely to be easily anticipated by shippers and there is no reason to think that supply of shipping services will be outpaced by demand. Discussions I have had with commodity shipping specialists who handle dairy and other containerized cargo lead me to believe that the increased importance of the East and West coast trades in relation to other destinations may give the Conferences additional bargaining power with smaller shippers. But it is also likely that the greater volume and value of bilateral trade will bring new competitors into the transport and logistics end of the value chain, moderating shippers costs.

²⁸The integration of the food processing industries of Australia and New Zealand may pose a problem of origin

6.2 Domestic supports: do they matter in an FTA?

Professor Garnaut argues that the continuing US support programs for commodities such as peanuts, dairy, sugar and grains may affect the CIE estimates of the gains for Australia:

The modelling assumes that subsidies (for example on production and exports of many agricultural products in the United States) are retained at current levels. The paper does not address the important issue of how it is possible to retain large export subsidies for some United States agricultural products while allowing free entry for similar products from Australia.²⁹

If the effect of the additional supply from Australia were to push large volumes of products into government stocks – as the government bought up product to support domestic prices – then the interaction of Australian access with the support programs would be an important issue to be considered. But the CIE models, which appear to hold price supports unchanged at current levels, suggest that the impact of Australian access for dairy and sugar on US domestic prices would be small: negligible for dairy and up to 1% for sugar. So the danger that imports from Australia would become a burden on the U.S. taxpayer — although it exists in the case of the 'no net cost' sugar loan program — is small and could be averted altogether by a small change in loan rate purchasing sometime during the ten year interim agreement. Free trade access by Mexican sugar in this time frame (due in 2008) will also impact on the loan program, so some changes in support seem inevitable if budget costs are to be avoided.

Although it possibly makes the FTA a more plausible project, the lack of real impact of Australian supply on the domestic support programs means that the FTA will not provide much incentive for the USA to remove the payments. Progress in multilateral negotiations remains the best hope for reduced support. Here, of course, the U.S.A. is itself proposing that production-related domestic supports should be cut to no more than 5% of the gross value of production over a 5 years period.

²⁹ *Op cit.*, p 131

6.3 U.S. export subsidies: a reduced threat?

At first sight it might seem *preferable* if the US were able to rely on the use of export subsidies to dispose of excess supply on the domestic market: this would help to remove any excess supply caused by Australian sales. But the gains on the U.S. domestic market would be more than offset by the depression of prices on the world market.

Fortunately, except in grains where neither the USA nor the EU has used export subsidies for most of the past decade, the U.S. export subsidy ‘entitlements’ under the Uruguay Round agreements are now at very low levels. The U.S. is proposing that the subsidies be eliminated by 2010.

Table 4: US Export Subsidy ‘Entitlements’ (2000)

	Dollars
Wheat	363,814,616
Coarse grains	46,117,755
Rice	2,368,924
Vegetable oils	14,082,900
Butter and butter oil	30,497,220
Skimmed milk powder	824,63,935
Cheese	3,638
Other milk products	2,0973
Bovine meat	22,822,166
Pigmeat	497,055
Poultry meat	14,554,827
Live dairy cattle (head)	11,881,419
Eggs (dozen)	1,604,478

source: WTO

7 Managing agriculture in the interim agreement

The agriculture issue will remain 'live' throughout the interim agreement. If the NAFTA experience is any guide³⁰ it would be prudent to expect continuing 'guerilla' action by some agricultural lobbies on both sides of the Pacific in an attempt to pare back the depth or pace of the trade liberalization agreed.

7.1 Sustaining liberalization 'lock-in'

There are two important strategic concerns to bear in mind:

Lock-in' of liberalization Among the greatest potential benefits of an FTA agreement for Australian agricultural producers will be the opportunity to access U.S. foreign direct investment, particularly by investors who are interested in production for the U.S. market.³¹ These investors will, however, be looking for 'lock-in' of Australia's access rights during the interim agreement. The best guarantee of this 'lock-in' will be progressive increases in access leading to full liberalization according to a schedule that investors can be confident the governments will adhere to.

The simplest liberalization schedule would comprise equal annual cuts in the tariff, leading to zero rates over the period of the interim agreement: or a shorter period, if agreed, for any product.

But in the case of high-protection industries this will often mean that in the early phases of the tariff cuts there will be no additional access: for example, a cut of 6 percentage points each year in tariffs on U.S. tariffs for cheese ('out of quota' rates) would see the 60 – 70% rates fall for at least 5 to 8 years before any commercial imports would occur. For most of the period of the interim agreement there would

³⁰Gallagher, Peter 'Agriculture: the strategic issues', in "An Australian/US Free Trade Agreement Opportunities and Challenges", APEC Study Center, Melbourne 2001

³¹According to the U.S. Department of Agriculture, sales from foreign affiliates of U.S. food processing firms were four times larger than U.S. exports of processed foods in 1994. At the same time, American affiliates of foreign firms sold more than \$45 billion in processed foods in the United States, twice the level of U.S. imports. Charles R. Handy, Phil Kaufman, and Steve Martinez, 'Direct Investment is Primary Strategy to Access Foreign Markets' **Food Review**, Economic Research Service, USDA, May-August 1996.

be no expansion of Australian access beyond any expanded multilateral access (negotiated in the Doha Round). This would minimize the impact on U.S. producers and would allow ‘sensitive’ industries as much time as possible for adjustment. But it would significantly delay the benefits and create doubts about ‘lock-in’.

In most agricultural commodities where access is now controlled by tariff-rate quotas, some quota expansion will have to be added to the liberalization schedule to ensure progressive reductions in barriers. The WTO schedules agreed in the Uruguay Round contain both tariff-cut and tariff-quota-expansion obligations to ensure that liberalization has a market effect. The Doha negotiations will very likely contain a similar mix of tariff cuts and tariff-quota expansion. The FTA negotiators could agree to accelerate the Doha liberalization schedule on a bilateral basis and to continue on the same basis for as long as necessary during the period of the interim agreement to reach free trade.

Safeguards Safeguards represent a significant danger to the ‘lock-in’ of agricultural trade liberalization. The elaborate safeguards adopted in NAFTA — for example on Mexican sugar³² — have sustained friction between the trading partners over the liberalization of the sector. It will be essential to keep safeguards simple and ‘universal’ rather than product-specific.

7.2 Are there quarantine issues that must be ‘managed’?

It is very likely that some Australian agricultural sectors that are currently protected from imports by quarantine barriers will be ‘sensitive’ to potential U.S. access to the Australian market.

Pork and poultry The U.S. is a highly successful exporter in both of these sectors, which are strongly protected by quarantine barriers in Australia. If measures to offset the quarantine issues — for example by regionalization of U.S. production — were to be successful, then these sectors could face stiff U.S. competition.

³²Gallagher, Peter Op.cit.

Grains There has been fierce resistance, in the past, to imports of grains from the U.S. Australian grower organizations have demanded that the imported U.S. grains be ‘sterilized’ at the point of entry to minimise pest risks.

Agricultural groups on both sides are likely to rely on quarantine measures to provide or sustain protection against imports. It will be essential for both governments to adhere strictly to WTO SPS Agreement rules on the use of quarantine barriers, and to leave any such measures open to adjudication in the multilateral as well as bilateral disputes settlement system.

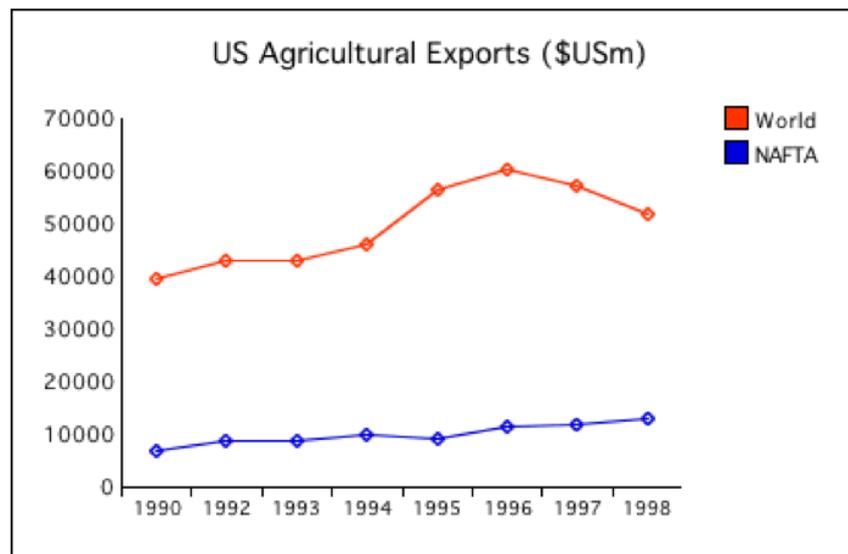


Figure 3: US agricultural exports to world and to NAFTA

8 The same destination

Seekers of ‘el Dorado’ are bound to be disappointed. If the FTA were an ‘el Dorado’ it would be impossible to get there and our attempt would be bitterly opposed. Even if we succeeded in reaching an el Dorado, the prize could be illusory: just as the mountains of silver that the Spanish took from the New World in the 16th century plunged their economy into a disastrous inflation that impoverished the land-based aristocracy and devastated their tenants and retainers.

We should not be blind to the very valuable opportunity that is now in front of us, or allow either easy skepticism or dogma to get in our way. Its an opportunity that we have to identify and actively seek, or it will never be ours.

In the future – let’s say in 2014 – the world will be a different place whether or not it contains an FTA between Australia and the United States. We can’t ‘manage’ the future: only our journey toward it. We have a choice of directions but we have to pick a direction without being able to see the destination.

No one imagines that the FTA will be our only future market: the global market will clearly always be bigger and, as a whole, more rewarding. But there is only one journey. If we chose to set out on a path that leads to an FTA, it will also lead into the future of *global* markets for agriculture and those future global markets will be profoundly affected by our choice.

Australia is today the largest exporter of beef and wool in the world, a major grains exporter, potentially the second largest exporter of sugar and, probably by 2014, the second largest exporter of dairy products having displaced New Zealand from that position during the period of the interim agreement. During the period of the interim agreement it is quite possible that the investment effects of the agreement and Australia’s comparative advantage in sophisticated, large-scale, low-cost agricultural production will result in the rapid expansion of other food and fiber industries helping us to more nearly achieve the ambition to be a supermarket to Asia. The effects of our choice of an FTA with the United States can make a difference not only to our own future but also to that of the United States and other countries in the Pacific region and beyond.

By choosing a path that leads through an interim agreement to an eventually ‘open’ free trade area with the United States, there is every reason to believe that we will find a short-cut to larger, more stable and better priced agricultural markets in the future.

Appendix

A The rents are bigger than the model suggests

We saw that the cost to the United States are likely to be smaller than U.S. producers may fear both in comparison to other changes in the U.S. agricultural economy and in absolute terms because the price gap between U.S. prices and world prices is likely to close as a result of multilateral liberalization and other factors. But doesn't a smaller price-gap also mean smaller 'rents' for Australian exporters, and therefore smaller benefits from the FTA?

The bonanza apparently described by the CIE models is an illusion; the result of inappropriately treating the analytical models as forecasts. There is no reason to expect that the bonanza will be there when we arrive in 2014. But that doesn't necessarily mean that the benefits will be smaller than the benefits illustrated by the CIE study. It is very likely that the CIE report *under-estimates* the potential value of the discriminatory elimination of barriers to bilateral trade in agricultural products.

The following estimates are made on the same basis as the CIE estimates: that is, they assume no change from world and U.S. domestic prices in 1999

Beef The value of the elimination of the beef TRQ was not taken into account in the CIE study because the quota was not binding in 1999: Australia did not have supply to fill the quota. But later work by CIE for Meat and Livestock Australia suggests that – depending on assumptions about demand in the Japanese market and the US production cycle – its removal could be worth as much as \$US495m at the farm gate in 2006. Thereafter, estimate of the additional access would vary in value depending on assumptions about demand and supply in Australia, the United States and Japan.

Dairy The CIE estimates are based on an under-estimate of the current barriers, in my view.³³ A more accurate evaluation of current barriers would imply

³³The value of the elimination of dairy barriers in the CIE report was based on a model that included a weighted average tariff of 23% on current Australian dairy exports to the USA. As the CIE report suggested, Australian dairy exports to the US market under conditions of 'free trade' are likely to be dominated by cheese. The CIE authors therefore calculated an *ad valorem* equivalent for US specific rates weighted to reflect US demand. However the tariff that they used (23%) seems to be much too low. ABARE, for example, in its report on the *Impact of Liberalizing World Trade in*

a bigger result from the elimination of barriers: possibly twice the value suggested by the CIE report.³⁵

These changes would bring the projected additional export sales for sugar beef and dairy up to about \$US755 million.

Table 5: The potential ‘rents’

Projected increase in exports	
<i>selected commodities – annual</i>	
Product	\$US millions
Beef	495
Dairy	520
Sugar	442
Total	755

Source: CIE for Beef, Sugar

Dairy Products calculates tariff equivalents for cheese at 66%³⁴ The USA, in documentation released in support of its recent WTO trade initiative suggests that its own tariff average across cheeses is above 50%. It appears that the CIE may have based their estimates on the *in-quota rate* for cheddar cheese – about 15%

³⁵If we say that the price fall following the elimination of barriers to imports of Australian dairy products into the USA will be 50% rather than the 23% assumed by the CIE authors and there is a linear relationship between the fall in the import price and the size of the increase in import demand for the quantities likely to be available from Australia — which are small compared to total US consumption — then we would be justified in assuming that the impact of a price fall following the elimination of a 50% barrier would be twice the impact following the elimination of a 23% barrier. Even this is likely to be an underestimate. ABARE’s models of the US dairy market assume an import price elasticity of -2.45 for small changes from current import price levels. This means that the percent increase in imports could be more than twice the percent change in prices: a responsiveness that ABARE points out is not unusual for products that are restricted by tariff quotas.