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11 February 2009

To the Government of the Commonwealth of Australia  
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## **Submission on the Possible Australia – Korea FTA**

### **Summary of Submission**

Australia should approach the negotiation of Discriminatory Trade Agreements ('DTA' often called FTAs) only in a manner which minimizes the extent to which DTAs make further multilateral liberalization less likely and should not open negotiations on DTAs with countries that have obstructed the achievement of comprehensive harmonizing trade liberalization in the Doha Round of WTO negotiations. The proposal to negotiate a DTA with the Republic of Korea fails to satisfy these two grounds.

### **Submission**

Although in a simple comparison between having an FTA and a counterfactual of not having an FTA with all other things staying the same, both parties to an FTA will achieve economic gains, the impact of an FTA on world welfare is not so clear cut. It is well established that FTAs are welfare enhancing for the world only if the welfare gains from trade creation exceed the welfare losses from trade diversion. The gains from trade creation are likely to be larger if the FTA covers everything without exclusions. The losses from trade diversion are likely to be smaller if the margin between the MFN rate charged to the rest of the world and the duty free rate charged under the FTA is smaller. That margin will be smaller if the FTA does not raise barriers to outsiders. However, even if the FTA does not raise barriers to outsiders, the

losses from trade diversion can be significant if the existing MFN rates of protection are significant. The size of any such welfare losses from trade diversion can be reduced over time if further multilateral liberalization reduces the MFN rates charged on imports from the rest of the world. If FTAs are followed in time by multilateral liberalization then the size of any loss from trade diversion caused by the FTA will be diminished so that it becomes more likely that the overall effect of the FTA is positive. In those circumstances FTAs may be viewed as stepping stones toward the larger welfare gains achievable from multilateral non-discriminatory liberalization.

Even for the individual countries that are parties to an FTA, the question of whether there is a welfare gain from an FTA may give a different answer if one compares the counterfactual of having an FTA but not achieving further multilateral liberalization and the counterfactual of not having the FTA but having further multilateral non-discriminatory liberalization. In that comparison, the position of having the FTA may not compare well with the situation of not having the FTA.

Whilst it is possible that FTAs can be stepping stones toward multilateral non-discriminatory liberalization, it is possible that the presence of discriminatory liberalization through FTAs can make it harder for nations to agree on multilateral non-discriminatory liberalization. In every nation faced with the possibility of entering into a multilateral liberalization agreement, there will be import competing industries who will lobby against the making of trade liberalization commitments. The only way that governments are politically able to go ahead in liberalizing in the face of that political opposition is if the agreement also delivers market access to other markets in a way that provides an incentive to exporting producers to provide political support for a government that enters into the multilateral liberalization agreement. One of the determinants of that political support from exporting producers is the incremental market access that would flow from the multilateral liberalization agreement. If exporters have already gained market access to particular countries through discriminatory FTAs, then the incremental market access that can accrue multilaterally is diminished. Therefore the incremental access coming from a proposed multilateral agreement may not be sufficient to provide an incentive to exporters to provide political support to governments that support a multilateral liberalization agreement.

Therefore, it is important that Australia does not itself enter into nor encourage other WTO members to enter into FTAs that diminish the likelihood of multilateral trade liberalization.

Australia has negotiated in the Doha Round of multilateral trade negotiations in a way that is consistent with the view that it is important that FTAs should be not more than temporary stepping stones toward multilateral non-discriminatory liberalization. By seeking comprehensive liberalization across products, sectors and countries, Australia is helping to achieve a multilateral result which would diminish the negative effects of FTAs by reducing the margins of preference that operate under FTAs.

In considering whether Australia should negotiate an FTA with the Republic of Korea, it is important to consider the contribution of Korea to the multilateral negotiations.

The Republic of Korea commenced the round having not yet undertaken one of the key actions of liberalization undertaken by other Members in the Uruguay Round. In that round, Members acknowledged that the presence of various forms of quantitative restrictions on agricultural trade had made it impossible for the system of reciprocal tariff reductions to achieve any real reduction in import barriers in the field of agricultural trade. For that reason,

Members made a concerted effort to abolish all quantitative restrictions on imports of agricultural products. They did this through a process of tariffication by which a calculation was made of the tariff equivalent of existing import quotas or prohibitions and Members then abolished the import quota or prohibition and then made the equivalent tariff their maximum tariff rate. Only 4 nations were allowed an exception from this rule, on the proviso that delaying their conversion of the import quota to an import tariff would require them to admit a given volume of imports at a near zero tariff rate. Japan, Korea and The Philippines received an exception for their tariff quota on rice and Israel for its import quota on sheep meat. Of those, Korea and the Philippines (now joined by Chinese Taipei on its accession) still have import quotas in place.

In the Doha Round, Korea has not offered to convert its import prohibition on rice to an ordinary tariff. It seeks to continue to apply a measure that other Members agreed to abolish at the end of the Uruguay Round.

Korea's approach to the reduction of tariffs on agricultural products is worth considering. Australia has sought to reach agreement with other WTO Members on tariffs reductions on agricultural products in a manner which would apply higher reductions to the highest tariffs. Using a harmonization formula that brings the highest tariffs down to ward the level of other tariffs and applying such a harmonization formula to all products without exception across all countries (even if the rates of reduction were reduced to a degree for less developed countries) has some significant advantages. This approach reduces tariff peaks and tariff escalation. This reduces the extent to which the structure of tariff protection exhibits increasing rates of protection through a spectrum from primary products moving to semi processed and processed products thus helping to remove what has always been an impediment to developing country exporters moving up along the value added chain. It ensures that trade liberalization is achieved in the politically difficult areas along with the less politically difficult areas. This approach means that the WTO system achieves liberalization across all products so that every country within the system receives benefits from trade liberalization. Ideally the system should operate in this way so that every country in the system receives the benefits of the system regardless of its area of comparative advantage.

To stress the importance of this approach to successful liberalization, let me set out a few facts about existing tariff levels. The following chart shows the WTO Member countries in each product area which have at least one product within that product area at the specified level: (source: the tables for each individual WTO Member country in *WTO Tariff Profile 2006*)

<b>Cereals:</b>	
>500%	Egypt Japan Switzerland Norway South Africa Republic of Korea
>150%	United States of America Canada Turkey Mexico
> 100%	European Communities India

<b>Dairy Products:</b>	
>400%	Japan Switzerland Norway
>200%	European Communities Indonesia
>100%	United States of America India
<b>Animal Products:</b>	
>400%	Japan Canada Switzerland Norway
>200%	European Communities Turkey Mexico
>100%	India South Africa
<b>Fats and Oils:</b>	
>400%	Japan Republic of Korea
>200%	Canada Switzerland Norway Mexico India
>100%	United States of America
<b>Sugar:</b>	
>400%	Switzerland
>200%	Norway Republic of Korea Mexico
>100%	United States of America European Communities Japan India Turkey South Africa

From the beginning of the Doha Round WTO negotiation on agriculture, the strongest impediment to achieving good liberalization of agricultural trade has been the calls of a number of countries for certain products to be designated as "Sensitive Products" and to be excluded from the formula approach to tariff cuts. The group of countries that is most supportive of this concept of softer liberalization for "Sensitive Products" is what is called the Group of 10 or G10 (comprised of Republic of Korea, Japan, Switzerland, Norway, Iceland, Israel, Mauritius, Chinese Taipei, Lichtenstein (Bulgaria used to be the 10<sup>th</sup> member)). They are supported by the European Union and even the Cairns Group Member Canada is supportive of this concept of Sensitive Products. This group of wealthy countries share the characteristic that even if they did wish to provide massive transfers of wealth to particular farmers, they are capable of doing so by subsidies and social security measures instead of

import barriers. All of these countries are fully capable of liberalizing import barriers so as to contribute fully to the public good of an open trading system without impairing their ability to use taxpayer money to support some level of local production and to support the income level of farmers. The G10 countries have argued that the "multifunctionality" of agriculture justifies them drawing an exception for their agricultural import barriers from multilateral reciprocal liberalization. The argument is proffered in deliberate and wilful ignorance of the way that any given governmental objective can almost always be achieved in a number of different ways and that import protection is very rarely the best way to achieve the objective. So while we can respect their choice to achieve physical beauty in their rural countryside, and environmental care of the countryside, we do not need to respect their choice of achieving it by blocking out imports to shelter producers from world prices.

Admittedly, the products designated as sensitive (and excluded from the harmonizing tariff cuts) are to be subjected to a requirement to apply a very low customs duty upon a designated volume (a Tariff Quota).<sup>1</sup> The expansion of TQ volumes might allow some additional import opportunities but has several disadvantages. The first disadvantage of TQs is that the entitlement to the TQ volume must be allocated in some way – and whichever method of allocation is adopted, the outcome will depart from the desired object of a tariff only system in which suppliers can compete for market share on the basis of price, quantity and service. The second disadvantage is that, once established, TQs are very difficult to remove. The best way to remove the TQs would be to reduce the ordinary out of TQ customs duties down to the point where the TQs become insignificant or irrelevant. However, the presence of the TQs creates perverse incentives which can make it harder to reach agreement on general multilateral tariff reductions. This is because those who receive the entitlement to import within the TQ volume receive an unearned gain, since they can import at a low price including the low in-TQ customs duty and can still sell into the domestic market at the high price supported by the ordinary out of TQ tariff rate. This unearned gain or "rent" would be eroded by further multilateral reductions of the ordinary out of TQ customs duty. Consequently, those receiving the TQ rents have at worst an incentive to lobby against further multilateral liberalization or at best a much diminished incentive to provide political support for further multilateral liberalization.<sup>2</sup>

The impact of the argument for excluding Sensitive Products from the ordinary tariff cuts is significant. A 2005 World Bank study (edited by Kym Anderson and Wil Martin<sup>3</sup>) estimated

<sup>1</sup> In the Uruguay Round, Tariff Quotas were introduced as a temporary measure so that countries tariffing very small import quotas into very high ordinary customs duties would be required to allow at least a small volume of imports at a low customs duty. At the time the concept of TQ was introduced into the UR negotiation, it was contemplated that at the end of the implementation of the UR tariff cuts, the ordinary tariff rates would be low enough to allow the temporary TQs to be abolished and the end result would have been to achieve the complete abolition of quantitative restrictions and the establishment of a tariff only regime. However, as the level of ambition in the UR receded to only a 36% average cut with a minimum of 15% on each tariff line, the TQ became a permanent part of the system.

<sup>2</sup> If the method of allocation gives the rent to exporters then those exporters have an incentive to oppose further multilateral liberalization (and we have clear evidence of this tendency in the way that countries receiving preferential access into the EC have lobbied against comprehensive Doha Round tariff cuts on grounds that their preferences would be eroded. If the method of allocation gives the rent to importers then they would have an incentive to protect their unearned gain by opposing further multilateral liberalization – the magnitude of this factor will be larger in countries in which in the presence of a prohibitive out of TQ tariff rate, the income level of the population is causing increases in Demand for the product widening the gap between the internal and world prices and therefore increasing the size of the unearned gain received by the TQ holders. (This increase must of course stop when the out of quota tariff rate ceases to be prohibitive, that is, when the internal price rises to the level of the sum of the world price and the out of quota tariff rate.)

<sup>3</sup> Anderson & Martin (eds), *Agricultural Trade Reform and the Doha Development Agenda* (World Bank & Palgrave, 2005). These findings relating to the impact of excluding Sensitive Products are repeated in

that excluding only 2% of product lines from the ordinary tariff cuts would lower the economic welfare gains achieved from the Round by two thirds. That result was qualified by an estimate that if the tariff reductions were accompanied by a rule imposing a 200% maximum tariff rate, then the loss of economic welfare gains could be reduced to one third instead of two thirds. The most recent draft of the Chairman of the Negotiating Group on agricultural trade liberalization contains an allowance for Members to designate 4% of product lines as "Sensitive Products", with Developing Members being able to designate 5.3% of lines as sensitive. At present Japan is still seeking to be able to designate 8% of product lines as sensitive and Canada is seeking to designate 6% of product lines as sensitive. The most recent draft does include provision for a tariff cap of 100% but the tariff cap provision would not apply to developing countries at all (therefore not to Korea) and would allow Developed countries to avoid the cap for all products designated as Sensitive. Therefore, on current drafts, with the figure for Sensitive Products rising to over 4% without an effective cap on the highest tariff rates, it seems that the parties would miss out on almost all of the potential economic welfare gains that could be obtained from a substantial harmonizing tariff cut. Korea continues to support the inclusion in the draft text of the concept of Sensitive Products. Korea and the other rich G10 nations and the EU and Canada continue to press for a result which would mean that the multilateral trading system would continue to fail to provide the benefits of the system to all Members regardless of their field of comparative advantage - which is what it must do if it is to help developing and developed countries alike.

The demand for exclusion of "Sensitive Products" from the ordinary tariff cutting formulas spawned demands for various other exceptions. A group of Developing Countries (the G33) have demanded a category of products called 'Special Products' should also be exempt from the ordinary harmonizing tariff cuts. Korea is a member of the G33 group too. Therefore, Korea has positioned itself both within one group of Developed country Members opposing agricultural trade liberalization (the G10) and in one group of Developing country members opposing agricultural trade liberalization (the G33).

The most recent (December 2008) draft text on special products (WTO doc TN/AG/W/4/Rev.4 dated 6 December 2008) would allow Developing country Members to have complete discretion to choose which products may be designated as Special Products. They would be able to designate up to 12% of tariff lines as Special Products (13% for the Peoples Republic of China). For 5% of tariff lines, Members would not need to apply any tariff reduction at all while for the total of the 12% of lines, there would be overall average tariff reductions of only 11%.

The G33 of which Korea is a member has also demanded that Developing country Members be able to impose safeguard tariffs without having to establish that an import surge is causing injury to a domestic industry, as is required under the normal safeguards provision. The most recent draft Special Safeguard Mechanism (SSM) (contained in WTO doc TN/AG/W/4/Rev.4 dated 6 December 2008) would allow Developing country Members to raise tariffs so as to bring them above the level prevailing prior to implementing any of the proposed Doha Round tariff cuts. In other words, the amendments proposed in the Doha Round would allow the pre-existing degree of liberalization to be unwound for some Member countries. The December 08 draft of the SSM provision would allow Developing Country Members (including Korea) to raise tariffs:

- 25% points above or to 125% of existing Uruguay Round bindings in the event of an import surge of only 15% above the rolling average for the previous 3 years: or

- 40% points above or to 140% of the existing Uruguay Round bindings in the event of an import surge of 35% above the rolling average for the previous 3 years.

Therefore Korea and Australia have been pursuing quite different objectives in the Doha Round negotiations on agricultural trade:

Australia has been supporting liberalizing all tariffs in all countries on a harmonizing basis which would contribute to achieving a number of useful welfare enhancing objectives for the world as a whole:

- reduce tariff peaks,
- reduce tariff escalation on processed products,
- reduce dispersion of tariff rates applied by any individual country,
- reduce disparities between the levels of tariff applied by different countries; and
- diminish any trade diversion effects operating as a result of existing Discriminatory Trade Agreements or one-way preferences, and
- help to ensure that the multilateral trading system provides benefits to every Member country regardless of where its comparative advantage may lie;
- contribute to the public good of having an open trading system; and
- Contribute to the public good of reducing insulation from world price signals within individual countries so as to have the effect of reducing the severity of fluctuations in world prices.

By contrast, the Republic of Korea supports an approach under which:

All Members would be able to exclude virtually all of their highly protected tariff rates from substantial tariff cuts by:

- allowing Developed Member countries to exclude up to 4% of tariff lines (possible 6% for Canada and 8% for Japan) as Sensitive Products (to some extent compensated by expansions in volumes of TQs); and
- allowing Developing Member countries:
- to exclude up to 5% of tariff lines from any tariff cut at all by designating them as Special Products;
- to apply a reduction of only 11% (10% for China) to 12% of tariff lines (13% for China) designated as Special Products;
- then in addition to the 12% of tariff lines designated as Special Products, to designate an additional 5.3% of tariff lines as Sensitive Products and on these to reduce the cuts to as little as 17% over 10 years (compensated by a TQ expansion of only 2.34% of domestic consumption (calculated excluding subsistence consumption); and
- finally to allow safeguard tariffs to effectively reverse the liberalization already achieved in the Uruguay Round in response to relatively small fluctuations in import flows.

In summary, the Republic of Korea has been a significant obstacle to achieving useful multilateral agricultural trade liberalization in the Doha Round.

In the absence of achieving harmonizing tariff cuts in the Doha Round, the existing trade diversion effects of existing Discriminatory Trade Agreements will not be significantly moderated.

To date, Australia has only negotiated Discriminatory Trade Agreements with countries which have supported comprehensive liberalization of agricultural trade in the Doha Round: the USA, Singapore, Thailand and Chile.

One should also mention the positions of Australia and Korea in the Doha Round negotiation on Non-Agricultural Market Access ('NAMA'). Australia has supported application of a harmonizing formula applying the highest cuts to the highest tariffs, though in NAMA, it has supported a Swiss formula (an approach which reduces the highest tariffs to the level of the coefficient used in the formula). The proposals for the NAMA negotiation circulated after the July 2008 Ministerial draft text would allow Developing country Members to choose a higher Swiss formula coefficient and a longer implementation period, a reasonable way to allow concessional treatment to Developing country Members without undermining the objective of comprehensive harmonizing liberalization. However, the proposals would also allow Developing members to apply no tariff cut at all to as many as 6.5% of tariff lines or 7% of imports by value or to apply only half of the formula tariff cuts to as many as 14% of tariff lines or 16% of imports by value.

For the Korean government to support a comprehensive harmonization approach to both Agricultural and NAMA trade liberalization, the Korean government needs to have political support from Korean exporters who would gain access to markets of other WTO Members (for example, such Korean exporters as the electronics manufacturer, LG, or the vehicle manufacturer Hyundai). If Korean exporters (e.g. LG or Hyundai) are able to obtain zero customs duties on access to other countries then those exporters would have no incentive to provide political support to a Korean government which was inclined to support comprehensive harmonizing tariff reductions in the Doha Round – and it would remain politically impossible for the Korean government to resist the political lobbying of import competing producers, especially in the agricultural sector.

Australia should set pre-conditions to the opening of the Discriminatory Trade Agreement negotiations with the Republic of Korea:

- that the Republic of Korea support a comprehensive harmonizing approach to liberalization in the Doha Round, and drop its support for Sensitive Products, Special Products and any version of the SSM which would allow tariffs to go over the current (pre-Doha round) levels; and
- that the Republic of Korea declare that it has graduated from Developing Member status to Developed Member status in the WTO and cease to claim that any provisions applicable to Developing country Members apply to Korea.

The Australian government should also be concerned that the proposed US-Korea Discriminatory Trade Agreement (currently being considered by the US Congress) would:

- inappropriately reward Korea for playing an obstructive role in the Doha Round; and
- make it even more difficult for subsequent Korean governments to garner sufficient political support from exporters to offset their opposition to multilateral trade liberalization;
- make it more difficult to achieve multilateral tariff reductions so as to diminish the diversion effects of existing Discriminatory Trade Agreements.

The Republic of Korea has a substantial interest in an open world trading system. Korea would be an extremely valuable partner in promoting the multilateral and non-discriminatory trade system. Australia needs to forge a partnership with Korea in promoting a multilateral



and non-discriminatory trade system instead of negotiating a Discriminatory Trade Agreement with Korea.

Yours Sincerely,

A handwritten signature in black ink, appearing to read "Brett Williams". The signature is fluid and cursive, with the first name "Brett" and last name "Williams" clearly distinguishable.

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