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THE AUSTRALIA-UNITED STATES FREE TRADE AGREEMENT: A PRELIMINARY ASSESSMENT

ABSTRACT

On 8 February Australian Trade Minister Mark Vaile concluded an agreed text for an Australia-United States Free Trade Agreement. This Issues Brief provides a preliminary assessment of the agreement, based on the limited information now available.

The exclusion of sugar from the deal and the strictly limited access granted to Australian dairy products mean that Australia's gains from the agreement look likely to be significantly less than the US\$2 billion estimate produced by econometric modelling. The freeing up of manufacturing trade, efforts to improve market access for services and changes to investment guidelines are likely to have a modest positive effect on Australian economic prospects, although the lack of detail on the proposed rules of origin mean that the ultimate impact of the deal is hard to assess at this point.

JEL classification: F1, F2

Key words: economic integration, trade negotiations.

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**HIGHLIGHTS OF THE AUSTRALIA-
US FREE TRADE AGREEMENT**

- The proposed agreement is disappointing in terms of agriculture. Of the three sectors that would have benefited the most from improved access to the US market (sugar, dairy, and beef), there has been no change to market access for sugar, a relatively modest increase for dairy, and a time-delayed improvement in access for beef.
- Trade liberalisation has been greater for the manufacturing sector, where the most significant gains are likely to be in textiles, clothing and footwear, and in motor vehicles and parts.
- Arguably the most significant change has occurred in the regulation of investment, where the threshold for the acquisition of Australian assets by the Foreign Investment Review Board has been raised from A\$50m to A\$800m.
- No details are yet available on the rules of origin that will be part of the agreement, the nature of which will have a significant effect on the overall impact of the agreement on welfare. There are also questions regarding the implications for the Pharmaceutical Benefits Scheme.
- On current information, the proposed agreement looks likely to provide a modest lift to the Australian economy. But the benefits look set to be smaller than what had been the most commonly-cited economic estimates of a US\$2b lift to real GDP.

**AGREEMENT REACHED ON AN
AUSTRALIA-UNITED STATES
BILATERAL TRADE DEAL**

Australia announced on 14 November 2002 that Australia and the United States would begin negotiations on a preferential trade agreement (an Australia-United States Free Trade Agreement, or AUSFTA). Negotiations were completed on 8 February 2004 when Australian Trade Minister Mark Vaile and US Trade Representative Bob Zoellick concluded an agreed text for the AUSFTA.

The United States is already a major trade and investment partner for Australia.

- In 2002-03 the United States was Australia's second largest merchandise export market (9% of total exports, equivalent to about A\$10.4b) and its largest source of merchandise imports (almost 17% of total imports, equivalent to about A\$22.5b). In terms of overall merchandise trade, the United States was Australia's second largest trading partner.
- The United States is also a key trading partner in services, accounting for 16% of Australian exports (A\$5.2b) and more than 18% of Australian imports of services (A\$6.1b) in 2002-03.
- The United States is both the main destination for Australian investment overseas (the home for about 42% of the stock of overseas Australian investment), *and* the main source of overseas investment in Australia (accounting for a bit less than 30% of the total).

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WHAT WAS EXPECTED FROM THE DEAL?

The welfare gain to Australia from concluding a bilateral trade agreement with the United States will be a function of several factors, including the nature of the existing trading relationship (its scale and composition); the level and scope of existing trade barriers between the two countries; and the amount of trade creation versus trade diversion produced by the agreement. In addition, critics of preferential trade agreements have argued that the potential for such deals to have an adverse impact on the health of the WTO-based multilateral trading system should also be taken into account, along with the distortions created by the rules of origin that are required to allow such deals to function.¹

The most commonly cited study on the potential merits of an AUSFTA was produced in 2001 by the Centre for International Economics (CIE). The CIE used the results of two macroeconomic models to gauge the possible net benefits of the deal.² Its report concluded that if AUSFTA membership had been agreed in 2001, then Australian GDP and real consumption would have been boosted by 0.4% by 2010, and in absolute terms real GDP

would be nearly US\$2b higher (almost A\$4b at the exchange rates then prevailing in 2001). The CIE study also found that the biggest potential sectoral gains for Australia would accrue to the sugar and dairy industries.

KEY ISSUES IN THE NEGOTIATIONS AND WHAT AUSFTA DELIVERED

Welfare gains to Australia from an AUSFTA accrue both from reductions in Australian trade barriers and from improved Australian access to the US market. The scale of any such gains will be limited however by the fact that even before the AUSFTA negotiations got underway Australia and the United States were already among the most open economies in the world, with very low average tariff rates (2.8% for the United States, 3.8% for Australia, according to the World Bank). Still, both countries maintained some significant barriers to trade, offering some scope for gains from trade liberalisation.

Before negotiations on the AUSFTA got underway, analysts identified several areas that would be critical in determining the likely gains from any agreement.³

¹ For a detailed discussion of the general case for and against preferential trade agreements see Lowy Institute Working Paper in International Economics No. 1 *Is the international trading system fragmenting? The dilemma for Australian trade policy.*

² Berkelmans, L., L. Davis, W. McKibbin and A. Stoekel. Economic impacts of an Australia-United States Free Trade Area: CIE report for the Australian Department of Foreign Affairs and Trade. Canberra, Centre for International Economics. June 2001.

³ The list of key negotiation issues that follows draws in large part on the discussion in chapter 2 and appendix A of the CIE report. Complete documentation of the AUSFTA is not yet available, so the detail on the deal is drawn from the briefing documents and fact sheets provided on the DFAT web site <http://www.dfat.gov.au/trade/negotiations/us.html> and the web site of the Office of the US Trade Representative <http://www.ustr.gov/new/fta/australia.htm>.

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- *US restrictions on dairy products*

The United States imposes tariff rate quotas (TRQs) across a range of dairy products in which Australia is internationally competitive. Out of quota tariffs are set at prohibitive levels. The Australian dairy sector was one of those industries identified by the CIE report as a potentially significant beneficiary of greater access to the US market.

The AUSFTA provides only small gains for the Australian dairy industry. TRQs are kept in place, with no change to the out-of-quota tariff, although Australia's actual quota is to be doubled. The US briefing material estimates that increases in Australian dairy imports under AUSFTA would amount to about 2% of the current value of US dairy imports and about 0.17% of the annual value of US dairy production.

- *US restrictions on sugar*

The United States also imposes extremely onerous TRQs on sugar. Along with the dairy industry, the CIE identified Australia's sugar sector as a key potential winner from an AUSFTA.

Sugar was excluded from the AUSFTA, with no change to Australia's current annual quota of 87,000 tonnes as determined under the existing Uruguay Round Agreements.

- *US restrictions on meat*

The US maintains TRQs on beef, and also applies tariffs to other meat imports. Beef

exports are the largest single export item from Australia into the US.

US above-quota duties on beef are to be phased out over an 18-year period. Australia will be granted gradual increases in quotas – growing by 18.5% over the 18 years – but these increases will start to take effect only after either US beef exports have returned to their 2003 (pre-BSE) levels, or three years after the agreement takes effect, whichever comes first.

Australian lamb and sheep meat producers will have most tariffs reduced to zero immediately, and the rest within four years.

- *US and Australian restrictions on textiles, clothing, footwear & leather*

Both countries impose restrictions – either in the form of tariffs or quotas – on imports of textiles and clothing. There are also some US restrictions on footwear, and Australian restrictions on leather imports.

Textile and apparel tariffs will be phased out over a maximum period of 15 years. Tariffs on some footwear will also be phased out.

- *US restrictions on ships/boats and shipping services (the Jones Act)*

The 1920 US Merchant Marine Act (the Jones Act) and related legislation impose severe restrictions on foreign access to the US ship and shipping services market, which has an adverse impact on Australian shipyards and the associated fast ferry business.

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A 50% tariff on ship repairs and maintenance (part of the Jones Act) will be removed.

- *US restrictions on commercial vehicles and Australian restrictions on motor vehicles & parts*

The US imposes significant tariffs on some commercial vehicles, including a 25% tariff on pickup trucks. Australia imposes tariffs on passenger motor vehicles and parts, and on light commercial vehicles and parts.

Both sides agreed to eliminate customs duties on “almost all automotive products” from the date AUSFTA enters force. This includes the removal of the 25% tariff on trucks.

- *US and Australian government procurement policies*

Both countries maintain government procurement policies that discriminate in favour of domestic producers and products. (The US waives these preferences for members of the WTO agreement on government procurement, but Australia is not a party to this agreement, and therefore does not benefit.)

Australia will be granted a waiver from US programs favouring domestic producers and products. All US federal government contracts over US\$58,550 (and construction projects over US\$6,725,000) will be open to Australian firms. Similarly, US suppliers are granted the right to bid on Australian government contracts. Australian preferences for small businesses and indigenous people will remain,

however, and the defence sector is excluded from the agreement.

- *Australia’s Foreign Investment Review Board (FIRB)*

The FIRB allows the government to review proposed overseas purchases of Australian assets, and the government has the power (under the Foreign Acquisitions and Takeovers Act) to block proposals deemed contrary to the national interest. In addition, there are several sectors which are subject to additional restrictions on foreign investment, including media ownership and content.

All US investment in new businesses will be exempted from screening under the FIRB. Thresholds for acquisitions by US investors in most sectors have been raised from A\$50m to A\$800m. US estimates suggest that this higher threshold would have exempted almost 90% of US investment transactions from screening over the past three years.

The FIRB will continue to advise the government on whether takeovers of telecommunications, transport and defence are in the national interest at the old threshold of A\$50m.

Foreign investments in urban land (including residential properties) and the media, and by foreign governments, will continue to be screened regardless of value. Existing foreign investment limits relating to the media, Telstra, CSL, Qantas and federal leased airports and shipping have all been preserved. The threshold will also protect Australia’s ‘four pillars policy’ in the banking sector, although

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strictly speaking this is only a restriction on the ability of the four big banks to merge.

- *US and Australian quarantine procedures*

Both countries make use of quarantine regimes which are sometimes accused of being used as a form of non-tariff protection. For example, in the past the United States has expressed concern that Australia has unnecessarily excluded products including chicken, pork, corn and grapes. In turn, Australia has raised concerns over products such as tomatoes, cherries and citrus.

According to the Australian briefing material, the “integrity of Australia’s quarantine regime and our right to protect animal, plant and human health and life are preserved” by the agreement. In addition, a “framework for discussions on specific products has been established.”

According to the US documentation, both sides will “work to resolve sanitary and phytosanitary barriers to agricultural trade, in particular for pork, citrus, apples and stone fruit.” The US also notes that the agreement establishes “a new mechanism” to resolve specific health matters.

- *Single desk arrangements*

Australia maintains so-called single desk (export monopoly) arrangements for sugar, rice, wheat and barley. In past WTO negotiations the US has argued strongly for the removal of these arrangements.

Single desk arrangements are not affected by the agreement.

The US briefing notes comment that “Australia committed to working with the US in the ongoing WTO negotiations to . . . eliminate restrictions on the right of entities to export.”

- *The Pharmaceutical Benefits Scheme (PBS)*

The PBS was thought likely to be a major target of US trade negotiators, since some major US drug companies have claimed that under the current system the PBS has rejected or delayed listing major drugs such as Viagra.

The Australian briefing states that “Australia will make improvements to the transparency and timeliness of PBS processes and provide more opportunities for companies seeking listing of new medicines on the PBS to have input to the process.” It goes on to stress that “[a]ccess by Australians to affordable medicines under the PBS will be maintained under the AUSFTA.”

The US briefing highlights the “establishment of an independent process to review determinations of product listings”. In addition, it notes that the “two sides also agreed to establish a Medicines Working Group that will provide for continued dialogue . . . on emerging health care issues.”

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**OTHER FEATURES OF THE
AGREEMENT**

Along with the key areas identified above, other items of note include:

- Over 97% of Australian manufacturing exports to the United States will receive duty free access to the US as soon as the agreement goes into operation. At the same time, more than 99% of US manufactured exports to Australia will also become duty free.
- About 66% of US tariffs on Australian agricultural products will go to zero immediately, with a further 9% going to zero in four years. All US agricultural exports to Australia will receive immediate duty-free access.
- All Australian metal and mineral exports to the United States will immediately become duty free.
- All tariffs on Australian wine will be reduced to zero over 11 years, albeit from an already relatively low level of protection.
- Improved access to services markets on both sides, with procedures to promote the mutual recognition of qualifications in professional services and increased recognition of Australian degrees.

EVALUATING THE AGREEMENT

Proponents of a bilateral trade agreement with the US cited several potential benefits of such a

deal. These included the almost US\$2b boost to real GDP identified by the CIE study and the opportunity to promote “deep integration” between the two economies by including investment and labour market regulations in the agreement along with trade in goods and services. They also claimed that a bilateral deal would allow negotiators to deal with issues that were too difficult to be addressed at a multilateral level, and to reach an agreement much more quickly than would be possible under WTO type arrangements. Political and security benefits from further cementing Australia’s relations with the US were also cited.

On the other hand, opponents of an AUSFTA argued that any *realised* gains from a deal would be much smaller than the *potential* gains identified by the CIE study, since agreement was unlikely to be reached on difficult-to-negotiate areas such as agriculture. They also stressed the tendency of bilateral agreements to generate complex rules of origin that could reduce welfare and prompt trade distortions and diversion.⁴ Some critics also argued that an agreement with the US could risk alienating key Australian trading partners in the region, and would also serve to undermine the prospects for further progress with multilateral trade negotiations.

Finally, some commentators worried that an AUSFTA would undermine the PBS and Australian quarantine regulations.

⁴ Rules of origin set out criteria for deciding whether a good shipped from a member country can be deemed to have originated there (for example, through requirements on the share of value-added created in the member economy).

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How do these claims and counter-claims stack up in light of the agreement as it currently stands?

- The gains from the trade liberalisation elements of the deal look set to be much less than the US\$2b CIE estimate, much as opponents of the deal argued.⁵ The CIE result was based on the (externally imposed) assumption of large-scale trade liberalisation across most sectors and industries. But key sectors such as sugar and dairy have either been excluded from the negotiations or granted only relatively small improvements in terms of access to the US market. And the CIE report suggested that for Australia the largest gains would come precisely from the sugar and dairy industries. So the trade gains coming from improved access for Australian exports to the US market are likely to be significantly less than assumed in the modelling exercise.
- On the other hand, the CIE reckoned that the bulk of gains in terms of greater US market access to Australia would come in the manufacturing sector. Here, the preliminary evidence suggests that the projected gains are more likely to be realised.⁶ However, some of the resultant

increase in trade between the US and Australia will be the product of trade diversion – probably from competing Asian manufacturers. The CIE’s estimates, for example, suggested that Japanese and Korean production of automobile components and Chinese production of footwear could suffer from trade diversion.

- The expectation that AUSFTA would include policies promoting “deep integration” has been met. The agreement contains provisions on labour and the environment, and on issues such as competition, telecommunications, e-commerce and investment. Indeed, the provisions relating to investment could prove to be one of the most significant elements of the agreement.
- Taken overall, therefore, on current information the AUSFTA is likely to have a quite modest positive impact on the Australian economy, although it is possible that there may also be some significant dynamic effects on the growth rate in the longer term.
- However, there is no detailed information yet available about the rules of origin that will operate under AUSFTA. Since these could potentially range from the relatively

⁵ The CIE report made no attempt to quantify possible dynamic gains from an AUSFTA arising from changes to investment incentives and productivity.

⁶ There is an interesting point about the political economy of trade negotiations here. From an economic welfare perspective, Australia will benefit both from improved access to the US market (good for Australian exporters) and from improved US

access to the Australian market (good for Australian consumers and those producers who will use imported inputs, abstracting for the moment from the problem of trade diversion). But trade negotiations are typically framed in the form of wins and concessions. Hence in the public perception as to whether a “good” deal has been reached, the gains from improved access to the US market will be weighted much more heavily than those accruing from domestic liberalization.

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simple rules required by the Australia-New Zealand Closer Economic Relations (CER) trade agreement through to the more than 200 pages in the North American Free Trade Agreement (NAFTA), this makes it difficult to judge the overall impact of the deal. Complex rules of origin can create significant costs and lead to major economic distortions that could undermine the benefits of an agreement.

- Even though the deal missed its original deadline of end-2003, the relative speed with which negotiations were concluded provides some support for the thesis that bilateral negotiations are less cumbersome than their multilateral counterparts. On the other hand, the exclusion of sugar and the relatively limited gains given to the dairy sector suggest that bilateral agreements do not provide significantly better chances for reaching agreement on sensitive trade issues.
- It is possible that Australia's demonstrated willingness to compromise on agriculture in bilateral negotiations could undermine its negotiating stance on these issues in the multilateral arena. Such an effect is hard to quantify, however.
- The impact of AUSFTA on Australia's relations with regional trading partners is also difficult to gauge. With trade agreements already signed with Singapore and Thailand, and with the possibility of a future deal with China being canvassed, the dangers of Australia being somehow "frozen out" by annoyed regional trading partners looks remote. Several regional economies are also hoping to pursue

similar deals with the United States. Still, if the deal leads to significant trade diversion from some sectors in regional economies (for example in the case of automobile parts) it could still create some trade policy tensions. The agreement could also have indirect effects by encouraging other regional economies to look more favourably on preferential trade agreements which would not necessarily include Australia. This trend was already in place before AUSFTA, however.

- The impact on the current multilateral trading round is similarly hard to estimate. The Doha Round was already in trouble after the collapse of the Ministerial meeting in Cancún last September, and it's not clear that an AUSFTA will have much of a direct impact on the current direction of negotiations. But by adding yet more momentum to the preferential trade bandwagon, there is some risk that an AUSFTA could add to the sense that the multilateral trading system is no longer the best place to seek trade deals. As we have noted before, as an open economy, Australia has a vital national interest in the ongoing health of the multilateral trading system. Any gains from individual preferential trade agreements would appear insignificant when set against the costs involved in a fragmenting global trading system. The dilemma for policymakers has been, and remains, whether to continue to push ahead with agreements like the AUSFTA, and hence risk collateral damage to the multilateral trading system, or to go no further down the preferential trade road, and take the chance of being left

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behind in the event that the rush to preferential trade agreements continues.

- Finally, the level of detail currently available makes it difficult to assess what the impact of AUSFTA will be on the PBS, since the implications of the Medicines Working Group and the introduction of a more “transparent” appeals process are not yet clear.