4 Issues and concerns with preferential trade agreements

Key points

- Diverse preferential trading arrangements add to the complexity of international trade and investment, are costly and time consuming to negotiate and add to the compliance costs of firms and administrative costs of governments.
  - Complexity stems in part from the diversity of approaches used to determine and list origin requirements (for both goods and services) in Australia's preferential agreements — revealingly referred to as 'denial of benefits' for services and investment.
  - Complexity also arises from the divergent market access and national treatment commitments for services activities across agreements.
  - The complexity and additional costs erode potential benefits of agreements.
- Some agreements entered into by Australia impose more stringent intellectual property protection than previously required. There is potential for future agreements to contain even more stringent levels of protection — imposing additional costs without commensurate benefits.
- The inclusion of investor-state dispute settlement (ISDS) provisions in Australia's preferential trade agreements and bilateral investment treaties has become contentious.
  - The provisions depart from national treatment principles by affording substantive appeal rights to foreigners not available to domestic firms, risk impeding domestic regulatory reform (regulatory chill), include safeguards and carve-outs of uncertain effect, lack transparency and have inadequate parliamentary scrutiny.
  - ISDS provisions also expose the Australian Government to potentially large unfunded contingent liabilities dependent on decisions by international arbitration tribunals.
  - Concerns are heightened by increases in the number of ISDS cases internationally.
- Against these concerns, it is not clear ISDS provisions respond to a demonstrable market failure or have been associated with the fostering of foreign investment flows, particularly between advanced economies with transparent and well-functioning legal systems.
- Preferential bilateral and regional trade agreements are complex and can affect wide sections of the economy.
  - However, current processes do not provide a sufficient understanding of the likely scale or scope of the net impacts of negotiated agreements. Full assessments of alternative reform strategies are also not provided.
- The complexity of bilateral and regional trade agreements and the potential for provisions to impose net costs on the community presents a compelling case for the negotiated text of an agreement to be comprehensively analysed well before signing.

Proponents of preferential bilateral and regional trade agreements argue that such arrangements are a pragmatic way of improving market access opportunities for Australian exporters in the absence of multilateral reform. Active participation is said to be needed to avoid placing Australian exporters at a disadvantage to competitors that are parties to such agreements. In practice, however, the give-and-take nature of preferential agreement negotiations means that certain domestic industries are favoured over others, imposing costs on the domestic economy which are only understood transparently through a comprehensive independent evaluation of each agreement.[21]

Accordingly, preferential trade agreements are not as effective in improving national welfare as unilateral action to reduce or eliminate trade barriers (primarily through greater domestic competition), or multilateral trade and investment liberalisation (PC 2010a). Preferential agreements also add to the complexity of international trade and investment, are costly and time consuming to negotiate and add to the compliance costs of firms (in the evaluation and utilisation of preferences) and administrative costs of governments. In the words of the Australian Chamber of Commerce and Industry (ACCI):

> When the hundreds of trade agreements across the globe are negotiated in aggregate by nations a complex barrier of administrative obligations and procedures emerges, which traders must understand and overcome for each specific agreement in order to obtain benefit. These agreement by agreement administrative barriers are an added cost to business, add risk for delay of goods should documentation and other requirements be addressed incorrectly, and ultimately risk reducing the streamlining of international trade. (ACCI 2013, p. iii)

The Commission's report on Bilateral and Regional Trade Agreements (PC 2010a) noted the importance of pursuing domestic reforms (including unilateral tariff reductions) as a preferable means of raising national welfare compared to preferential or discriminatory trade agreements. Nevertheless, Australia has actively pursued such preferential approaches in recent times. The resulting agreements are complex. Considered analysis of individual agreements is beyond the scope of this review. The impacts of those agreements therefore remain unclear and highlight the need for rigorous evaluation of the negotiated text prior to their signing. In this edition of the *Trade & Assistance Review*, the Commission draws attention to several material areas of concern including:

- differing rules of origin for merchandise and services trade and investment
- variable coverage of services across agreements and the likely effectiveness of services sector liberalisation
- likely costs of more stringent intellectual property rights protection
- concerns about the variability, effectiveness and unfunded liability posed by investor-state dispute settlement provisions
- the evaluation of the negotiated text of agreements.

[21] Efficiency costs are created when resources move from efficient industries that are not direct beneficiaries of the agreement to the beneficiaries of preferential market access arrangements, such as in the area of export-oriented agricultural products. Negotiated preferential arrangements also do not provide protection against the granting of preferential access to other trading partners.

4.1 Rules of origin

Rules of origin are incorporated in preferential trade agreements in order to restrict access to tariff and other preferences to goods and services deemed to originate from parties to the agreement. Without such rules there would be an incentive to import goods or services from a third country into one of the member countries in order to take advantage of the negotiated preferences offered by the agreement (PC 2004a, 2010a). Origin rules pertaining to merchandise trade typically relate to the sourcing or nature of inputs to production, whereas origin rules (termed denial of benefits) pertaining to services relate to location of substantial business activity, ownership and control. Importantly, rules of origin are treated as non-tariff barriers to trade in the UNCTAD (2013) and by the WTO. While it is difficult to gauge the protective effect of these rules in Australia's preferential agreements, origin rules are negotiated around the commercial interests of firms. This implies that the rules play at least some contemporaneous role in protecting domestic industries from import competition and affording a 'margin of preference' to partner suppliers.

Merchandise trade

Australia's preferential trade agreements contain a range of approaches to conferring origin that businesses must consider when sourcing inputs to attain concessional tariff rates for merchandise trade.[22] Typically, a good is eligible for preferential tariff treatment if:

- the good is wholly obtained in the territory of one or both of the Parties[23]
- the good is produced entirely in the territory of one or both of the Parties, exclusively from originating materials
- the good satisfies all applicable requirements of the Product Specific Rules schedule where the good includes non-originating materials.

Where a good is designated not to be 'wholly obtained' or 'produced entirely locally', the main approaches used for determining origin of merchandise trade are shown in box 4.1. The approaches described are variously applied individually or in combination to determine origin in Australia's preferential agreements. The application of the approaches varies between products within agreements and, for individual products, between agreements.

22 Most rules of origin require direct consignment of goods meaning that for a product to be eligible for origin treatment it must be transported directly from the place of production to its preferential destination. The purpose is to ensure that imported goods, in particular bulk cargo etc. whose identity is difficult to establish, are identical with the goods that left the exporting country and to reduce the risk of eligible goods being mixed with non-eligible goods.

23 Australia's exports of energy, minerals and agricultural commodities generally comply with the wholly obtained rule.

Box 4.1 **Approaches for determining origin of non-originating materials used in merchandise trade in Australia's preferential trading agreements**

There are three common tests used for determining origin for goods that contain non-originating materials:

- The change in tariff classification (CTC) test — a good is transformed if there is a change in tariff classification, using the Harmonized Commodity Description and Coding System (HS). The CTC method can be applied at the HS 8-digit, HS 6-digit, HS 4-digit or HS 2-digit level of classification.
- The specified process test — a good is transformed if it has undergone specified manufacturing or processing operations which are deemed to confer origin of the country in which they were carried out.
- The regional value content (RVC) test — a good is transformed if a threshold percentage value of locally or regionally produced inputs is reached in the exporting country.

These rules are variously applied individually or in combination with one another. In some agreements, such as the ASEAN and Malaysia agreements, a choice between rules is afforded.

Source: PC (2010a, p. 79).

This adds to the complexity and costs facing businesses when sourcing inputs to attain preferential treatment.[24] ACCI recently noted:

> Preferential agreements, while potentially providing 'freer' trade between the agreement parties, are specifically designed to be restricted to the parties and so exclude non-parties by way of complex 'rules of origin'. (ACCI 2013, p. iii)

Moreover, the administrative features of particular origin rules can add to business costs in unexpected ways. A specific example is provided by the ASEAN-Australia-New Zealand agreement (AANZFTA) which was recently amended because:

> Australian industry came to Government with concerns that a number of administrative requirements in AANZFTA discouraged use because they required some businesses to provide commercially sensitive information. The Protocol addresses these concerns and modernises the presentation of the Agreement's Rules of Origin. This should reduce costs and make doing business under AANZFTA easier. (Robb 2014e)

Recent studies have suggested that the cost associated with origin requirements could be as high as 25 per cent of the value of goods trade within ASEAN (APEC 2009, p. 67).

The product-specific rules can be expressed at the 2-digit chapter, 4-digit heading, 6-digit sub-heading, 8-digit tariff line item or for groupings of tariff line items under the Harmonized System (HS) of international trade. While the rules apply to a similar number

24 Exporters have a choice of whether to access preferential treatment subject to meeting rules of origin or exporting under the MFN regime. Where the latter approach is chosen this avoids the compliance costs associated with origin rules, but it also means the negotiated agreement is of no practical benefit to those firms.

of tariff items overall, the approach to listing those rules varies considerably from a single three-tiered regional value content based rule in the agreement with Singapore to more than 5200 individual rules in the agreement with Korea (table 4.1).[25,26]

Table 4.1 **Count of listed rules of origin by trade agreement**
Number of rules listed in agreements

	New Zealand	*Singapore*	*Thailand*	*USA*	*Chile*	*ASEAN*	*Malaysia*	*Korea*	*Japan*
Number	2826	1	2900	980	2803	3102	2658	5205	1943

Source: Commission estimates.

The different rule structures across agreements means that a firm trading with multiple countries faces greater complexity and compliance costs through the need to interpret, and comply with, different rules of origin schedules. A specific example of how these differences manifest in actual agreements with respect to a single tariff item (bed, table and other linen) is shown in box 4.2.

In addition to differences in the number of origin rules listed in schedules, there is also a diversity of approaches used for conferring origin. The most common rule is the change in tariff classification (CTC) test but there is considerable variation in how CTC rules are combined with other rules and how they are applied across agreements (figure 4.1).

In the Japan-Australia agreement (the latest agreement to enter into force), just over 40 per cent of the origin rules are based on a CTC only test (left hand panel in figure 4.1). This differs considerably from the use of CTC only rules in Australia's earlier agreements. For example, a CTC only test made up just 11 per cent of the origin rules in the ASEAN and Malaysian agreements and 60 per cent in the Korean agreement. Further, just under 50 per cent of the origin rules as specified in the Japan-Australia agreement involved a rule choice between a CTC rule or a regional value content rule. This compares with 72 per cent in the ASEAN agreement, 86 per cent in the Malaysian agreement and 22 per cent in the Korean agreement.

25 The presentation of product-specific rules is negotiated as part of each agreement with some partners preferring a disaggregated approach while others prefer a summary where the same rule applies under a chapter or heading. While Australia generally seeks the same product-specific rule outcome in its agreements, variations result from different industry sensitivities across agreement partners. (DFAT, pers. comm., 21 May 2015).

26 While the Commission understands the more detailed list of rules in the Korea agreement was intended to simplify the use of the origin-rule schedule for firms, that justification appears not to have been carried over to the more recent Japan-Australia agreement which contains 1943 individual origin rules.

Box 4.2 Rules of origin for Bed linen, table linen, toilet linen and kitchen linen (HS item 6302)

In order to qualify for concessional entry, Bed linen, table linen, toilet linen and kitchen linen [HS item 6302] must meet the following criteria:

- *Australia-United States*. Change to heading 6302 from any other chapter, except from heading 5106 through 5113, 5204 through 5212, 5307 through 5308 or 5310 through 5311, Chapter 54, or heading 5508 through 5516, 5801 through 5802 or 6001 through 6006, provided that the good is both cut (or knit to shape) and sewn or otherwise assembled in the US or Australia.
- *Thailand-Australia*. Change to heading 6302 from any other chapter, provided that any non-originating material that is fabric is pre-bleached or unbleached, and that there is a regional value content of not less than 55 per cent.
- *Australia–New Zealand*. Change to heading 6302 from any other chapter, provided that where the starting material is fabric, the fabric is raw and fully finished in the territory of the Parties; or No change in tariff classification is required, provided that there is a regional value content of not less than 45 per cent based on the build down method.
- *Australia-Chile*. Change to heading 6302 from any other chapter provided that where the starting material is fabric, the fabric is raw and fully finished in the territory of the parties.
- *Malaysia-Australia.* Change to heading 6302 from any other chapter, provided that where the starting material is fabric, the fabric was greige fabric that: (a) is dyed or printed; and (b) finished in Australia or Malaysia to render it directly usable.
- *Japan-Australia.* CC [Change to heading from any other chapter] provided that, where non-originating materials of headings 50.07, 51.11 through 51.13, 52.08 through 52.12, 53.09 through 53.11, 54.07, 54.08, 55.12 through 55.16, or chapter 60 are used, each of the non-originating materials is woven, or knitted or crocheted entirely in the Area of one or both Parties.

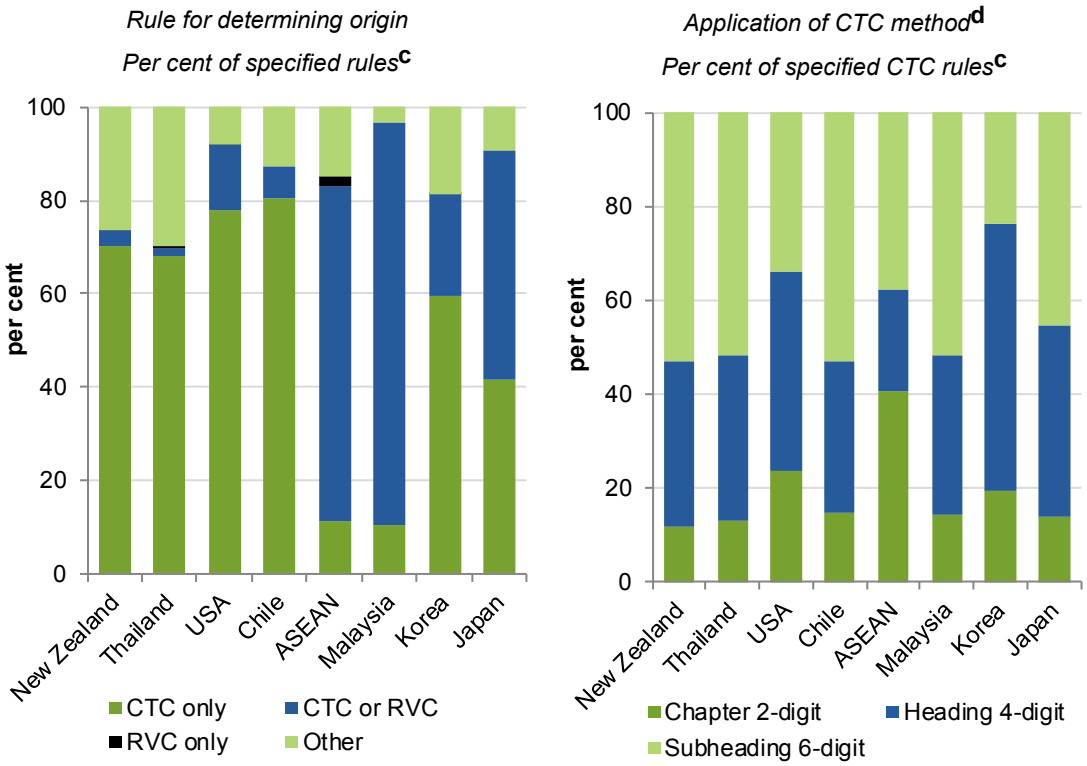
In other agreements, the qualifying criteria are described at the HS 6 digit level. For example, in order to qualify for concessional entry, the 6 digit sub-item *Bed linen, table linen, toilet linen and kitchen linen - Bed linen, knitted or crocheted* [item 6302.10] must meet the following criteria:

- *ASEAN-Australia-New Zealand.* CC [Change to subheading from any other chapter], provided that where the starting material is fabric, the fabric is raw or unbleached fabric and fully finished in the territory of one or more of the Parties.
- *Korea*-Australia. CC [Change to subheading from any other chapter], provided that where the starting material is fabric, the fabric was greige fabric that is dyed or printed and finished in the territory of one or both of the Parties to render it directly usable.

Source: Australian Customs and Border Protection Service (2015b).

At a more detailed level, 45 per cent of the CTC origin rules in the Japan-Australia agreement require change from a detailed HS 6 digit subheading item level to another chapter, heading or subheading (right hand panel in figure 4.1). This compares with 38 per cent in the ASEAN agreement, 52 per cent in the Malaysian agreement and just 24 per cent in the Korea agreement.

Figure 4.1 **Methods used to determine origin of merchandise trade in Australia's preferential trade agreements**[a,b,c,d]



[a] CTC refers to a change in tariff classification test. RVC refers to a regional or qualifying value content rule. 'Other' includes, combined CTC and RVC rules, CTC rules with exceptions and specified process tests requiring particular production methods needed to qualify for preferential entry. The figures are slightly different to those published in the *Trade & Assistance Review 2012-13* due to minor revisions to selected calculations. [b] The agreement with Singapore is not included as it applies a single three-tiered test of origin. [c] Individual rules can be expressed at the 4 digit heading level, 6 digit subheading level or groupings of tariff line items. [d] When the Australia-New Zealand CER agreement entered into force in 1983, an RVC rule with a simple technical test was the main rule applied. The revised rules reported replaced that rule and have been in force since 1 January 2007.

Source: Commission estimates.

Services and investment

While the existence of rules of origin in goods trade is well known, their application (and associated consequences) in services trade and investment has received much less attention. Rather than defining the origin of the service or investment (the focus in goods trade), trade agreements have generally sought to delineate the origin of a service supplier or investor (Fink and Dikomborirak 2007). The effect is to deny designated foreign (non-Party) owned or controlled companies access to the provisions negotiated in trade agreements.

Most of Australia's bilateral agreements have adopted a near identical services and investment origin rule requiring *substantial business operations* in the Territory of a Party

(the United States example in box 4.3 is typical of the wording in many agreements) although the meaning of 'substantial' is not defined.[27] As such, a non-party services supplier or investor engaging in substantial business operations in a member State may also benefit from an Agreement. The broad application of services and investment origin requirements (which allows branches of foreign owned companies as well as formally established enterprises to access agreement commitments) is intended to encourage foreign investment in Australia including through the establishment of regional headquarters as a base to invest in partner countries (DFAT, pers. comm., 21 May 2015).

The Japan-Australia agreement (in force since 2015) goes further by stipulating that an enterprise may be denied the benefits of the Agreement if it is more than 50 per cent owned by a non-party or has a majority of its directors appointed by a non-Party which has no substantial business activities in the area of the other Party. Similarly, the Thailand-Australia agreement (in force since 2005) stipulates that a service supplier or investor must not be owned or controlled by persons of a non-Party.

On the other hand, the Australia-New Zealand agreement (in force since 1983) requires that a service or investment must not be *indirectly* provided by a person of neither member State. This variability across agreements adds to the complexity facing Australian-located service suppliers and investors seeking to utilise negotiated access commitments.

Given the direct or vague references to foreign ownership or control in these agreements, the level of foreign ownership in Australian services providers is relevant to whether the origin rules actively deny the services commitments in an agreement to foreign-owned firms and whether this impacts foreign firm decisions to actually use Australia as a base for investment in partner economies. From this perspective, the level of foreign direct investment in Australian service industries is about $265 billion (nearly 40 per cent of total foreign direct investment) with financial and insurance, wholesale and retail trade, real estate and information and communication services attracting the largest shares of inward foreign direct investment in services (table 4.2).

27 The term *substantial business operations* is based on the language contained in the WTO General Agreement on Trade in Services and is designed, inter alia, to prevent 'shell companies' being established to access preferential market access treatment. Denial of benefits clauses also provide governments with the power to impose sanctions on other countries in line with international obligations such as in the area of human rights violations. (DFAT, pers. comm., 21 May 2015)

Box 4.3 Services and investment origin (denial of benefits) rules in selected Australian trade agreements

New Zealand

Services (Article 14)

A Member State may deny the benefits of this Protocol to persons of the other Member State providing a service if the Member State establishes that the service is indirectly provided by a person, not being a person of either Member State.

Investment (Article 18)

A Party may deny the benefits of this Protocol to an investor of the other Party that is an enterprise of such other Party and to investments of that investor if the enterprise has no substantive business operations in the territory of the other Party and persons of a non-Party or of the denying Party own or control the enterprise.

Thailand

Services (Article 804)

A Party may deny the benefits of this Chapter to a service supplier of the other Party where the Party establishes that the service supplier is owned or controlled by persons of a non-Party.

Investment (Article 905)

A Party may deny the benefits of this Part to an investor of the other Party that is a juridical person of such Party and to investments of such an investor where the Party establishes that the juridical person is owned or controlled by persons of a non-Party.

United States

Services (Article 10.11)

A Party may deny the benefits of this Chapter to a service supplier of the other Party if the service supplier is an enterprise owned or controlled by persons of a non-Party or of the denying Party that has no substantial business activities in the territory of the other Party.

Investment (Article 11.12)

A Party may deny the benefits of this Chapter to an investor of the other Party that is an enterprise of such other Party and to investments of that investor if the enterprise has no substantial business activities in the territory of the other Party and persons of a non-Party, or of the denying Party, own or control the enterprise.

Japan

Services (Article 9.14)

A Party may deny the benefits of this Chapter to a service supplier of the other Party that is an enterprise of the other Party, where the denying Party establishes that the enterprise is owned or controlled by an investor of a non-Party or of the denying Party and the enterprise has no substantial business activities in the area of the other Party.

Investment (Article 14.17)

A Party may deny the benefits of this Chapter to an investor of the other Party that is an enterprise of the other Party and to its investments, where the denying Party establishes that the enterprise is owned or controlled by an investor of a non-Party or of the denying Party and the enterprise has no substantial business activities in the Area of the other Party.

In both cases, owned means greater than 50 per cent equity interest and controlled means the power to name a majority of directors or otherwise legally direct an enterprises actions.

Source: DFAT (2015c).

Table 4.2 **Foreign direct investment in Australia, at December 2014**
$ billion and per cent

Industry	*$ billion*	*Per cent*
Services		
Electricity, Gas and Water	13.3	1.9
Construction	18.9	2.8
Wholesale and Retail Trade	63.0	9.2
Accommodation and Food Services	8.1	1.2
Transport and Storage	13.6	2.0
Information and Communication	24.6	3.6
Financial and Insurance	66.9	9.7
Real Estate Services	47.7	6.9
Other	9.1	1.3
Sub-total	**265.8**	**38.6**
Merchandise trade and unallocated		
Agriculture, Forestry and Fishing	1.3	0.2
Mining	264.7	38.4
Manufacturing	88.1	12.8
Unallocated	68.5	10.0
Total	**688.4**	**100.0**

Source: ABS (2015b).

As activities across these areas feature prominently in the services commitments found in Australia's preferential trading agreements, the level of foreign ownership highlights the potential for announced liberalisation benefits to overstate the actual benefits.

The discretionary nature and vagueness of the services and investment rules of origin leave a number of questions as to the actual or potential impact of the rules of origin on services trade and investment activity. For example, 'To what extent would the provisions chill (or influence) commercial activity that may otherwise have occurred' and 'Under what circumstance would the partner government invoke the provisions and in such an event, how would terms such as 'ownership and control' and 'substantial business operations' be interpreted.

4.2 Service sector coverage

The size of the services sector in developed economies and its growing importance in developing economies, has seen service sector liberalisation become an increasingly important focus of trade negotiations at the multilateral, plurilateral, regional and bilateral level. The role of services as a facilitator of goods trade and an emerging recognition of its role in intermediate supply reinforces the need to remove restrictions on the efficient supply of, and trade in, services (chapter 2).

Trade agreements, however, typically concentrate on 'at the border' barriers to services trade imposed via restrictions on entry or commercial presence of foreign service suppliers. Other barriers to services trade involve 'behind the border' restrictions on entry such as through control of recognition of qualifications by professional associations and non-tariff barriers such as language and cultural differences and complex and unfamiliar legal systems. Trade agreements cannot be reasonably expected to address all forms of behind the border protection. Their purported benefits need to be viewed in that light.

Against that background, the China-Australia bilateral trade agreement was presented as a landmark achievement in market access concessions for Australian service providers. Commenting on the services outcomes in ChAFTA, the Australia Minister for Trade and Investment said:

> The Australian Government has secured the best ever market access provided to a foreign country by China on services, with enormous scope to build on an export market already worth $7 billion. (Robb 2014c)

Without the availability of the agreement's text, detailed assessment remains elusive. As such, the Commission is unable to form a view as to whether the aspirational goals are commensurate with potential real-world impacts. Several questions pertinent to such an assessment include: are there limits to the amount of additional services that can be supplied to expanded market opportunities; are there material trade barriers that exist beyond the scope of agreements; what is the net impact of rules of origin (termed denial of benefits); what is the tenor of phasing arrangements; what carve-outs quarantine certain activities from the liberalising intent of the agreement; to what extent is the agreement necessary to achieve the announced goals (a form of additionality); and what are the opportunity costs of not pursuing unilateral reform in order to retain negotiating coin.

The approach to defining the boundary of Australian agreements on services trade has been to use both negative lists (only specified activities are excluded from the commitments) and positive lists (only specified activities are included in the commitments) to determine the coverage of services in an agreement (PC 2010a). Negative listing is generally viewed as superior because coverage is more transparent, extensive and automatically includes new services industries and innovations. Negative lists have been used in six of Australia's trade agreements (those with New Zealand, Singapore, the United States, Chile, Korea and Japan). In contrast, the agreements with Thailand, ASEAN (which has ten member States) and Malaysia have adopted a positive list approach. A dual listing approach is being adopted in the agreement with China with provision to move to a negative list approach over time (DFAT pers. comm., 21 May 2015).

The potential impact of any particular agreement will depend on the collective and net 'sum of parts' which reflect the net impact of the respective approaches actually taken. And while negotiated reforms may cover barriers in a range of services industries, the benefits obtained depend in large measure on the subsequent uptake of opportunities by business and the extent to which the liberalised barriers are important to facilitating trade. A related issue is whether negotiated agreements work to maintain and further liberalise

existing levels of market openness through 'standstill' and 'ratchet' provisions, or whether they simply codify existing arrangements — potentially making future reform more difficult or slowing the willingness to reform domestically.[28]

Another issue involves the divergent market access and national treatment commitments in Australia's negotiated trade agreements and the complexity this presents for Australian firms. A summary of the nature and extent of services liberalisation commitments for each country that is party to the AANZFTA (which adopts a positive list approach to listing commitments) is presented in table 4.3. These commitments relate to removing restrictions on market access or national treatment in terms of cross-border supply, consumption abroad and commercial presence.

As mentioned, the agreements with the United States, Chile, Korea and Japan use a negative list approach to listing services commitments and do not contain market access or national treatment restrictions. Examples of activities not subject to the liberalising commitments (or carve outs) in these agreements include requirements in AUSFTA that directors of a national bank must be US citizens; prohibition in certain US States on the establishment of a branch or agency by a foreign bank and branches of foreign insurance companies are not permitted to provide surety bonds for US Government contracts.

At the sectoral level, there is considerable disparity in the negotiated services outcomes across countries with the most open being Australia (9 restricted sectors) and New Zealand (5 sectors) which have the lowest number of sectors restricting market access and/or national treatment for foreign firms.[29] Where restrictions persist in those two countries, these are mainly in the areas of banking services, insurance, maritime transport and media ownership. Those restrictions typically apply to domestic and foreign firms (that is, national treatment is applied) so they are non-discriminatory. By comparison, other parties to the AANZFTA agreement have a much higher number of restrictions in place (including those countries such as Malaysia, Thailand and Singapore which have separate bilateral agreements with Australia).

28 Standstill provisions are intended to bind existing levels of regulation and prevent backsliding to more protectionist measures while ratchet provisions automatically extend the commitments to include future liberalising measures.

29 Importantly, the failure of agreements to mention commitments in a number of service sectors should not necessarily be interpreted as representative of a market access restriction between the Party's to the agreement. Similarly, sectors listed as unrestricted may still be subject to qualifications such as carve outs or rules of origin requirements that limit the extent of liberalisation. For example, Korea listed an extensive range of carve-outs in its services undertaking including aspects of construction, transportation, distribution, agriculture and livestock, business services, wholesale and retail distribution, telecommunications, real estate, professional services (legal, accounting etc), engineering and education as non-conforming measures (typically requiring a commercial presence through the establishment of an office in Korea).

Table 4.3 **Services commitments in the ASEAN-Australia-New Zealand trade agreement[a,b]**

Number of sectoral line items with restricted or unrestricted market access and national treatment provisions

Member	*Restricted sectoral line items*	*Unrestricted sectoral line items*
Australia	8	81
New Zealand	5	93
Singapore	31	39
Thailand	25	41
Vietnam	49	40
Indonesia	59	3
Malaysia	72	6
Laos	10	26
Myanmar	22	9
Cambodia	19	60
Philippines	56	1
Brunei	22	1

a Commitments are not made to a uniform classification. Hence, aggregation of restricted, unrestricted and unlisted items do not add to a common total across members. **b** The methodology used to construct this table involved an examination of the schedules of specific services commitments provided by individual ASEAN members as part of AANZFTA. Where countries indicated no market access or national treatment limitations on cross-border supply, consumption abroad or commercial presence, the relevant sector or sub-sector was categorised as unrestricted. Where some form of limitation was indicated, the relevant sector or sub-sector was categorised as restricted. Where no specific reference to a sector or sub-sector was made, that sector or sub-sector was not included as either a restricted or unrestricted category. Differences in individual country reporting practices means the combined number of restricted and unrestricted sectors differ across countries.

Source: Commission estimates (see Appendix D).

While this analysis sheds light on the number of restrictions across countries and their broad nature it does not indicate the degree of absolute or relative trade restrictiveness. Nor does it show how AANZFTA commitments compare to multilateral undertakings. Fully assessing the depth and quality of commitments is problematic (WTO 2011b). Nevertheless, partial assessments have been made by assigning scores to market access commitments depending on whether they involve 'full', 'partial' or 'no liberalisation'. The resulting index calculated by weighting scores across trade categories, can then be used to compare the level of liberalisation across countries and across time.

Table 4.4 presents index scores for individual country commitments in AANZFTA which entered into force in 2010 and compares these with commitments made to the WTO General Agreement on Trade in Services (GATS) which entered into force in 1995. The table highlights and reinforces the significant disparity in services commitments across countries, the size of the gap between actual commitments and unrestricted services trade (a score of 100) and also the limited progress in further liberalising services trade in AANZFTA compared to the earlier GATS commitments. And while Australia ranks as the

most open country relative to its AANZFTA partners, Australia's services commitments in other preferential agreements are considerably more liberal. For example, in its bilateral agreement with the United States, Australia achieved an index score of 81.5 under the WTO index. This result is consistent with the observation that larger trading powers tend to receive more concessions in preferential trading agreements than other trading partners (WTO 2011b, p.8).

Table 4.4 **Comparison of GATS and AANZFTA services commitments[a]**
Index score out of 100

	Brunei	*Indonesia*	*Malaysia*	*Philippines*	*Singapore*	*Thailand*	*Vietnam*	*Australia*	*New Zealand*
GATS	7.99	17.26	27.47	16.41	37.59	19.39	34.18	57.06	54.42
AANZFTA	10.2	22.3	32.36	21.47	40.31	19.69	34.35	57.06	55.44

a A score of 100 represents full commitments in all subs-sectors and relevant modes of supply (cross border trade and commercial presence). For each sub-sector and mode of supply, a score of 1 is given for a full commitment, 0.5 for a partial commitment, and 0 for no commitment. Where a partial commitment improves on GATS, a score of 0.75 is awarded. The index implicitly assumes that all commitments with the same score are equivalent. This is a simplification which cannot substitute for a qualitative analysis of the depth and value of commitments undertaken.

Source: WTO (2011a).

In addition, the relaxation of ownership and other restrictions in a number of agreements (especially those with non-English speaking countries) needs to be viewed in the context of cultural or institutional barriers that may limit the effective levels of services liberalisation. Language barriers; complex, unfamiliar legal systems; historical and cultural norms all present material impediments to Australian firms in markets covered by some recent bilateral agreements. In this context, it has been found that Australian services firms tend to enter markets with similar institutions, rules and regulations to those in Australia with Commonwealth countries providing notable examples (Findlay and Rammal 2013). An issue therefore in this context is whether the detailed provisions have any material effect on actual services trade between partner economies. The scale of commercial opportunities offered by offshore markets (particularly those in Asia) would provide a strong incentive for Australian firms to at least consider alternative means of accessing those markets.

Prospects for expanded services trade as a result of specific agreements need to be considered in this overall light. In its report on Bilateral and Regional Trade Agreements, the Commission found that Australian firms had made little use of the services provisions in BRTAs negotiated up to that point (PC 2010a, p. 156). Reasons for not taking advantage of negotiated provisions for market access varied across service industries but in broad terms reflected the fact that the *actual* barriers to services trade existed beyond the sphere of government control and hence were not influenced as much by services provisions in trade agreements (although it was recognised they can serve as one possible catalyst for negotiations between sub-government service regulators) as other factors. For example, in professional services (such as legal, financial and architectural firms), the requirements for

registration and professional practice are regulated by professional associations rather than jurisdictional governments.

Also, the incremental benefits of agreement provisions may not be as great as envisaged because the negotiated commitments have been rendered superfluous because firms had already found cost-effective ways to work around existing barriers behind the border. For example, where foreign ownership (in whole or part) of service providers has been limited or prohibited, Australian firms may forge strategic and other alliances (including networks) with local firms to circumvent such restrictions (PC 2010a, p. xxiv).[30]

4.3 Intellectual property provisions

The protection of intellectual property (IP) rights has become a mainstream feature of trade agreements at the bilateral, regional and plurilateral level. While the WTO Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement set minimum standards for the scope, length of term, administration and enforcement of IP rights, some preferential agreements (including those to which Australia is a participant) have provided, or are seeking to provide, more stringent protections. For individual countries, the impact of these provisions will directly depend on whether they are net exporters or importers of different forms of IP material. More broadly, the impact of the provisions will depend on how they affect the level and growth in economic activity in partner economies.

While most of Australia's bilateral trade agreements simply reaffirm commitments to the TRIPS Agreement, the agreement with the United States (a net IP exporter) and Chile (which has a similar agreement with the United States) have a wider coverage than either TRIPS or other bilateral agreements and impose more stringent provisions. For example, the term of copyright protection under the Australia-United States agreement was extended to the life of the author plus 70 years and compares with life plus 50 years under TRIPS. As discussed in the Commission's report on Bilateral and Regional Trade Agreements, that extension is likely to have imposed a net cost on Australia (PC 2010a, p. 259).[31] Concerns have also been expressed about other features of AUSFTA. These include restrictions on circumventing technological protection measures (TPMs) which the Senate Committee examining the effects of the agreement viewed as anti-competitive (box 4.4).[32]

> However, copyright holders who are in the position to use TPMs can potentially create their own additional de facto monopoly rights by restricting access on their own terms. This could

[30] While there may be cost-effective ways to bypass existing barriers, any liberalising provisions of trade agreements may still offer even lower-cost ways of accessing markets.

[31] Dee (2005) found that an extension of copyright to between 80 and 100 years after death under the AUSFTA would result in a net cost to Australia of $88 million per annum or up to $700 million in net present value terms.

[32] TPMs include measures such as geo-blocking of internet sites to prevent non-residents from accessing content available in specific markets. Australian consumers access to the United States based Netflix service provides an example.

lead to significant anti-competitive results, with increased costs and/or decreased choice for consumers. State sanctions against circumvention of TPMs substantially increase this risk. This is especially the case where the definition of TPM, for the purposes of the protection of the law, includes any measure which controls access to material, as AUSFTA requires, rather than merely preventing or inhibiting infringement, which is the current Australian position. (SCFTAAUSA 2004, pp. 32-33).

Box 4.4 Article 17.4.7 AUSFTA: circumvention of technological protection measures

In order to provide adequate legal protection and effective legal remedies against the circumvention of effective technological measures that authors, performers, and producers of phonograms use in connection with the exercise of their rights and that restrict unauthorised acts in respect of their works, performances, and phonograms, each Party shall provide that any person who:

- (i) knowingly, or having reasonable grounds to know, circumvents without authority any effective technological measure that controls access to a protected work, performance, or phonogram, or other subject matter, or
- (ii) manufactures, imports, distributes, offers to the public, provides, or otherwise traffics in devices, products, or components, or offers to the public, or provides services that:
- (A) are promoted, advertised, or marketed for the purpose of circumvention of any effective technological measure
- (B) have only a limited commercially significant purpose or use other than to circumvent any effective technological measure, or
- (C) are primarily designed, produced, or performed for the purpose of enabling or facilitating the circumvention of any effective technological measure

shall be liable and subject to the remedies specified in Article 17.11.13. Each Party shall provide for criminal procedures and penalties to be applied where any person is found to have engaged wilfully and for the purposes of commercial advantage or financial gain in any of the above activities. Each Party may provide that such criminal procedures and penalties do not apply to a non-profit library, archive, educational institution, or public non-commercial broadcasting entity.

Source: AUSFTA (2005).

The relevance of trade related IP issues for Australia has gained even greater prominence because of the potential reach of the proposed TPP in this area. Potentially, the IP chapter in the TPP could be extensive and go beyond the provisions contained in the TRIPS Agreement and AUSFTA. For example, based on US media access to the current draft text, it appears likely that the TPP will include obligations on pharmaceutical price-determination arrangements in Australia and other TPP members, of an uncertain character and intent. The history of IP arrangements being addressed in preferential trade deals is not good. Indeed, to the extent that the return to IP holders awarded by more stringent IP laws outweighed the benefits to the broader economy, the provision would also impose a net cost on both partners, lowering trading and growth potential across the bloc.

For such reasons, the Commission has previously recommended that:

> … Australia's participation in international negotiations in relation to IP laws should focus on plurilateral or multilateral settings, and that its support for any measures to alter the extent and enforcement of IP rights should be informed by a robust economic analysis of size and distribution of the resultant benefits and costs. (PC 2010a, p. 264)

More recently, the Australian Government's Competition Policy Review (Harper 2015) recommended that an overarching review of intellectual property be conducted by an independent body. Amongst other things, it recommended that the review cover the incorporation of intellectual property provisions in international trade agreements.

4.4 Dispute settlement

Some trade agreements and investment treaties entered into by the Australian Government contain investor-state dispute settlement (ISDS) provisions for settling disputes between an investor of one party to the agreement and the government of the other party. Under the provisions, dispute settlement options can include third-party arbitration. For example, the ISDS provisions in the Bilateral Investment Treaty between Australia and Hong Kong were used by Philip Morris Asia to initiate third party arbitration in relation to Australia's tobacco plain packaging laws (chapter 7).

Trends in international ISDS cases

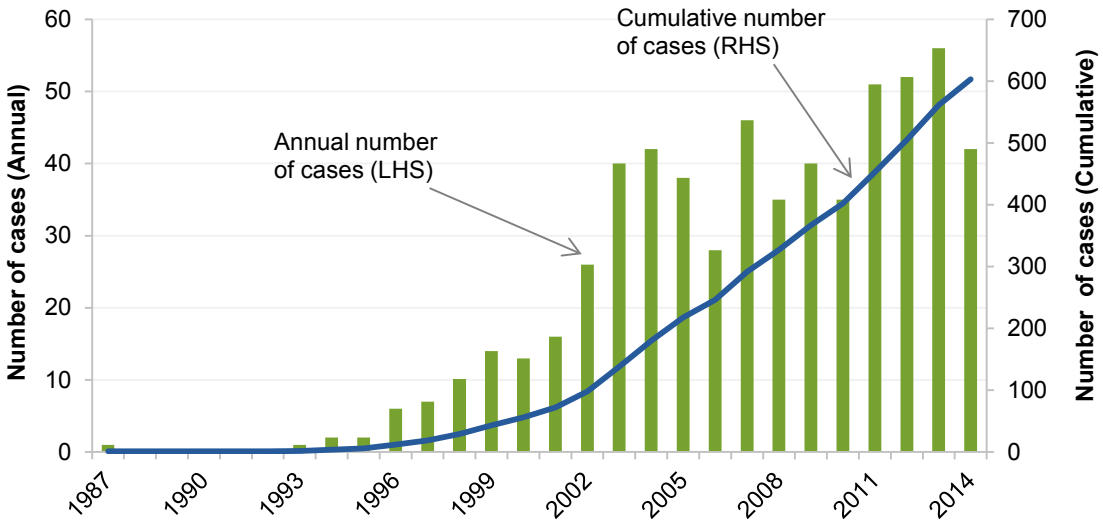
There has been a growing number of ISDS cases in recent years with 42 new claims in 2014 (figure 4.2). While claims have historically been dominated by initiations against developing and transitional States, recent years have witnessed an unusually high number of cases against developed economies (around 40 per cent of the total for 2014). A broad range of government measures have been challenged in recent years including changes related to investment incentive schemes, cancellation or alleged breaches of contracts, revocation or denial of licenses and alleged direct or de facto expropriation (in part, the issue at the heart of Philip Morris Asia's claim against the Australian Government).

In terms of case outcomes, for those ISDS claims decided by arbitration or settled prior to arbitration (which together account for about half the cases shown in figure 4.2), around 37 per cent were ruled in favour of the State, 25 per cent were ruled in favour of the investor and 28 per cent were settled prior to arbitration. While information on the amount of compensation sought by applicant investors is scarce, the amounts claimed ranged from US$8 million to US$2.5 billion for cases where this information was reported (UNCTAD 2015a). However, a combined award of US$50 billion to investors in three closely related cases in 2014 was the highest known award on record.[33]

33 The aggregate amount of compensation obtained by the three claimants constituting the majority shareholders of former Yukos Oil Company in the ISDS proceedings against the Russian Federation. See

Figure 4.2 **Known ISDS cases, 1987 to 2014**

Number of cases



Sources: UNCTAD 2015a, 2015b.

As noted, the Australian Government is currently defending an ISDS case bought by Philip Morris Asia over Australia's introduction of tobacco plain packaging laws in 2011 (chapter 7). While the amount of compensation sought by Philip Morris in its claim against the Australian Government has not been publicly disclosed, the company has stated it will be seeking substantial remedies and that financial losses that have resulted from the plain packaging laws. While the potential risk to future budget outcomes from this case was disclosed (for the first time) in the Australian Government's 2014-15 Budget Papers, the size of the risk has not been quantified nor provisioned in any substantive way. In reporting on this issue, the Australian Government said:

> In 2014-15, the Government will continue to fund the defence of legal challenges to the tobacco plain packaging legislation in international forums. Further information about these cases has not been disclosed on the grounds that it may prejudice the outcomes of these cases or may relate to commercial information. (Australian Government 2014c)

The inclusion of ISDS provisions is contentious

The inclusion of investor-state dispute settlement provisions in Australia's preferential trade agreements and investment treaties has become a contentious issue. In response to

Hulley Enterprises Limited (Cyprus) v. The Russian Federation, UNCITRAL, PCA Case No. AA 226, Award, 18 July 2014; Yukos Universal Limited (Isle of Man) v. The Russian Federation, UNCITRAL, PCA Case No. AA 227, Award, 18 July 2014; Veteran Petroleum Limited (Cyprus) v. The Russian Federation, UNCITRAL, PCA Case No. AA 228, Award, 18 July 2014.

concerns about these provisions, the Senate Foreign Affairs, Defence and Trade Legislation Committee (SFADTLC) conducted an inquiry into a bill proposing the Commonwealth be prevented from entering into agreements that include ISDS provisions. The Committee released its final report in August 2014.

The Committee noted that the majority of submissions supported the intention of the bill for reasons which included:

- growth in the number of ISDS cases brought internationally
- extension of substantive appeal rights available to foreigners not available to domestic firms
- risk of regulatory chill
- effectiveness of safeguards and carve-outs
- lack of transparency and inadequate parliamentary scrutiny of ISDS (and other) provisions.

Those not supporting the bill primarily argued it would prevent the negotiation of future international agreements including plurilateral agreements such as the TPP, would disadvantage Australian companies investing in countries with high sovereign risk and that existing safeguards were sufficient to protect the public interest. The Committee concluded that ISDS issues should be assessed on a case-by-case basis and therefore did not support the bill. In reaching its conclusion, the Committee said:

> The committee is of the view that a blanket ban on ISDS would impose a significant constraint on the ability of Australian governments to negotiate trade agreements that benefit Australian business. It is for this reason that the committee considers the current case-by-case approach to ISDS is in Australia's long-term national interest and a sound policy for weighing the risks and benefits of ISDS provisions in trade agreements. (SFADTLC 2014, p. 17)

Another argument advanced in favour of ISDS provisions is that they can be used as a negotiating mechanism to trade-off against other elements of an agreement that are viewed as more important. However, such an approach would appear to be a very high risk strategy of achieving market access objectives especially given the potential size of compensation claims involved and the unfunded nature of those claims (discussed above).

Commenting separately on the ISDS issue, the Chief Justice of the High Court recently cautioned against any potential undermining of the authority of domestic courts by ISDS arbitration. He argued that as trade agreements and bilateral investment treaties were long-lived, and resort to ISDS had increased significantly over time, it was not sufficient to argue that because Australia had only been subject to one ISDS claim (that bought by Philip Morris Asia under the Hong Kong IPPA) that the risks posed by ISDS were overstated. The Chief Justice suggested the primacy of domestic courts be maintained:

> An approach designed to protect the finality and authority of domestic judicial decisions could consider a limitation on ISDS mechanisms applicable to Australia which would preclude any challenge to the decision of an Australian domestic court as constituting a breach of the

> relevant BIT or FTA clauses. Such an approach could also consider precluding the canvassing in an arbitral claim of the correctness of a decision of an Australian domestic court and in particular, decisions on questions of law binding on lower courts. (French 2014, p. 11)

Australia is not the only country to be considering the appropriateness of ISDS provisions with France and Germany both opposed to the inclusion of such provisions in the European Union-United States trade agreement known as the Trans-Atlantic Trade and Investment Partnership which is currently being negotiated. Germany has also indicated it will not ratify the recently signed European Union-Canada agreement (known as the Comprehensive Economic and Trade Agreement) which contains ISDS clauses reportedly on the grounds that:

> It must not be that international investors have rights and influence before arbitration tribunals, which national enterprises don't have in their own country. (ICTSD 2014)

The possible inclusion of an ISDS mechanism in the TPP could similarly allow investors to bring claims for private arbitration directly against governments and potentially undermine the role of domestic courts and freedom of governments to regulate in the public interest. The greater the stringency of specific provisions, the greater the risk of ISDS actions against government as firms have more at stake in relation to government decisions that directly or indirectly affect their commercial interests. Similarly, where interpretation of the negotiated text may be subject to dispute, understandings or expectations between TPP members over how these provisions will be interpreted may not necessarily be taken into account by an international tribunal hearing a claim bought by a private company.[34]

Given the persistent and unresolved debate surrounding this issue, a relevant question to be considered is what impact existing ISDS provisions (or their absence) have had on investment flows and whether those impacts deem ISDS provisions necessary. Australia has included ISDS clauses in six of its bilateral trade agreements — Singapore (2003), Thailand (2005), Chile (2009), ASEAN and New Zealand (2010), Korea (2014) and China (not yet in force). Australia currently also has ISDS provisions in its 21 Investment Protection and Promotion Agreements (IPPAs) signed over the last three decades with Argentina, China, Czech Republic, Egypt, Hong Kong, Hungary, India, Indonesia, Laos, Lithuania, Mexico, Pakistan, Papua New Guinea, Peru, Philippines, Poland, Romania, Sri Lanka, Turkey, Uruguay and Vietnam.

An examination of foreign investment trends with Australia's main foreign investment partners suggests that ISDS provisions are unlikely to have been relevant considerations in the investment decisions of Australian firms investing abroad or foreign firms investing in Australia. Inward and outward foreign investment stocks are dominated by a small number of developed countries with the United States and United Kingdom accounting for 49.6 per

[34] Some agreements specifically allow the Parties to consult on the meaning of a treaty and any written record of what negotiating parties understood provisions to mean can be taken into account as official documents (DFAT pers. comm., 21 May 2015). Given the confidential nature of TPP negotiations, it is not clear whether it is intended that the agreement will provide scope for Parties to consult on the meaning of individual provisions.

cent and 44.6 per cent of total inward and outward stocks respectively in 2013 (table 4.5). Only two of the top ten source and destination countries (Hong Kong and Singapore) had signed a preferential trade agreement or IPPA containing investor-state dispute provisions with Australia. These two countries accounted for just 4.6 per cent of Australia's inward foreign investment stock and 2.2 per cent of Australia's stock of investment abroad in 2013 (largely unchanged from the shares in 2003). These features suggest ISDS protections are not necessary or sufficient to foster investment flows between developed countries with transparent and well-functioning legal systems.

Table 4.5 **Australia's major foreign investment relationships[a]**

Stocks of inward and outward foreign investment

	Inward stock (%)			*Outward stock (%)*	
Country	*2003*	*2013*	*Country*	*2003*	*2013*
United States	27.5	26.7	United States	38.1	28.9
United Kingdom	24.9	22.9	United Kingdom	15.7	15.7
Japan	4.4	5.3	New Zealand	6.7	5.0
Singapore*	2.1	2.5	Germany	1.7	3.5
Hong Kong*	2.7	2.1	Canada	1.0	3.3
Switzerland	2.0	1.9	Japan	3.6	3.1
Netherlands	2.1	1.5	Switzerland	1.1	2.3
China*	0.3	1.3	Singapore*	2.2	2.2
New Zealand	1.2	1.2	France	1.9	2.1
Canada	1.1	1.1	Netherlands	2.6	2.1
Other ISDS*	0.2	0.5	Other ISDS*	3.4	6.4
Other countries	30.8	33.0	Other countries	22.1	25.5
Total	100.0	100.0	Total	100.0	100.0

a Refers to total foreign investment. * Signifies agreement in force prior to 2003 which contains ISDS provisions.

Source: DFAT (2014b).

The majority of Australia's IPPAs have been largely negotiated with less developed countries with perceived higher levels of sovereign risk and questions over the reliability of their legal systems. Despite these agreements, the share of Australian investment abroad accounted for by IPPA countries represented just 6.4 per cent of Australia's outward foreign investment stock in 2013 (excluding Hong Kong which has a highly developed, English-based legal system). While this share has increased over the decade, it is not clear whether the presence of ISDS materially influenced the relative growth or whether it was the result of broader factors relating to commercial opportunity.

As reported in a previous edition of *Trade & Assistance Review*, there have only been three cases where Australian firms have used ISDS provisions in bilateral investment treaties (each involving less developed countries). The only successful case involved the Australian company (White Industries) which brought proceedings against the Indian

Government in relation to a contractual agreement between White Industries and a state-owned enterprise. The two other cases involved Australia-incorporated companies (Planet Mining and Tethyan Copper Company) initiating ISDS claims against the Governments of Indonesia and Pakistan, respectively (PC 2013).

In its report on Bilateral and Regional Trade Agreements (PC 2010a, p. 271), the Commission concluded there was an absence of an identifiable underlying economic problem on market failure grounds that necessitates the inclusion of ISDS provisions. The apparent lack of evidence regarding the effects of such provisions on Australian foreign investment leads the Commission to emphasise its previous recommendation that:

> The Australian Government should not include matters in bilateral and regional trade agreements that would serve to increase barriers to trade, raise costs or alter established social policies without a comprehensive review of the implications and available options for change. On specific matters, the Australian Government should:
>
> - c) seek to avoid the inclusion of investor-state dispute settlement provisions in BRTAs that grant foreign investors in Australia substantive or procedural rights greater than those enjoyed by Australian investors. (PC 2010a, p. xxxviii)

4.5 Assessing the potential impacts of trade agreements

The complexity of bilateral and regional trade agreements and the potential for provisions to impose net costs on the community presents a compelling case for the negotiated text of an agreement to be comprehensively analysed before signing. A comprehensive and robust evaluation framework based on the Commission's framework for evaluating national economic reforms and its findings in the 2010 report on bilateral and regional trade agreements that addresses the relevant issues is set out in box 4.5.

However, current processes fail to adequately assess the impacts of prospective agreements. They do not systematically quantify the costs and benefits of agreement provisions, fail to consider the opportunity costs of pursuing preferential arrangements compared to unilateral reform, ignore the extent to which agreements actually liberalise existing markets and are silent on the need for post-agreement evaluations of actual impacts.[35]

[35] The Commission acknowledges the practical difficulties involved in quantifying the impacts of agreements due to the variable quality and completeness of international services trade and investment statistics and the inherent difficulty in quantifying services and investment trade barriers compared to tariff measures. Nevertheless, given the potential for preferential agreements to impose net costs on Australia, these difficulties should not be used as a justification to avoid greater scrutiny, including through the quantification of potential impacts.

Box 4.5 Possible evaluation framework for trade agreements

A comprehensive and robust analysis of an agreement would:

- provide information on the potential national economic impacts of the full agreement, including estimates of the economy-wide and distributional effects of change
- assess, where practicable, the impact of the agreement on assisting Australia achieving its productivity and trade potential and the opportunities for improvement, recognising the differences in customs tariffs and other barriers to trade across countries, as well as the different nature of merchandise trade, services trade, direct and portfolio investments, intellectual property and the movement of natural persons, carve outs and phasing, and the time paths over which benefits are likely to accrue and costs incurred
- assess the scope for agreements to evolve over time to assist Australia to meet its productivity and trade potential, including through review provisions and built-in agenda
- assess the scope and appropriateness of the agreement to act as a model or template for other agreements.

At a more detailed level, the analysis would (for each chapter of the agreement):

- identify the current institutional settings and changes from those settings, including phasing arrangements
- list the eligibility requirements (including rules of origin for goods, services and investment) for the receipt of preferences under the agreement
- report on who or what could be potentially directly affected by the agreement, and levels and trends in bilateral trade and investment
- identify the nature of potential direct benefits and costs of full implementation of the text of an agreement and impediments, if any, to the take up of preferences
- quantify, where practicable, the potential benefits and costs and the timescale over which they are likely to occur
- identify and quantify where practicable transition costs compared to 'business as usual', that are likely to be incurred achieving preferences under the agreement
- assess any potentially adverse impacts of an agreement, including regulatory chill
- assess the opportunity cost of an agreement, including holding back domestic reform to maintain negotiating coin.

Sources: Based on PC (2010a, 2010b).

In assessing current processes, the Commission has chosen to benchmark the evaluation framework shown in box 4.5 against the assessment actually undertaken for the Japan-Australia agreement.

Current requirements for the assessment of prospective trade agreements involve the preparation of Regulation Impact Statements (RISs) for compliance assessment by the Office of Best Practice Regulation (OPBR), a National Interest Analysis (prepared by the Department of Foreign Affairs and Trade) and a review by the Joint Standing Committee on Treaties (JSCOT) to consider whether ratification of the agreement is in the national interest.

The Australian Government's best practice regulation requirements stipulate the preparation of a Regulation Impact Statement identifying and quantifying the compliance costs to business and the community from a regulatory change.[36] Under OBPR guidelines proponents are required to answer the following questions.

(a) What is the problem you are trying to solve?

(b) Why is government action needed?

(c) What policy options are you considering?

(d) What is the likely net benefit of each option?

(e) Who will you consult and how will you consult with them?

(f) What is the best option from those that you have considered?

(g) How will you implement and evaluate your chosen option? (Australian Government 2014a, p. 1)

With respect to trade agreements, a two stage formal RIS process is invoked — with the first RIS required prior to the decision to enter into negotiations of an agreement and the second prior to the signing. For the Australia-Japan Economic Partnership Agreement — the most recent agreement in force — the OBPR advises that a RIS was not prepared for the decision to enter into negotiations and, accordingly, DFAT had not complied with RIS requirements for this stage of the process (OBPR 2014). The second stage RIS was prepared by DFAT with the OBPR ruling that although the RIS was viewed as compliant with Australian Government requirements at the final decision point, 'having regard to the significance and widespread nature of the likely impacts of the proposal on the Australian economy, the OBPR does not consider that the RIS is best practice' (OBPR 2014). The OBPR went on to provide a number of specific examples of the shortcomings in the prepared RIS (box 4.6).

The National Interest Analysis, also prepared by DFAT, simply listed a set of claims regarding the benefits of market access and other commitments in the agreement which were supported by little in the way of quantitative or qualitative evidence. Further, the analysis ignored the non-tariff barriers included in the agreement such as carve-outs and rules of origin, the opportunity cost of delaying domestic reform to maintain negotiating coin to achieve an agreement, nor did it provide a view on the counterfactual — that is, what was likely in the absence of an agreement.

36 These requirements first came into effect in November 2006.

Box 4.6 OBPR assessment of the JAEPA RIS

The OBPR noted that the RIS prepared by DFAT did not provide the reader with sufficient understanding of the likely scale and scope of the impacts of the JAEPA on affected parts of the Australian economy. OBPR provided the following examples to support its assessment:

- the RIS relies heavily on 'before and after' comparisons of tariff levels and quotas, with insufficient analysis of the expected impacts of these changes on the Australian economy;
- with the exception of the beef industry, the RIS does not attempt to quantify the likely impacts of JAEPA on trade volumes or prices for key Australian export industries, or on trade volumes in aggregate;
- the RIS contains only a brief reference to the likely impacts of tariff removal on those Australian industries that currently compete with Japanese imports, without quantifying or analysing the likely impacts of these;
- the RIS contains claims about the benefits of the JAEPA for Australian exporters, importers and consumers which are not supported by the level of evidence and quantification presented; and
- the RIS includes relatively brief and high-level analysis of the impacts of trade liberalisation for those Australian industries that compete with Japanese imports.

Source: OBPR (2014).

Nevertheless, on the basis of broad-level support of most submitting industry representatives and other interested parties JSCOT recommended the treaty be ratified. While it may be expected that potential direct beneficiaries of an agreement would voice support and that general support may be given favouring measures that move toward a more liberal trading regime, such support stands in contrast to earlier indications that businesses generally have made limited use of the opportunities available from Australia's exiting bilateral and regional trade agreements (PC 2010a, p. xiv). Accordingly, such broad support is not a sufficient measure of what is in the national interest.

In reaching its conclusion, JSCOT stated that the agreement would give Australian exporters significantly improved market access in goods and services and provide Australian industries with a 'first mover' advantage over other countries seeking to sign preferential agreements with Japan. It said:

> The Committee is satisfied that JAEPA has the potential to provide Australian business and industry with a range of profitable opportunities. The Committee believes JAEPA will provide a net benefit to the economy and is in the National interest and recommends that the Treaty should be ratified and binding treaty action be taken. (JSCOT 2014)

Although there could be debate as to the most appropriate methodology for quantifying and assessing the scale and scope of the impacts of a bilateral or regional trade agreement, one point of reference is the Commission's economy-wide methodology for assessing the impacts and benefits of national economic reforms (PC 2010b). By reference to this methodology, there are a number of gaps at all stages of the assessment process used for the JAEPA (figure 4.3). For example, there are reporting gaps in relation to the scale of

activities directly affected, the expected import price changes, the restrictive impact of origin rules, take-up of preferences and productivity effects, and the projected economy-wide effects of these changes. Unilateral reform, the mainstay of Australia's economic reform efforts is not identified and discussed as an alternative reform stream.

To close the evaluation gaps a more comprehensive and robust evaluation methodology carried out independently and with transparency is needed. A comprehensive evaluation of existing or prospective trade agreements would include a consideration of the likely incremental effects of an agreement over what would have occurred in its absence. It would also cover the likely direct effects on trade and investment after taking account of the incremental changes referred to above, actual take-up of preferences which will be influenced by rules of origin and other non-tariff barriers, carve-outs (sectors or activities where the agreement's commitments are quarantined) and negotiation and administration costs. Economy-wide impacts would be canvassed taking account of the direct effects and resource constraints in sectors gaining market access and the economy more broadly (such as labour market constraints). The prospect of inducing regulatory chill through new treaty obligations would also feature prominently as would the contingent liabilities created by the agreement. A key example of the latter is the operation of an investor-state dispute mechanism. Finally, the opportunity costs of the agreement in terms of delaying detailed unilateral liberalisation for the sake of maintaining negotiating coin would need to be evaluated.

Figure 4.3 **Gaps abound – the Government's assessment of the net benefits of the Japan Australia Economic Partnership Agreement**