

# **Adding value to the WTO<sup>1</sup>**

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## **I. Summary**

There are two views about the relationship between bilateral and regional trade liberalization agreements and multilateral trade liberalization – they either stepping stones or stumbling blocks to multilateral liberalization. Neither result is pre-ordained. It is determined by the way in which the bilateral or regional agreement is set up. Australia and the US can and should negotiate an FTA which adds value to the WTO.

## **II. Stepping stone or stumbling block?**

There has been a tendency in academic discussion in Australia to presume that any process of liberalization other than unilateral or multilateral liberalization will have negative effects on economic welfare or produce suboptimal results. The debate is wider than the version of it which occurs in Australia. It is reviewed in Annex 1 of this paper.

The traditional measure of whether or not bilateral or regional trade liberalization agreements support or undermine multilateral trade liberalization is “does it enhance or detract from the economic welfare of those in the agreement and their trading partners outside the agreement?” The traditional test of this has been “does the agreement create more trade than it diverts?” This is an empirical test, not a theoretical principle.

It is easy enough to set up a regional agreement which adds to economic welfare. Australia and New Zealand demonstrated how in the Australia New Zealand Closer Economic Relations and Trade Agreement (ANZCERTA) by, among other things, ensuring that trade barriers with other countries were reduced at roughly the same rate as trade barriers between Australia and New Zealand were reduced.

For reasons that are not at all clear, the importance of this example is rarely acknowledged in Australian academic circles, although it is in New Zealand. Perhaps the reason is that New Zealand, like all smaller partners in trade liberalization arrangements, secured greater benefits from the Agreement than Australia.

It must also be pertinent that things have changed. The average tariff in global trade is around four percent. It was around 40 percent when the General Agreement on Tariffs and Trade was negotiated in 1948 and the process of progressive multilateral liberalization of global trade began under its aegis. High protection persists in one sector, agriculture, and a few industries, particularly clothing and textiles. About 20

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<sup>1</sup> This paper draws heavily on a larger paper by the same author “Free Trade Agreements in the era of globalization - new instruments to advance new interests – the case of Australia.” which has been submitted to the Journal of the Australian Institute of International Affairs and has been made available to conference participants.

percent of world trade in goods is highly protected. Conversely protection of about 80 percent of world trade is low and these low levels are generally secured by legal commitments not to increase trade barriers which are made under the provisions of the World Trade Organization.

This has important implications for the general impact of bilateral and regional agreements. As a generality, if average tariffs are low, then the degree of preference to be provided in bilateral and regional agreements is low and the prospect for trade diversion is correspondingly low. That must be the case today. Evidently a proliferation of bilateral or regional agreements in an environment of high average tariffs, such as in 1948, was prospectively a greater threat to the efficacy of non-discriminatory multilateral trade liberalization than would be the case in today's low tariff environment.<sup>2</sup>

The most thorough and most recent effort to assess the empirical impact of regional integration agreements was a study undertaken by the World Bank, published in 2000 under the title "Trade Blocs". Its conclusion was that there was no evidence to generalize that these agreements reduced economic welfare.

The second implication is the importance of "deep integration"<sup>3</sup>. Bilateral and regional integration agreements (and for that matter even the WTO) now seek removal of barriers to trade in services as well as goods and increasingly seek freedom of movement of the factors of production. Measuring the economic welfare effect of "deep integration" agreements requires the impact of these measures to be taken into account as well as the impact of the removal of barriers to trade. The World Bank study points out that the tools for measuring trade diversion and trade creation of traditional controls on trade in goods were never very strong. The capacity to measure the effect of "deep integration" agreements is even weaker. However we know that the economic welfare effects of properly designed deep integration agreements must be higher than traditional measures to reduce barriers to trade in goods.

### **III. Stepping Stones**

There are several cases where bilateral and regional agreements have pioneered modes of liberalization which have later been adopted in the WTO. The Australia New Zealand Closer Economic Relations and Trade Agreement was the first international trade agreement to secure comprehensive liberalization of trade in services. It employed a negative list approach in which both countries committed to remove all barriers to trade in services, except those listed in a negative list.

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<sup>2</sup> Of course, specifics matter. If significant preference is given in industries where protection is high, trade in specific industries can be diverted.

<sup>3</sup> The term "deeper integration" to describe the impact of bilateral and regional agreements was used by Robert Lawrence in a report published by Brookings in 1994 (see Lawrence, 1994). These are agreements that aim for deep economic integration based on neoliberal economic principles. In a comprehensive review of bilateral and regional agreements and their economic impact, a World Bank report (2000: 3) describes them as "Regional Integration Agreements". The report, drawing on earlier work by Schiff and Winters, commends such agreements for achieving "deep integration." provided they are properly framed. (World Bank, 2000: 13; Schiff and Winters, 1998a, 1998b).

Commitments were made to revise the list in future with a view to progressively reducing the exceptions.

In both the EC Single Market Agreement and NAFTA, there are formal commitments to remove barriers to investment. NAFTA provided legal rights to individuals in member countries to contest observance of those rights by governments.

The EC Single Market Agreement provided freedom of movement of personnel. That was not part of the ANZCERTA Agreement, but that right for nationals of Australia and New Zealand had been provided in earlier agreements.

The EC Single Market Agreement provided the most extensive commitments on trade facilitation. It had been established under earlier EC law that a right of cross recognition of product standards had been created. This was advanced under the Single Market Agreement, extending to cross-recognition of qualifications and mutual recognition of conformance assessments of compliance with standards.

The WTO GATS Agreement drew on the experience acquired developing modes for liberalization of services in ANZCERTA and the measures providing for greater freedom of supply of services in the EU Single Market Agreement. The GATS Agreement is not as “clean” as the relevant provisions of ANZCERTA. It uses a positive list (countries list the areas in which they have committed to liberalize and the extent of liberalization) as well as a negative list (they are also required to indicate where they have not liberalized). It does not require a commitment to eliminate barriers, just to liberalize them. As well, extensive rights were provided in GATS to enter exemptions to the acceptance of the commitment to apply the MFN principle.

The precedential effect of a number of these measures in bilateral and regional agreements is shown in the Doha mandate. Investment and trade facilitation as well as competition policy are now on the agenda of the Doha WTO negotiations, although concrete decisions are required at the Mexico WTO Ministerial meeting if specific provisions are to be negotiated

#### **IV. Making an Australian US FTA a stepping stone for the WTO**

For some analysts, the point of departure when considering the impact of liberalization in regional agreements on the WTO is whether or not the terms of the regional agreement satisfy the terms of Article XXIV of the WTO. Some argue that unless commitments to reduce protection of agriculture are comprehensive and comparable with commitments to reduce in industrial sectors, an agreement cannot be considered to comply with the terms of the WTO.<sup>4</sup>

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<sup>4</sup> It is asserted incorrectly that an FTA must achieve complete liberalization in all sectors to comply with the terms of Article XXIV of the GATT. A reading of the relevant Article (XXIV.6) is recommended (the agreements must cover “substantially all” trade) and a study of the processes of review in the WTO is recommended. If the rule were so interpreted, most customs unions and free trade agreements would have been ruled inconsistent. The process is more flexible than is understood by those who argue this).

Proposals have been made in the WTO, including by Australia, to clarifying the terms of regional agreements to ensure they are consistent with the WTO. Such proposals typically include propositions such that the coverage of agreements should be comprehensive, timetables for liberalization should be finite and the agreements should make provision to enable others to join should they want to do so.

Setting aside the questions of whether or not such action is necessary (if there is no evidence that trade diversion is a problem, why tamper with the rules?), and whether or not adoption of new principles in the WTO would make any difference (members of the WTO have been loathe to apply rigorously the existing provisions of Article XXIV) these considerations suffer from the fact they somewhat abstracted from the reality.

An alternative approach is to consider what measures might be included in an FTA which will serve as exemplars for multilateral liberalization in the WTO.

### ***1. Set absolute targets for liberalization.***

Australia and the US should declare clear goals for liberalization and commit to them, for example, that all barriers will be removed within a specified timeframe, say 10 years.

There will be need for provision for exceptions – there are exceptions in all trade agreements – and a negative list approach should be adopted. Products or industries to which the zero target and timetable do not apply should be listed. Then there should be a commitment to remove barriers in the listed products. If a date cannot be specified about when that is to occur, a good second best is to commit to a process – a commitment to review items on the negative list every five years with a view to removing products from that list until all items are removed.

*Standard for the WTO* The practice in WTO/GATT multilateral trade negotiations is not to adopt commitments to remove all barriers. It is to negotiate levels of reduction, for example all tariffs to reduce by one third; set periods by which the reductions are to be achieved, say 10 years; and provide for exceptions to those commitments, say this does not apply to agriculture or clothing and textiles.

### ***2. Make coverage of commitments in goods and services comprehensive***

Australia and the US should commit to apply the goal of zero barriers to all products and services. (Commitments to free the factors of production and secure deep integration are addressed separately below).

*Standard for the WTO.* The practice in the WTO/GATT is to exempt industries and sectors from commitments or to adopt lesser commitments. In goods, agriculture and clothing and textiles were traditionally exempted. In services, air transport, coastal shipping have been effectively exempted.

### ***3. Commit to facilitate deep integration and remove barriers to it.***

Australia and the US should extend the coverage of the FTA to the measures which secure deep integration:

- removal of barriers to investment,
- adoption of competition policy,
- harmonization or cross recognition of regulations or processes to determine compliance with standards and regulations

*Standard for the WTO.* The WTO does not have general provisions for this although the modes for liberalization of services provide for removal of barriers to investment and removal of barriers to recognition of professional qualifications and movement of personnel.

#### ***3a. Extend commitments to freedom of movement of personnel***

Australia and the US should commit to freedom of personnel between the two economies as applies between Australia and New Zealand. As radical as this may seem, since both countries are recipients of emigrants, this should not raise the traditional apprehension among immigration officials that open borders facilitate illegal immigration

*Standard for the WTO.* No general provisions although, as noted above, in the case of services, provision exists for freedom movement of foreign natural persons providing services.

#### ***3b. Commit to full free freedom on "deep integration" obligations.***

Commit to full freedom for all obligations and, where it cannot be applied, adopt the procedure of recording exemptions in a negative list and committing to a process of regular reviews of that list to reduce it, working to realize the ultimate commitment to eliminate all exceptions.

*Standard for the WTO.* As noted above, the practice in the WTO is not to commit to goals of complete liberalization, but to adopt goals of partial liberalization.

### ***4. Commit to make obligations to remove barriers MFN***

Australia and the US could, either in the agreement or independently, undertake to make any commitments, particularly relating to reductions of barriers to trade in goods and services, MFN commitments. In this way each country would be securing the greatest economic benefit. It is very unlikely that the US would contemplate such a provision. US trade law, history and practice requires reciprocity in trade agreements. It is a more practicable option for Australia given than its markets are already highly liberalized.

## **V. Wider impacts**

Any of the above measures would have precedential impact on negotiations in the WTO and encourage greater liberalization. The same impact is prospectively generated for liberalization among APEC economies where a large number of bilateral and regional agreements are under consideration.

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## **VI. Annex I - Measuring the welfare effect of bilateral and regional liberalization**

Free market economists (Bhagwati, Greenaway and Pangariya 1998) fret when they see threats to the multilateral trading system, given its fundamental importance to global prosperity. They have their Australian counterparts, traditionally Rattigan and Carmichael<sup>5</sup>, and most recently, Garnaut (Garnaut 2000). There has been an upsurge in development of regional agreements over the last decade. 200 have been notified to the WTO, one hundred since 1995 (World Bank, 2000: 2). Sixty percent of them entail regional and bilateral agreements with the European Union (EU) and flow on from the completion of the Single Market Program in 1992 (World Bank, 2000).

Not all arrangements promoting the expansion of trade among countries have the desired effect. For example, if countries reduce barriers to trade among themselves and retain high trade barriers with other countries, the impact on economic welfare can be negative. The theoretical case for the potential negative economic impact of bilateral and regional agreements when trade diversion exceeds trade creation is well established (Viner, 1950).

This is why free market economists are inclined as a matter of principle to advise against bilateral or regional free trade agreements. There is apprehension that interest in negotiating regional and bilateral free trade agreements and customs unions in the last dozen years or so threatens the authority and effectiveness of the WTO system. The way in which the European Community protects its agricultural markets clearly illustrates the case.

The European Community is a Customs Union. Members agree to remove barriers to trade among themselves and apply a common tariff on imports from outside. It is similar to a Free Trade Agreement in which members agree to remove barriers to trade among themselves, and continue to apply higher, but not common, tariffs on trade with other countries. The use of these rules is positive for the economic welfare of the countries of the EU and its trading partners where they apply to industrial products, but negative in the case of agricultural products (ERS, 2002: 6).

Under the Common Agricultural Policy, the EU fosters freedom of movement of agricultural products within the European Community (although this freedom is only partial). The EU maintains very high barriers against imports from outside the EU.

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<sup>5</sup> Although in Australia the GATT/WTO has not been universally supported. Bill Carmichael and Alf Rattigan, doyens of the free trade community in Australia, were part of the school of economists who harboured suspicions of the GATT for fostering mercantilism. The GATT was based on the principle of reciprocity. They read this to mean countries would not liberalize unless others did. Australian officials certainly invoked the principle for a long time to justify retention of high levels of protection of Australian manufacturing on the grounds the EC and the US were not reducing protection of their agricultural sectors. It is this writer's view that this mercantilist critique of the GATT failed to appreciate the liberalizing effect of the commitment in the rules to apply whatever reductions in protection were agreed to by other members of the GATT. This negated the consequences of any effort by members of the WTO to secure mercantilist advantage from the GATT. If Governments wanted to be protectionist, they would be. The GATT did not give them new opportunities to do so. To the contrary, it exerted consistent pressure on those countries which provided protection, as the record of Australia's participation in the WTO reveals. Ann Capling's history (2001) of Australian involvement in the WTO makes this clear.

This makes EU farmers prosperous and attracts investment into the EU farm and agricultural industry. The economic cost to the EU is high. Consumers pay much more for food than they would otherwise need to (ERS, 2002: 6). Investment is diverted into food industries which, if directed instead to more globally competitive industries, would produce an economic gain to the EU. The economic cost is greater than the benefit. The Common Agricultural Policy diminishes wealth in the EU rather than increasing it.

The Vinerian analysis allows simple policy prescriptions to ensure that trade diversion is obviated in an FTA or Customs Union. The policy tools to guard against the risk of trade diversion have been well known for some time, but little recognized in Australia, despite the fact that Australia participated in one of the most successful demonstrations of them. It was a New Zealand scholar (Scollay 1996, and 2001: 1141-2) who pointed out that, as in the case of Australia and New Zealand, a bilateral FTA can work without creating trade diversion, provided members also progressively reduce trade barriers with countries outside the agreement. Among Australian academics, this was only really recognised by Peter Lloyd (1999). Another relatively obvious point is that diversion is only a risk if the trade barriers to be reduced in an agreement are high.

Since the rise of regional and bilateral agreements, new concerns have been aired. One is concern that with so many overlapping obligations and systems of regulation (Snape, (1994) called it the “hub and spoke” effect when referring to NAFTA, and Bhagwati (1998) calls it the “spaghetti bowl” effect, referring to the myriad set of relationships among European economies) there are anti-liberal effects. These reduce to two: one, adoption of different rules of origin when free trade agreements are negotiated, creating regulations and paperwork, the administration of which itself impedes trade; and two, facilitation of the emergence of contingent protection (anti-dumping, countervailing and safeguards). (Bhagwati).

Some rules of origin, such as those for textiles and automobile parts in NAFTA have protectionist effects which are deliberate. This is a different issue to the argument that administration of several sets of rules of origin create administrative bottlenecks. The empirical effect of administration of rules of origin appears not to have been assessed. One would have to suspect however that with the introduction of paperless customs administration, the transaction cost of processing must be falling. Bhagwati may have a point if bilateral and regional agreements permit differential standards of treatment when contingent protection is applied. However, the economic effect is minor compared to the problem of the increase in protection through the global rise in the use of contingent protection. This is the cause at root where this problem must be tackled.

Various efforts have been made to assess empirically the overall economic effects of regional and bilateral agreements. In a comprehensive study in 1994, the OECD concluded that there was no concrete evidence that these agreements caused trade diversion (OECD 1994). It noted, also, that FTAs often serve the purpose of stepping-stones to global liberalization in the multilateral system. Writing for the WTO, Heydon (2002: 19) concluded that there is in fact a “symbiotic relationship” between the multilateral and bilateral processes, “with Regional Trade Agreements

drawing on agreed provisions from the multilateral system and the multilateral system picking up regional initiatives.”

As noted above, a major study of the impact of regional agreements was also undertaken by the World Bank (2000). It assessed key regional agreements to see if they diminished or enhanced economic welfare, this being the key measure of whether or not regional agreements undermine the multilateral trading system. The results were inconclusive: in some cases weak evidence of trade diversion was found, in other cases no evidence was found. The ultimate conclusion was that “it is not possible to conclude that trade diversion has been a major problem” (World Bank, 2000: 48). Although some of the empirical findings on FTAs were inconclusive, the report unambiguously affirmed positive effects for countries forming FTAs which facilitated “deep integration”.

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