

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT:

Key Issues and Options



Edited by Jane Drake-Brockman and Patrick Messerlin



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POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

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Since June 2018, Australia and the European Union have been negotiating a Free Trade Agreement. This book offers insights from recognised experts in the field, from Australia, Europe and Asia, on the potential economic benefits to be reaped from greater economic openness. It addresses issues of direct relevance to both negotiating teams as well as policy makers, academics, and business leaders across Australia and the European Union.

The book covers 21st century topics such as regulatory cooperation, global value chain connectivity and digital trade. Professional services, audio-visual services, financial services, investment, investor-state dispute settlement and government procurement are explored in depth; as is agriculture and food.

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ABBREVIATIONS

A&F	Agricultural and food (including beverage and tobacco) products
AANZFTA	ASEAN-Australia-New Zealand Free Trade Agreement
ABTC	APEC Business Travel Card Program
ABS	Australian Bureau of Statistics
AEC	ASEAN Economic Community
AFTA	ASEAN Free Trade Area
AIP	Australian Industry Plan
ARFP	APEC Region Funds Passport
ANCA	Australian Numerical Controls and Automation
ANU	Australian National University
ANZCERTA	Australia-New Zealand Closer Economic Relations Trade Agreement
ANZGPA	Australia and New Zealand Government Procurement Agreement
ANZSOG	Australian and New Zealand School of Government
APEC	Asia-Pacific Economic Cooperation
APPs	Australian Privacy Principles
APRA	Australian Prudential Regulatory Authority
ASIC	Australian Securities and Investments Commission

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

ASEAN+1	ASEAN (Association of South East Asian Nations) plus individual trade agreement partners: People's Republic of China, Japan, Republic of Korea, India and Australia/New Zealand
ASEAN+3 (APT)	ASEAN plus trade agreement with People's Republic of China, Japan and Republic of Korea (as a group)
ASEM	Asia-Europe Meeting
ASR	Australian Services Roundtable
AT	Appeals Tribunal
AU/AUS	Statistical code for Australia
AUSFTA	Australia-United States Free Trade Agreement
Austrade	Australian Trade Commission Agreement
B2B	business-to-business
BREXIT	Exit of the United Kingdom from the European Union
BCI	business confidential information
BITs	Bilateral Investment Treaties
CAP	Common Agricultural Policy
CCIV	Corporate Collective Investment Vehicle
CCP	Common Commercial Policy
CEPR	Centre for Economic Policy Research
CEPS	Centre for European Policy Studies
CETA	Comprehensive Economic and Trade Agreement (EU Canada Free Trade Agreement)
CGE	Computable General Equilibrium
ChAFTA	China-Australia Free Trade Agreement
China	People's Republic of China
CUHK	The Chinese University of Hong Kong
CIF	cost, insurance and freight
Council	Council of the European Union
CPR	Commonwealth Procurement Rules

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CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
CSIRO	Commonwealth Scientific and Industrial Research Organisation
CTC	Change in Tariff Classification
DEAT	Australian Department of Foreign Affairs and Trade
DoB	denial of benefits
DSB	WTO Dispute Settlement Body
DSU	WTO Dispute Settlement Understanding
DVA	Domestic Value-added
ECIPE	European Centre For International Political Economy
ECJ	European Court of Justice
ECT	employment contribution test
EEAS	European Union External Action Service
EEC	European Economic Community
ENT	economics needs test
EMM6	6th ASEM Economic Ministers' Meeting
EMM7	7th ASEM Economic Ministers' Meeting
EPA	Economic Partnership Agreement
ESF	European Services Forum
EU	European Union
EU14	For statistics provided by a body in one EU15 country, the body will show the statistics for the EU15 country it is operating in, and show the rest of the countries as a singular EU14 bloc.
EU15	The number of Member States in the EU prior to accession of ten candidate countries on 1 May 2004. Comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden and the United Kingdom.
EU27	EU consisting of 27 Member States post-Brexit

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EU28	EU consisting of 28 Member States pre-Brexit
EUMS	EU Military Staff
EUSFTA	EU-Singapore Free Trade Agreement
FATA	Foreign Acquisitions and Takeovers Act
FDI	foreign direct investment
FDI INDEX	FDI Regulatory Restrictiveness Index
FIRB	Foreign Investment Review Board
FOB	Free-on-board
FTA	free trade agreement
GATS	(WTO) General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GBR	Statistical code for the UK
GDP	gross domestic product
GDPR	(EU) General Data Protection Regulation
GI	geographical indication
GIN	Global Innovation Network
GPA	WTO Agreement on Government Procurement
GRP	good regulatory practice
GVC	global value chain
HS	Harmonized Commodity Description and Coding Systems
Hong Kong SAR	Hong Kong Special Administrative Region of the People's Republic of China
IATRC	International Agricultural Trade Research Consortium
ICAO	International Civil Aviation Organisation
ICI	imported content impost
ICS	investment court system
ICSID	International Centre for Settlement of Investment Disputes
ICT	information and communications technology
IIA	International Investment Agreement

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IPP	Industry Participation Policy
IP	intellectual property
IRSG	International Regulatory Strategy Group
ISDS	investor-state dispute settlement
ITA	Information Technology Agreement (WTO)
IT	information technology
KAFTA	Korea-Australia FTA
Korea	Republic of Korea
KOREU	Korea-EU FTA
MADB	market access database
MBIE	New Zealand Ministry of Business, Innovation and Employment
Mega-RTA	Mega-regional Trade Agreement
MERCOSUR	Economic block made up of Argentina, Brazil, Paraguay and Uruguay
MFN	most-favoured nation
MFAT	New Zealand Ministry of Foreign Affairs and Trade
MRA	Mutual Recognition Agreement
NAFTA	North American FTA
NGO	non-government organisation
NRA	nominal rate of assistance
NTB	non-tariff barrier
NTM	non-tariff measure
NZ	New Zealand
NZL	Statistical code for New Zealand
NZPC	New Zealand Productivity Commission
OTC	over-the-counter (derivatives)
PC	(Australian) Productivity Commission
P4	Pacific 4 FTA (Brunei, Chile, NZ, Singapore)

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

PSE	producer support estimate
PTA	preferential trade agreement
R&D	research and development
RCEP	Regional Comprehensive Economic Partnership
RoO	rules of origin
RPP	regional price preferences
RTA	regional trade agreement
RVC	regional value content
Sciences Po	The Paris Institute of Political Studies
SDR	special drawing rights (IMF)
SITC	standard international trade classification
SME	small- and medium-sized enterprise
SoE	state-owned enterprise
SPS	sanitary and phyto-sanitary
STRI	Services Trade Restrictiveness Index
TBT	technical barriers to trade
TFA	Trade Facilitation Agreement (WTO)
TFEU	Treaty on the Functioning of the EU
TFI	Tribunal of First Instance
TiSA	Trade in Services Agreement
TiVA	Trade in Value-Added
TPP	Trans-Pacific Partnership
TPP-12	TTP including the United States
TPP-11	11 members of TPP after United States withdrawal (CPTPP)
TRAINS	Trade Analysis Information System (UNCTAD)
Treasury	Australian Department of the Treasury
TRQ	tariff rate quota
TTIP	Transatlantic Trade and Investment Partnership

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TTMRA	Trans-Tasman Mutual Recognition Arrangement
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom (of Great Britain and Northern Ireland)
UNCITRAL	United Nations Commission on International Trade Law
UNECE	The United Nations Economic Commission for Europe
US	United States (of America)
Vienna Convention	Vienna Convention on the Law of Treaties
WIOD	World Input-Output Database

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PREFACE

Jane Drake-Brockman and Patrick Messerlin

By June 2018, the negotiations for a free trade agreement (FTA) between Australia and the European Union (EU) were up and running. This book tells some of the story of why these negotiations are underway, from both an Australian and a European perspective. It brings an innovative approach to the analysis of some key challenges in the bilateral commercial relationship and it recommends some ways forward.

The research for this book began more than two years ago in 2015. It began as a project among a group of Australian and European trade economists on the benefits of free trade, funded by the EU Centre for Global Affairs in the Institute for International Trade, The University of Adelaide. Popular anti-globalisation sentiment was arising in many advanced economies and the benefits of trade were being actively questioned in many quarters. An unprecedented public backlash had already developed in Europe against the Transatlantic Trade and Investment Partnership (TTIP) with the EU's largest trading partner, the United States (US). The US had frozen the plurilateral negotiations for a Trade in Services Agreement in Geneva and withdrawn from the Trans-Pacific Partnership (TPP) negotiations it had hitherto led in the Asia Pacific region. Against that background, this project determined to help articulate the case for free trade, specifically through a trilateral Australia-Asia- Europe lens as the EU deepened its commercial policy engagement in East Asia.

The study was designed to focus squarely on the twenty-first century challenges of globalisation, against the background of an unambiguous shift to digitalisation of the global economy. Global value chains (GVCs), services, investment, regulatory cooperation, e-commerce and digital trade would all receive dedicated attention.

As momentum built in Brussels and Canberra for closer bilateral commercial relations, this research project also evolved to focus specifically on the opportunities

presented in an FTA between Australia and the EU. A cross-disciplinary multistakeholder team of well-known trade policy authors was assembled from both economics and trade law, as well as services industry associations from locations in Australia, Europe and also Asia.

On the same day as the first research workshop brought the authors together to share initial findings, all preliminary thinking was thrown into disarray by the outcome of the British referendum on the exit of the United Kingdom (UK) from the EU (known as 'Brexit'). For most contributors, it was back to the drawing board.

As the dust settled, and new authors were brought onboard to help analyse the implications of Brexit, other problematic global trends already evident in 2015, came increasingly to light. The Doha Development Agenda in the WTO was no longer merely faltering but was decidedly going nowhere. Trade tensions in the Group of 20 and even in the G7 and the OECD became palpable. APEC started to fall short in its usual ability to hold a torch for openness to trade. Barriers to digital trade began to fragment the global market and cross-border data flows ratcheted to the top of business attention.

The news was not all negative, with growth in world trade more robust than might have been expected during the recovery from the global financial crisis. A new plurilateral process on e-commerce was potentially getting underway in Geneva and informal discussions began on investment facilitation. But even as this book goes to press, the spectre of 'trade war' between the US and the People's Republic of China (China) haunts the background. 2018 is a year of significant risk to the world trading system. As such, this volume has two purposes. It throws light on some of the negotiating issues that no doubt have the potential to be both deal breakers and deal makers in the Australia-EU FTA. Even more importantly, this volume constructs a case for trade.

As the research for this book drew to its close at the end of 2017, it became evident that investment issues (other than commercial presence in services sectors) would be unlikely to find their way, at least for some time, into the EU negotiating mandate for the Australia-EU FTA. The narrowed negotiating mandate, limited to issues of exclusive EU competence, rather than mixed competence with the EU Member States, is seen as essential in Brussels for 'fast-tracking' this FTA (once completed) through the EU ratification process. Speed is important to both FTA parties. One key reason for this is their shared desire to send a pro-trade signal to the rest of the world at a time when protectionism and departure from the rules-based order appear to be on the rise. The expectation on both sides is that in due course, most likely post Brexit, the 27 remaining Member States of the

EU (EU27) will achieve a new follow-up negotiating mandate for a supplementary agreement on investment with Australia. This book includes discussions on important investment-related topics which, whether or not they find their way to the immediate negotiating table, remain actively on the joint business agenda.

The book opens with a **brief commercial history**, written by **Gonzalo Vilalta Puig**, tracing the ups and downs in Australia-EU trade diplomacy from the accession of the UK to the European Economic Community in 1973. The chapter highlights the need, in the circumstances of modern times, to manage a fluid and practical negotiation, if traditional agricultural trade irritants are not to sabotage success.

The book also offers opening perspectives from both editors: an Australian perspective written by **Jane Drake-Brockman** and a European perspective written by **Patrick Messerlin**, co-authored with **Jimmyn Parc**.

Drake-Brockman draws attention to underlying trends in both foreign and trade policy that contribute to Australia's current strategic interest in filling a significant gap in its trade architecture via pursuit of an FTA with the EU. Given the weight of the services sector in the Australian economy and the evident under-performance in services exports to the Asia Pacific region, the chapter shines a light on what has long been a blind spot in Australia; namely, the overwhelming relative importance of services in Australia's trade with the EU.

Messerlin and Parc focus on the underlying economic objectives of FTAs and the opportunities offered to the EU by an Australia-EU FTA. These opportunities are crucial for Europe's economic future given the forecast negative impact of Brexit on the EU economy and the lack of US engagement with the EU's global trade strategy. The likely positive impact on the EU stems from the high quality of Australia's economic governance, which is critical to the FTA's delivery of mutual benefits in regulation-intensive areas such as services and investment. It also stems from Australia's deep political and economic relations with the fast-growing East and Southeast Asian nations, which could lend instrumental support to success of the EU trade strategy in Asia.

L. Alan Winters considers the effects that **Brexit** might have on the Australia-EU FTA. In terms of Australia's imports, there is no major sector in which the UK is the predominant supplier; however for exports, the UK is a major market for Australia in several sectors. Australian exports of meat face a high average tariff in the EU. Nearly half of these exports go to the UK, so Brexit may reduce the attraction of the EU FTA for Australia. Moreover, these exports face a tariff-rate quota; splitting that quota between the UK and the EU27 is likely to complicate FTA negotiations. In services, the UK has generally championed

liberalisation in the EU, so Brexit may reduce EU pressure for a deep FTA with Australia. On the other hand, precisely to demonstrate that trade liberalisation is not just a British idea, Brexit will increase the incentive for the EU to sign a deal of some sort.

Yose Rizal Damuri introduces the backdrop of **Asia Pacific mega-regionalism**—the TPP on one hand and the ASEAN-led, China inclusive-Regional Comprehensive Economic Partnership on the other. Australia is taking part in both initiatives, both of which represent potential pathways in APEC to a Free Trade Area of Asia Pacific. The trading rules and disciplines set in these mega-regional trade agreements have potential to become benchmarks for the global trading system, including for example the provisions on data flows. The chapter suggests that for the EU, the Australia-EU FTA could reduce negative impacts from mega-regionalism in the Asia Pacific region, regain economic share in the region and balance its economic influence. The opportunity exists to achieve broader regulatory coherence and harmonisation of trade governance.

Pascal Kerneis provides an explanation of the **limits to EU negotiating competence** that will impact significantly on the FTA with the Australia. It is the only FTA (other than the recent EU-Japan Comprehensive Economic Partnership Agreement) for which the EU negotiating mandate specifically excludes any areas for which the EU does not have exclusive competence (that is, any areas of mixed competence shared with the Member States). In November 2015, a year after completion of negotiations for the EU-Singapore FTA, the European Commission requested an Opinion of the European Court of Justice (Opinion 2/15)—on the scope of EU powers in relation to that agreement, asking whether it fell entirely within EU exclusive competence. The Council of the EU, and the governments of all Member States that submitted observations to the Court, asserted that the EU could not conclude the agreement by itself, because certain parts of the agreement fell within competence shared with the Member States, or even within exclusive competence of the Member States. The Court's verdict clarifies the scope of EU competence in trade policy, defining clearly what is the exclusive competence of the EU in the Common Commercial Policy.

Exploring the **emergence of GVCs** centred especially on Europe and East Asia, and largely bypassing Australia, **Richard Pomfret and Patricia Sourdin** argue that an Australia-EU FTA promoting deep integration could stimulate Australian participation in EU-centred value chains and provide a possible link between EU and East Asian chains. GVC participation is closely related to business-to-business trade, in which services are becoming increasingly important. A prerequisite for GVC participation is low cost of international trade, which is likely to involve

efficient service activities. For Australia, distance and high trade costs have deterred fine degrees of firm-level specialisation in areas where Australia's comparative advantage was less pronounced than wool, coal or minerals. Nevertheless, Australia has produced a variety of world-class companies, and the tyranny of distance is being neutered by innovations in information and communications technology that make real-time communication inexpensive. The chapter analyses the role of an Australia-EU FTA from the perspective of GVC participation, infrastructure improvements and servicification.

Given that services trade issues relating to commercial establishment are explicitly covered in the EU negotiating mandate with Australia, **Shandre Thangevalu and Christopher Findlay** provide a full overview of two-way Australia-EU investment flows and policy irritants, including Australia's Foreign Investment Review Board investment-screening threshold, which is higher for the EU than for countries that already have preferential trade agreements with Australia. The chapter also discusses the link between **investment, economic growth and innovation** into the future.

Public procurement will be another important element of EU focus on an Australia-EU FTA, given that Australia uses public purchasing as an instrument to support small and medium-sized enterprises, indigenous communities and more generally Australian industry. **Bernard Hoekmann** discusses procurement policy in Australia and the EU and provides an overview of the content and approach taken in trade agreements towards public procurement. The chapter argues that the implications of the Australia-EU FTA for procurement practice will be limited, given Australia's decision to join the WTO Government Procurement Agreement and the empirical evidence from existing trade agreements that include procurement which suggests that trade agreements do not result in major changes in sourcing behaviour by government agencies.

Regulatory cooperation is much more than removing barriers to trade. **Peter Mumford** shows that while this remains an important objective, regulatory cooperation between states is also required to achieve important societal outcomes in areas such as health, safety and environment. This accounts for the fact that a considerable amount of cooperation takes place outside the framework of trade agreements. While regulatory cooperation can be presented as 'win-win', there are significant obstacles to its achievement, to the extent that desirable cooperation is not undertaken. This chapter explores the barriers to regulatory cooperation, making the case that cooperation specifically within the framework of trade agreements should focus on what matters most for business, and identifying favourable conditions.

In his chapter, **Kym Anderson AO** shows that bilateral trade flows between Australia and the EU have been declining in relative importance for both parties over recent decades, and so too has the **role of agricultural products** in that trade. Farm and food policy interventions continue to contribute to that demise, along with the trade-diverting effects of other preferential trading arrangements involving either the EU or Australia. Nonetheless, each party has several issues concerning the trade effects of the other's agricultural, food and beverage policies that could be addressed constructively in a bilateral FTA negotiation. They include meat, sugar and wine market access as well as regulations on sanitary and phyto-sanitary and technical barriers to trade. These need to be considered, bearing in mind that a UK-EU27 bilateral trade agreement is likely to be negotiated before an Australia-EU27 FTA is finalised, and an Australia UK-FTA may also be concluded once the UK-EU27 one is settled.

Hosuk Lee-Makiyama explores the prospects for establishing e-commerce rules in the Australia-EU FTA against the background of ongoing digitalisation of international trade. **E-commerce or digital trade** disciplines in trade agreements are necessary policy responses against government efforts at discriminatory interventions in the digital economy. It is imperative for Australia and the EU to establish a set of binding non-discriminatory rules on digital trade. Assuming Australia's textual proposals would be based on the TPP however, the EU-Australia negotiations on e-commerce will pose a challenge to its conclusion. At a time when the EU and Australia share a common interest in the pursuit of constructive negotiations on these issues with third parties, and in the WTO, there is also a danger that the EU negotiations for FTAs with Australia and New Zealand could result in asymmetric outcomes leading to further fragmentation of digital trade. This asymmetry may be even more pronounced if Australia fails to obtain an adequacy decision with respect to EU privacy rules, which do not allow onward transfer to third countries of personal information.

The case for coverage of **audio-visual services** in the Australia-EU FTA is made by **Jimmyn Parc and Patrick Messerlin**. The Australian film market has potential—due to the demand size, cultural diversity, supply size—to attract the EU film industry, and hence for stakeholders to envisage negotiations favourably. The chapter presents an overview of audio-visual provisions in FTAs concluded to date by Australia and the EU, and assesses the level of protection granted by the existing Australian and EU regulatory barriers. It argues that the Australia-EU FTA negotiators should seek to increase market access by improving the provisions on co-production that exist in the Australia-Korea and Korea-EU FTAs. These provisions have the merit not only of reducing the remaining regulatory barriers, but also of offering opportunities to address the global problem arising with

respect to large and increasing subsidies—the most important problem facing film industries in the years ahead.

In the chapter on **professional services**, **Pascal Kerneis** provides a tour d’horizon across the content that professional services providers expect to be covered in the FTA. This includes market access limitations such as residency requirements and restrictions to legal corporate forms for services providers. It also includes an array of issues affecting the temporary movement of natural persons; the chapter proposes how to handle these in the FTA context drawing on both Australian and EU experience in other FTAs, as well as in APEC. These issues include visa facilitation for business visitors, intra-corporate transferees, contract services suppliers and independent professionals. The chapter also explores the potential for innovation in negotiation of mutual recognition agreements of professional qualifications, based on the outcome in the recent EU-Canada Comprehensive Economic and Trade Agreement.

John Cooke analyses the current trade in **financial services** between the EU and Australia, some of the trends underlying it, and the scope for increasing trade flows in financial services. The chapter considers existing barriers to trade in financial services, taking account of analytical approaches such as the OECD Services Trade Restrictiveness Index, studies commissioned by the EU, and WTO Trade Policy Reviews. It describes the financial services features of the EU negotiating mandate, together with stated Australian objectives for these negotiations, taking account of business views on both sides. There is some examination of the scope for greater regulatory coherence, and cooperation between EU and Australian financial regulators. The chapter also considers the potential effect of Brexit on financial services trade, given that a substantial share of this trade has hitherto been between Australia and the UK, with the consequent prospect of future changes in volume and composition of financial services trade between Australia and the EU27 post Brexit.

Yves Renouf and **Julien Chaisse** provide a unique exploration of the pros and cons of the EU proposal for a **multilateral investment court system** (ICS) compared with the arbitration-based investor-state dispute settlement (ISDS) system currently prevailing in international investment agreements. They consider how this issue might be handled in the context of an eventual negotiation on this issue between Australia and the EU. The chapter argues, based on the WTO experience with a quasi-judicial dispute settlement mechanism, that an ICS could contribute to a more transparent, predictable, objective and uniform resolution of investor-state disputes in general and, more particularly, in a FTA between the EU and Australia. The chapter nonetheless questions the feasibility of such

a system in this particular FTA, having regard to the differences in political and practical experiences of the EU and Australia with ISDS.

Together, these sixteen chapters make an important contribution to increased public understanding of the factors likely to shape the future of Australia-EU commercial relations.

PART 1

AUSTRALIA, EUROPE, ASIA: EVOLVING COMMERCIAL DIPLOMACY

1

AUSTRALIA AND THE EUROPEAN UNION: A BRIEF COMMERCIAL HISTORY

Gonzalo Villalta Puig

ABSTRACT

The history of economic relations between Australia and the European Union (EU) is largely about trade in agriculture. Before the accession of the United Kingdom (UK) to the European Economic Community in 1973, Australia could export meat, dairy and other agricultural goods to the imperial metropolis with ease. In the two subsequent decades, Australia had to find, not without some political resentment, alternative export markets in Asia for its agricultural goods. The Common Agricultural Policy meant that Australia's agricultural exports were no longer competitive in the UK or indeed elsewhere in Europe. In reaction, Australia launched a firm agricultural trade diplomacy campaign, which, with initiatives such as the establishment of the Cairns Group, placed it well outside the European trade policy agenda. However, the gradual reduction of agricultural trade subsidies after the closure of the Uruguay Round of trade negotiations under the General Agreement on Tariffs and Trade, and the entry into force of the Agreement on Agriculture with the establishment of the World Trade Organization in 1995, relaxed many of the tensions in the bilateral economic relationship. In this period, both parties concluded numerous sectoral agreements and began to recognise almost identical trade values in each other. Aware that Australia needs the EU's influence as a world-trade-standard-setter and that the EU needs Australia's economic influence in Asia, both parties now have the maturity to further advance their partnership through a free trade agreement.

INTRODUCTION

No commentary on the present negotiations for a free trade agreement (FTA) between Australia and the European Union (EU) would be complete without a historical account of their trade relationship. It is now as it has always been a strong but not easy relationship.

Drawing on previous work by the author (Villalta Puig 2014; Villalta Puig 2018), this account is organised into four parts. First, a review is made of the special relationship between Australia and the United Kingdom (UK) and its significance to the history of the relationship between Australia and the EU. Second (and inevitably), a discussion is presented regarding agricultural issues between Australia and the EU. Third, policy developments between the 1980s and 2000s that progressively repurposed the relationship are outlined. The fourth and final part of this account summarises more recent policy developments in the relationship.

THE SPECIAL RELATIONSHIP BETWEEN AUSTRALIA AND THE UK

It is mandatory to consider the relationship between Australia and the UK, that is, both Australia's place in relation to the UK and also the UK's place in the EU (or the European Economic Community (EEC) as it was then). Historically, the essential relationship has been between Australia and the UK, as Australia was part of the British Empire. Australia benefited from an early trade arrangement—the British Imperial Preference under the Ottawa Agreement of 1932. For Australia, this period of external trade relations was relatively stable and prosperous: Australia exported meat, wool, fruit, sugar and dairy products to the mother country market with relative ease. However, that early contentment in the trade history between Australia and the UK ended suddenly in 1973 when the UK decided to join the EEC. This decision was, for Australia, a kind of betrayal, bringing a sudden end to the ease with which Australia had exported primary products to the UK. UK membership of the EEC led to the unwinding of preferential trade arrangements with most Commonwealth countries, including Australia.

AGRICULTURE IN THE TRADE RELATIONSHIP BETWEEN AUSTRALIA AND THE EEC

In parallel to the UK's inclusion in the EEC was the almost simultaneous development in Europe of the Common Agricultural Policy (CAP). The CAP subsidised agricultural overproduction heavily through direct subsidies to specific agricultural products and tariffs. With this, the EEC became a fortress. This system of tariffs, export refunds and CAP direct payments ensured that European markets,

from the mid-1970s, were almost impossible for Australian primary producers to access. Australian producers were forced to change their market orientation, moving into Asia. There was no other option; in the collective mindset, Australians idealised agriculture as the country's backbone, the spirit of the nation. A historical understanding of Australia's economy recognises that beef and wheat were indeed essential products.

The mid-1970s coincided with the rise to power of a conservative coalition in the Australian Government, which allowed the then National Country Party (now the National Party of Australia) to safeguard the trade portfolio. John Howard, as Minister for Special Trade Negotiations in the late 1970s, found he had little or no influence in attempting to negotiate with the EEC. It was a time of firm, strong diplomacy from the Australian Government in relation to its affairs with the EEC. During this period, Australia progressively developed a science-led biosecurity system of quarantine requirements and food safety standards, a luxury car tax and Australian Industry Participation rules for government procurement market access. All of these still are trade irritants for the EU in its present relationship with Australia and will feature prominently in FTA negotiations.

AUSTRALIA-EEC/EU POLICY DEVELOPMENTS FROM THE 1980S

In the 1980s, with Robert Hawke and more notably Paul Keating leading the Australian Government, increasingly flexible trade policy positions were introduced. Hawke and Keating brought an almost neo-liberal approach to the external economy, in the spirit of the unilateral tariff reduction of the Whitlam Government in the early 1970s. The relationship between Australia and the EEC became more pragmatic. The two sides signed the Kerin-Andriessen Accord of 1985. This accord did not affect the domestic subsidisation of beef production in Europe but did result in exports of EEC-subsidised beef to traditional Australian markets in Asia being curtailed.

A year later in 1986, in opposition to the 'fortress Europe' concept, the Australian Government established the Cairns Group of Fair Trading Nations. The Cairns Group sought to improve market access for agricultural exports by abolishing export subsidies. Meanwhile, diplomatic work progressed in the background, along with an initiative of the Keating Government to negotiate an FTA. However, this initiative did not eventuate. Under John Howard's Prime Ministership from 1996, issues concerning a human rights clause derailed FTA negotiations.

Nevertheless, a change in the attitude of both sides was evident. With Jacques Delors and his legacy in the European Commission, a more unified approach to

the market in Europe reinforced the free trade principle everywhere. These years witnessed successful completion of the Uruguay Round, which, in turn, led to the establishment of the World Trade Organization (WTO), the Cairns Group-led WTO Agreement on Agriculture, and a more productive approach to trade in agriculture, multilateral trade and bilateral trade relationships.

This approach allowed the subsequent post-Uruguay Round signature of a number of bilateral diplomatic instruments, including sectoral agreements on wine and on mutual recognition of conformity assessment procedures. Importantly, the relationship received formal recognition through a Joint Declaration on Relations between the EU and Australia in 1997 (updated with the establishment of the Australia-EU Partnership Framework in 2008). These developments coincided in the 2000s with an explosion of FTAs in reaction to the steady failure of the Doha Development Agenda. Australia signed FTAs, such as those with the United States in 2004, and with regional trading partners, like Singapore and Thailand, and later Malaysia, the Republic of Korea, the People's Republic of China and, in 2015, Japan. The European Commission has done the same with renewed Common Commercial Policy competence through the Treaty of Lisbon 2007 reforms. This enthusiastic approach to FTAs has led to the current moment in the Australia-EU relationship.

MORE RECENT DEVELOPMENTS IN THE AUSTRALIA-EU RELATIONSHIP

Now that Australia and the EU have both accumulated positive experiences in negotiating and concluding FTAs, space exists in the policy agenda to reconsider the relationship. Room exists on both sides for greater regulatory cooperation. A political commitment to translating the relationship into an FTA is evident. With the signing of the Framework Agreement between Australia and the EU in 2017, a bilateral commitment to dialogue and cooperation in trade and investment is apparent. An FTA scoping exercise also concluded in 2017. Negotiations have started, successfully bringing to reality what, in recent decades, has been an increasingly constructive relationship.

CONCLUSION

The Australia-EU economic relationship is caught between two moments: the time before the establishment of the WTO (a time of firm diplomacy and tension over the CAP after the end of 'Empire Free Trade') and the time after the establishment of the WTO (a time of multilateral free trade advancement and bilateral engagement). The various stages in the history of the relationship were born of the circumstances of the times, in many respects inevitable. In the current

FTA negotiations, policymakers will need to remain very sensitive in managing expectations around the agricultural debate. Agriculture is no longer the only priority for either side, but it still has the potential, if not to sabotage, then certainly to interrupt what should be a negotiation based on practical considerations. Only a fluidly negotiated FTA will ease the impact of agricultural protection through an increase in tariff rate quotas and easier quarantine requirements, as well as enhance cooperation to reduce the regulatory divergences that hinder bilateral trade.

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2

AN AUSTRALIAN PERSPECTIVE ON THE AUSTRALIA-EU FREE TRADE AGREEMENT

Jane Drake-Brockman

ABSTRACT

This chapter introduces emerging trends in Australian foreign and trade policy which together contribute to Australia's current strategic interest in filling a significant gap in its trade architecture via pursuit of a free trade agreement with the European Union (EU). It draws attention to the recent evolution of Australia's economic diplomacy towards a plurilateral approach in the WTO, a pragmatic approach to regional architecture (and more broadly across the Group of 20), and more outspoken interaction with its largest trading partners in favour of a rules-based order. Given the weight meanwhile of the services sector in the structure of the Australian economy and the evident under-performance in services exports to the Asia Pacific region, the chapter shines a light on what has long been a blind spot in Australia; the overwhelming relative importance of services in Australia's trade with the EU.

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MORE THAN ‘JUST ECONOMICS’

In May 2018, the Council of the European Union (EU) gave the green light to commencement of negotiations for a free trade agreement (FTA) with Australia and New Zealand (NZ). This green light was hard won, given historical sensitivities and differences in agricultural trade policy between the two parties. The launch of negotiations signals a significant turning point in bilateral commercial relations. It reflects the recent emergence, and continued risk of escalation, of new global tensions in the world trading system and a shared determination on the part of both the EU and Australia to find ways of overcoming traditional trade policy irritants and to take strong visible action together against protectionism and in support of a rules-based liberal trading order.

As with all bilateral preferential trading arrangements, this negotiation signals shared political and geostrategic interests as much as business stakeholder concerns, as the People’s Republic of China’s (China) growing economic power and the reality of the ‘Asian Century’ become more evident. As is to be expected, commentators in Europe and in Australia have slightly divergent perspectives on all these issues.

For Australia, large fast growth markets in the Asia Pacific region have tended for thirty years now to dominate business export focus and the domestic trade policy thrust. For much of the Australian public, the idea of prioritising a major effort on a probably difficult FTA negotiation with the EU would initially have seemed somewhat off target. For Europe, FTA ‘fatigue’ showed signs of setting in after the failure of efforts to negotiate the Transatlantic Trade and Investment Partnership (TTIP) with the United States (US). But as negotiations neared completion with Canada and Japan, the new EU trade policy ‘Trade for All’ (European Commission 2015), announced in 2015, set a new strategic direction—to increase the EU footprint in fast-growing East Asia, including in Australia’s own perceived ‘backyard’ among the members of ASEAN.

Australia is located further from Beijing than the EU Member States are (as documented in chapter 7) and Australia is less well integrated than many EU Member States into Asia Pacific manufacturing value chains. These two facts tend to escape public attention in Australia, given the extent of trade flows to and from Asian markets, the close policy dialogue with ASEAN and the close people-to-people relations built up over generations, largely due to Australian education exports. The idea that Australia has much to offer the EU in terms of access to Asia Pacific markets rings especially true to the Australian public when it comes to Australia’s nearest neighbours in ASEAN, notably the fastest growing and closest of them, Indonesia. The idea also resonates with Europeans, given

Australia's deep leadership experience in APEC and the vital role Australia has played in both the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the ongoing negotiations for a Regional Comprehensive Economic Partnership (RCEP). A trilateral Europe, Australia, Asia lens makes sense in a world of mega-regional trade arrangements (mega-RTAs).

The EU's 'Trade for All' Strategy was not necessarily comfortable for Australia. Explicitly anchoring EU engagement abroad in EU standards and values (including United Nations sustainable development goals), it departed from the more austere Australian approach of distinguishing trade policy objectives from other public policy concerns. It also introduced a high degree of public transparency. This included publication on dedicated 'Transparency in Action' webpages of mandates for trade negotiations, specific negotiating proposals, reports of negotiating rounds and completed negotiating text (even before legal 'scrubbing' and Parliamentary and Council procedures begin). As a trade policy, this stood out at the time as somewhat at odds with Australia's approach.

The story has become increasingly intricate. The US seemingly stepped backwards, not only from its 2012 'pivot to Asia', but also from leadership in both multilateral and plurilateral trade negotiations in Geneva. The UK voted in favour of exit from the EU (Brexit). The EU articulated its first efforts towards a common foreign and security policy in support of the 'rules-based order' (EEAS 2016). By 2017, APEC started falling short in its usual ability to hold a torch for openness to trade openness, the WTO limped both into and out of its tenth Ministerial meeting in Buenos Aires, and security concerns accumulated in both the South China Sea and the Baltic Sea. Trade tensions in the Group of 20 (G20), even more apparent recently in the G7, became palpable. Barriers to digital trade began to fragment the global market and freedom of cross-border data flows ratcheted to the top of business attention. The bilateral policy dialogue between Australia and the EU focused increasingly on shared perspectives and even shared 'values', including support for the 'rules-based order', and less on historical differences. This does not mean that agricultural trade policy ceased to be an irritant: far from it. But other shared interests, including on the foreign and security policy side, diluted its impact.

In November 2017, the Australian Government released a new *Foreign Policy White Paper* (DFAT 2017a). The overall policy conception has Australia's economic and security interests closely intertwined. But it also warned that Australia could no longer operate according to the standard assumption that trade, investment and other business links would necessarily act in future, as they have in the past, to restrain or dilute strategic rivalry. The *White Paper* described an emerging

era of hybrid ‘geo-economic’ competition, rife with tension and challenge for a smaller player such as Australia. It reaffirmed Australia’s determination to fight protectionism on the part of others, advising the Australian public that even as others retreat from openness—and even though Australia is too small to influence larger players—openness on Australia’s part remains in Australia’s own interest. The *White Paper* stressed that more inward-looking and less open economies would be less prepared to respond to major global crises or work collectively to address global challenges.

The *White Paper* concluded that Australia’s interests are best served by deepening regional economic integration in a way that maximises growth through open trade and investment on ‘market-based principles’. It stated publicly for the first time that the WTO faces considerable systemic risk, making comprehensive deals in the WTO unlikely. It also suggested that the ‘ideal’ of a Free Trade Agreement for Asia-Pacific (FTAAP) is likely to be a ‘generational endeavour’. The conclusion is that pragmatic bilateral and regional efforts must remain essential complementary elements in Australia’s trade policy. The *White Paper* set a goal of having over 80 per cent of Australia’s total trade being conducted with FTA partner countries by 2020.

In the words of the former Australian Prime Minister Malcolm Turnbull (Turnbull 2018), speaking in Berlin six months after its release, the *White Paper* was animated by a new central idea:

the liberal rules-based order that has enabled us all to pursue security and prosperity without compromising autonomy, is now straining under the weight of its success ... We must actively defend, extend and augment the rules-based structures that have enabled peace and prosperity so far.

In reviewing implementation of its ‘Trade for All’ Strategy in September 2017, the European Commission had similarly noted that the environment had changed considerably, with renewed domestic concerns about the impact of globalisation and real dangers of a protectionist resurgence in EU markets. It concluded that a trade policy which is highly transparent and based on values is needed more than ever before (European Commission 2017b). By 2018, the nuances of difference between ‘Trade for All’ and the trade policy approach set out in the Australian *Foreign Policy White Paper* had diminished significantly.

By April 2018, media warnings of a looming ‘trade war’ between the US and China and fear of potential protectionist sentiment in their own jurisdictions increasingly gave both Australia and the EU strengthened imperative to make a case both for trade and more generally for the rules-based international trading

system.¹ On 23 April 2018, former Prime Minister Turnbull delivered a keynote speech to the Konrad Adenauer Foundation in Berlin; this was foreshadowed in the Australian media (Coorey 2018a) as ascribing a much greater purpose for the proposed FTA than ‘just economics’.

The speech did indeed offer some insight into why Australia sees the FTA with the EU as so important:

We believe you cannot have prosperity without security. They go hand in hand. Each reinforces and enables the other.

We understand that the liberal, rules-based order ... has underpinned our prosperity and security for all of the post-war era. Yet the very same economic forces that have delivered prosperity and opportunity are also generating political uncertainty, military capability and strategic ambition.

Political alienation is feeding populism and protectionism and providing opportunities for foreign interference. All of these forces have been turbocharged by technological change at an unprecedented pace and scale.

We are navigating a rapidly changing multipolar world in which each of the major players are testing their relationships with each other, while undergoing rapid change themselves.

On the trade front, we're seeing rising tensions between the major powers—focused, dirigiste state capitalism in China, rising protectionism in the United States—all of which could test the capacity of the World Trade Organization to settle disputes based on law and precedent. (Turnbull 2018)

To a European audience, it might seem that Australia's recently expressed interest in European ‘values’ comes at a time when Europeans themselves are losing their sense of shared ‘values’. But for Australia, the recently increased rhetoric on shared ‘values’, including liberal democracy, seems to have become both synchronous and intertwined with support for the ‘liberal trading system’ and more generally, the broader strategic ‘rules-based order’.

Turnbull's Berlin speech also offered a perspective on why the trilateral Europe-Australia-Asia nexus is so important to Australia at this time, both strategically and economically:

In our region ... , we're blessed with the world's most dynamic economies. But we lack Europe's deeply rooted rules and institutions. An FTA is our opportunity to combine the best of both.

1 The most recent WTO monitoring report suggests the reality is less alarmist than the rhetoric. Nevertheless, more than US\$200 billion of merchandise trade is estimated to be covered by import-restrictive measures every year between 2011 and 2015. This is roughly equivalent to Australia's annual merchandise imports (Pedersen et al. 2018, p. 9). The risk that governments will cede ground to protectionist pressures remains very real in 2018.

We want our FTA to build a more seamless business environment, including one that makes it easier for European businesses to use Australia as a launchpad into Asia. (Turnbull 2018)

BACK TO THE ECONOMICS

Typical discussions of trade or trade policy focus first on the goods sectors, and then eventually add some comment on services trade and investment. In this chapter, the order is reversed to begin with investment. This is because, from an Australian perspective, the idea of attracting European businesses to use an Australian-headquartered base as a launchpad into Asia implies attracting EU investment into Australia. This is a rational economic objective. This chapter further innovates by reversing the traditional emphasis on trade in goods to focus here on services, leaving a discussion of merchandise trade to other chapters. There are several very good reasons for this, as explored below.

INVESTMENT

The Australia-EU foreign investment relationship is already very strong. In 2016, the EU accounted for a fifth of Australia's total two-way foreign direct investment (FDI) (DFAT 2017b). Australia ranks as the world's fourteenth largest destination for foreign investment and the EU's eighth largest investment destination (DFAT 2017b).

For Australia, the EU ranks as the largest source of inward FDI stock in Australia, with an approximate 25 per cent share, amounting to A\$165 billion in 2016. The UK is the dominant source, but France, Germany, Italy and the Netherlands are also important.

The Australian statistical collections shed little light on the industries into which EU investment is directed. Eurostat data for 2014 (DFAT 2017b) shows that the EU is also the world's biggest investor in services, with services accounting for more than 60 per cent of EU outward FDI. Eurostat data for 2014 showed EU affiliates in Australia were focused in the services sector (predominantly wholesale, retail, financial services, insurance, professional and technical services, information and communication technology (ICT) and construction—they were valued at A\$116 billion, roughly equal to the combined value of EU affiliates in mining and manufacturing and providing 183,100 jobs (1.6 times more than in mining and manufacturing combined). There were over 400 EU enterprises in each of the finance/insurance and professional/technical services sectors alone.

Eurostat data for the EU shows Australia ranks 8th as a source of inward FDI stock in the EU with a 4.5 per cent share, with the US (25 per cent share), Brazil (9 per cent) and Norway (8 per cent) in the top three (DFAT 2017b).

From an Australian perspective however, the EU is Australia's largest destination for outward FDI, amounting in 2016 to A\$105 billion. Services industries figure importantly in this flow: Eurostat data for 2014 shows that sales by Australian affiliates in the EU in wholesale, retail, professional, scientific and technical services generated more sales than Australian affiliates in manufacturing.

Despite the fact that the EU Member States together rank as Australia's top source of foreign investment, Australia currently discriminates against EU investors—because it reduces its investment screening threshold on a preferential basis only for trading partners which have FTAs with Australia. The Australian Government might be undoing foreign and trade policy legacies with respect to an FTA with the EU, but it is not undoing the economically irrational legacy of preferential investment liberalisation. As a small relatively open economy, the Australian Government clearly continues to view the investment-screening threshold as valuable bilateral negotiating coin for all FTAs.

Despite the above, commercial establishment, at least for services, is undoubtedly covered under the EU's FTA negotiating mandate. As such, Australia's foreign investment screening process is expected to be on the negotiating table.² This matters for the reasons stated above. It also matters because most unusually, other investment issues are off the table for this phase of this particular FTA. In the interests of avoiding prolonged political delays with EU ratification, as occurred with the EU-Singapore FTA and with CETA, negotiations with Australia are being 'fast tracked'. This means that the negotiating mandate given to the European Commission is limited to issues of exclusive EU competence, consistent with a decision handed down by the European Court of Justice (ECJ) in May 2017. Issues of mixed competence, requiring individual EU Member State Parliamentary ratification, are excluded from these negotiations, namely portfolio investment, investment promotion and investment dispute settlement.

These are not insignificant issues to set aside. Take portfolio investment for example; for the year ending 31 December 2017, as much as 54 per cent of the total foreign investment stock in Australia was portfolio investment, and about 45 per cent of Australia's total outward investment was portfolio investment (ABS 2018). Disentangling the data for the EU shows that as much as 64 per cent of the EU investment stock in Australia in 2015 was portfolio investment. This was up by 8 per cent from 2014 (Casella 2017).

² Unlike EU FTAs, no Australian FTA to date has a chapter entitled 'Commercial Establishment'. The Australia-EU FTA will presumably need to include such a chapter, so as to cover Mode 3 services trade, because there will be no 'Investment' chapter. Alternatively Australia will need to depart from its usual practice of including a chapter on "Cross-Border Trade in Services" and construct a new template for a chapter covering all modes of services trade.

An FTA with a developed economy partner that does not include an investment chapter is a marked departure for Australia in its preferred architectural approach to FTAs since the Australia-US FTA in 2004. It is also unprecedented in EU FTA negotiating mandates since the 2007 Lisbon Treaty on the Functioning of the EU. So why have the parties agreed to this ‘fast track’ approach?

Certainly, both parties share a desire to send a pro-trade liberalisation signal to the rest of the world at a time during which protectionism appears to be on the rise and hence prefer a rapid and impactful result. Brexit, which is covered in detail in a separate chapter, may also be contributing to this decision. The EU presumably prefers to make progress on an FTA with Australia before Brexit interferes. Australia certainly prefers to get on with both an FTA with the EU and in due course an FTA with the UK. The narrow negotiating mandate is seen as critical in Brussels to ‘fast tracking’ this FTA, once completed, through the ratification process.

Meanwhile, the UK accounts for well over half of total EU investment (about 60 per cent of direct EU investment) in Australia and is the destination for two-thirds of Australian outward FDI in the EU (DFAT 2017b). Of the UK investment in Australia, more than half is portfolio investment (Casella 2017), the competence for which, as explained in chapter 6, is deemed by the ECJ to be a Member State responsibility. The absence of investment from the EU negotiating mandate potentially frees the UK and Australia to commence early informal bilateral discussions on certain limited investment issues without waiting for Brexit or the final shape of the future EU-UK trade arrangement.

The expectation for both Australia and the EU27 (EU minus the UK) is that in due course post-Brexit, the EU27 will achieve a new follow-up FTA negotiating mandate for a supplementary deal with Australia on investment.

SERVICES

This chapter turns next to a discussion of services, as a priority over one on trade in goods for a number of reasons.³ First, services are the dominant activity in the Australian economy—this is not unusual—it tends to be true everywhere though it generally goes unrecognised. Second, services are the dominant sector in Australia’s exports to the EU—this is very unusual, indeed it is unique for Australia—Australia’s trade with the EU is very much more services-intense than with any other trading partner. Third, the balance-of-payments is a poor overall reporter of trade in services—as an analytical tool it can now be supplemented by the OECD/WTO Trade in Value-Added (TiVA) dataset, providing some insight into the role of Australian services inputs in generating exports of both goods and

3 The discussion here draws on and builds from Drake-Brockman (2016, 2017d and 2017e).

services, as well as some insight into Australia's role in global value chains (GVCs). Fourth, barriers to trade in services tend, globally, to be higher than barriers to trade in goods (including agriculture) and hence have greater potential relevance to twenty-first century trade negotiations, especially with the shift to the digital economy. The OECD's Services Trade Restrictiveness index (STRI) provides a new trade negotiating tool to help compare the trade restrictive impact of services regulations in Australia and the EU. Finally, the Australia-EU FTA services story is very much a UK story—Brexit will complicate its ending.

Despite the traditional prominence of agriculture and mining in Australia's public policy conversation, the services sector is by far the largest sector of economic activity, accounting for 83.4 per cent (World Bank 2018) of industry value-added. The services sector is also by far the largest and fastest growing employer, accounting for 85 per cent of Australian jobs (OECD 2018a). Overall, Australia's services sector productivity performance is judged by the OECD to have outperformed goods-producing sectors during the last 15 years (OECD 2018b).

The services sector is a high performer in terms of output and employment. But with respect to trade, a mere 3.6 per cent of Australia's services output is exported (OECD 2018b). Despite the dominant role of services in the domestic economy, services seriously underperform in Australia's balance-of-payments, accounting for 25 per cent of Australian exports.

With the global share of trade in services set to rise against a background of long-term decline in world merchandise trade (Constantinescu, Mattoo & Ruta 2016) it is vital for Australia's future trade outlook that the significant underperformance of services exports be improved. The Australia-EU FTA offers a unique opportunity to do so. But if not fully recognised, the opportunity risks being missed.

'STATISTICS, DAMMED STATISTICS AND LIES'

What is the scope for development of the relationships in services between the EU and Australia?

In March 2018, DFAT (2018a) reported the US as Australia's largest two-way services trading partner for 2016-2017, accounting for 14 per cent (A\$23.8 billion) of Australia's total services trade, followed by China, accounting for 10.5 per cent (A\$17.5 billion) and the UK, accounting for 8 per cent (A\$13.5 billion).

The DFAT report did not choose to mention the EU in this particular ranking of total two-way services trade. With respect to groupings of countries, the same publication (DFAT 2018) did report, however, that APEC economies accounted

for 60.6 per cent of Australia's total services trade; G20 members for 60 per cent; OECD countries for 48.7 per cent; ASEAN for 16.8 per cent; and 'members of the EU' for 19 per cent (20 per cent in 2016). Despite the DFAT choice of interpretation, this unquestionably puts the EU, not the US, as Australia's largest two-way services trading partner. (Post Brexit, the EU27 will drop in ranking but seems likely on current trends to remain ahead of China and potentially ahead of the UK.) Australia's total trade in services with the EU28 has grown on average more than 9 per cent per annum over the last decade.

DFAT also reported that for 2016-2017 China was Australia's largest services export market (A\$14.7 billion). Again the DFAT report did not mention the EU, though it did note that taking Australia's exports of services as a whole, the last 15 years have seen a steady decline in the share taken by Europe and an increase in the share taken by Asia and Oceania.

It is worth recalling, however, that the EU was Australia's top services export market until very recently. In 2015-2016, the EU absorbed 15 per cent of Australia's services exports (A\$10.5 billion). But that year the Chinese market surged ahead of the EU for the first time to reach A\$10.7 billion, due to rapid growth in Chinese tourists. Australia's exports to China are dominated by education and increasingly by tourism.

Tourism also figures importantly with the EU, accounting for roughly half of services exports to the EU; with roughly 1.5 million personal travellers each way in 2016. But high value-added knowledge-intensive business services (including professional and technical services) also figure importantly, accounting for more than 30 per cent and growing. This is not the case with respect to China.

In China's case, moreover, services accounted in 2016-2017 for only 12 per cent of Australia's exports to China, a highly problematic underperformance given that services averaged 22 per cent in total Australian exports.

In the case of the EU, on the other hand, services accounted for nearly 40 per cent of Australian exports to the EU—a remarkable performance compared with the average. And the trend is positive. Australia's services exports to the EU rose 2 per cent in 2016 while services imports fell 5.4 per cent. Over the last five years, Australia's imports of services from the EU increased by an annual average rate of 4.8 per cent, but Australia's services exports to the EU also increased by an average annual rate of 4.5 per cent.

Notably, DFAT reported that for 2016-2017 the top five services exporters in the world were the US, the UK (growing more slowly and with less than half the US export volume), followed in relatively quick succession by Germany, France and then China.

Again the DFAT report did not mention the EU. Again the data is worth reporting, indeed worth emphasising. The EU28 is by far the biggest services exporter in the world, accounting in 2015 for 25 per cent of the world's services exports (Kerneis 2013 & 2017). Adding intra-EU services trade, EU Member States together account for 42 per cent of the world's services exports! The EU28 is also the largest services importer in the world.

The 'alternative' narrative presented here is based on the same statistics as the DFAT narrative. It is a narrative largely at odds with Australia's agricultural and regional trade policy focus until now. But as the Australia-EU FTA negotiations get underway (Council of the EU 2018), it couldn't be clearer that services loom twice as large in the overall trading relationship with the EU than on average with other trading partners. From an Australian perspective, this suggests that they deserve perhaps twice as much public policy attention.

The focus on services is not going to diminish. The simple fact is that the rise of knowledge-based activities and the growing importance of intangible assets, together with increasing digitalisation and the enhanced role of services inputs in manufacturing and agricultural value chains, all lead to an increasing importance of services both in Europe and in Australia. Today's big bilateral business opportunities lie in collaborative innovation and development of the modern services economy: in intensifying an exchange in data-related services inputs to business processes that can drive productivity gains across all industry sectors.

This positive bilateral story on services contrasts with the recent evolution of bilateral merchandise trade. In 2016-2017, the EU accounted for 8 per cent of Australia's goods exports and 18 per cent of Australia's goods imports. Goods exports to the EU are heavily skewed towards gold (nearly all of it to the UK), accounting for 41 per cent, and minerals and fuels (another 20 per cent). Manufactures exports account for 23 per cent and agriculture for 15 per cent. On the import side, manufactures account for 89 per cent and agriculture for 10 per cent (DFAT 2017c). Australia's goods exports to the EU have fallen over the past five years by an average annual rate of 2 per cent, and goods imports have risen by an annual average rate of 2.8 per cent (DFAT 2017c). Australia's goods trade deficit with the EU is on the rise.

The clear conclusion is that trade in services is where the real bilateral growth activity is taking place. It is also where the negotiating effort should focus. Australia's *Foreign Policy White Paper* foreshadowed a fundamental reinvigoration in Australia's approach to trade in services, including in the context of the digital economy. It identified Australia's education services providers (the world's third largest education exporters) and Australia's research and development (R&D) services providers as among Australia's core national strengths. It recognised the

potential, with the right policy and regulatory settings at home and abroad, for rapid export growth in knowledge-intensive services such as health care, financial services, ICT, marketing, engineering and design. The Australia-EU FTA comes at the right time.

INSIGHTS FROM TRADE IN VALUE-ADDED

A further dimension of the services trade relationship is revealed through input-output data analysis.

Perhaps unsurprisingly, given Australia's geographic remoteness and the dominance of mining exports, share of domestic value-added (DVA) in Australian exports is high at over 87 per cent (see Figure 2.1). This is higher than the share in New Zealand (NZ), more than ten percentage points above the OECD average of 76 per cent, 17 percentage points above the EU (and ASEAN) averages of 70 per cent and 20 percentage points above China. And in Australia's case—unlike the OECD country trend, the DVA share in exports has seen no more than a trivial drop over 15 years, from 88 per cent in 1995.

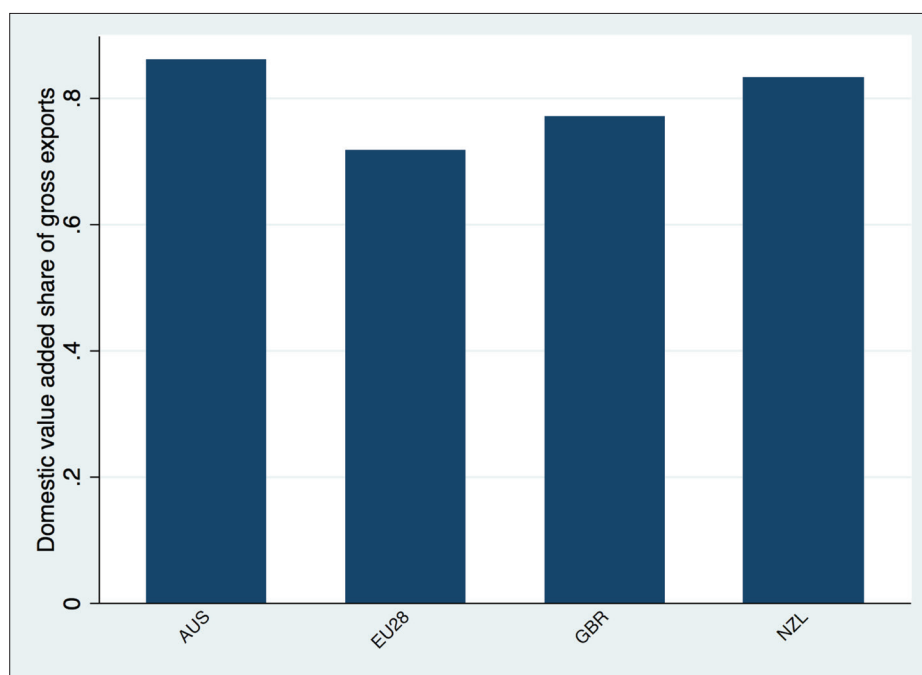


Figure 2.1: Domestic value-added share of gross exports, 2011.

Source: OECD/WTO TIVA Database 2011.

This data indicates that Australian industry has experienced persistent difficulty in accessing and participating in GVCs.⁴ Australia's 'GVC Participation Index' (OECD STRI 2017), based on the percentage of a country's total exports which are engaged in GVC activity, is also relatively low, at just over 40 per cent. Two-thirds of Australia's exports of intermediates are destined meanwhile for further processing offshore (that is Australia's limited participation in GVCs tends to be 'forward' rather than 'backward'.) This issue is taken up in more detail in chapter 7, which focuses on Australia's relative lack of participation in and access to manufacturing GVCs and the manner in which an Australia-EU FTA might address this circumstance. But it is worth noting here that recent global measures (Drake-Brockman 2018a) point especially to strong global growth potential for intermediate GVC trade in services themselves, especially digitally-enabled services.

The new OECD/WTO TiVA data also tracks the industry source of value in Australia's total production of exported goods and services. This data shows that services content makes up 45.6 per cent of Australia's total gross exports (see Figure 2.2). But this is decidedly less than the EU; it is as much as 18 percentage points below the UK.⁵

The services content of exports originates from domestic and foreign sources. Figure 2.3 shows this division. The share of foreign services content in Australia's exports is relatively low, which is of potential concern. Global evidence suggests moreover that imports of services (contributing to foreign services content) tend to generate exports, of both goods (Escaith 2013) and services (Rizal Damuri 2014). A higher level of imports of services could potentially improve Australia's overall export performance. It is worth noting in this context that the percentage of imported foreign services content is noticeably higher in the metals and electrical and optical sectors than is the case for other goods sectors. These are also the manufacturing sectors most integrated in Australia into GVCs, largely because of imported high value-added services content (Drake-Brockman 2014).

The EU is the largest importer of services in the world (Kerneis 2017) and in 2016 was also Australia's largest services import source (DFAT 2017d), along with the US (which at A\$15.3 billion, was the largest for 2016-2017.) A deeper

4 High percentages of DVA can be expected in: (1) large economies that can source inputs domestically; (2) geographically isolated economies; (3) countries with high levels of trade barriers; (4) economies with exports dominated by upstream activities with little local value-added, such as mining; or (5) economies with strong export performance in pure services, as distinct from services intermediates embodied in goods.

5 For a discussion of trends in the services content of EU gross exports, see KommersKollegium 2016.

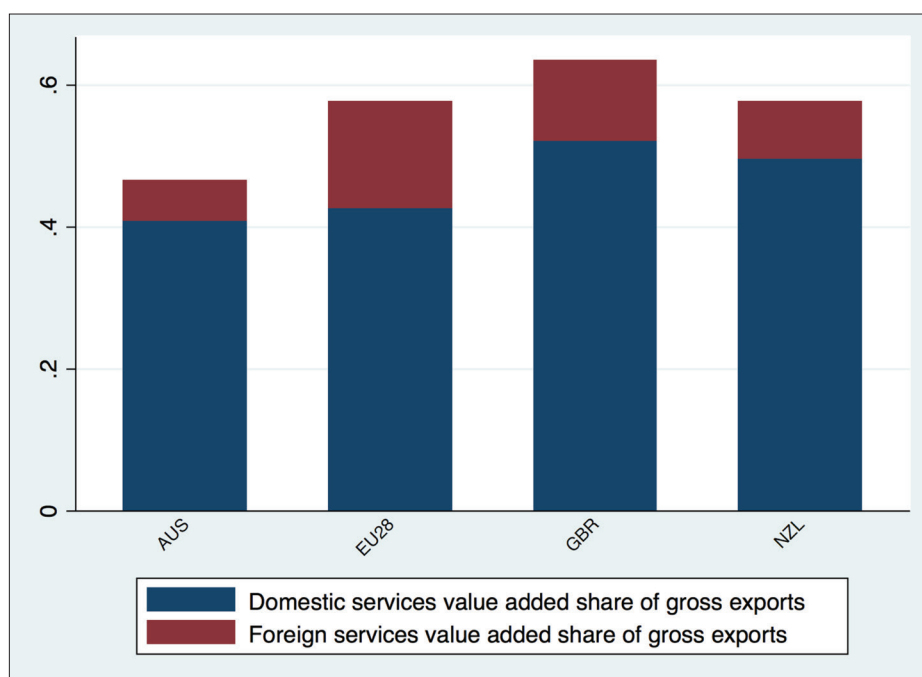


Figure 2.2: Services content of gross exports, 2011.

Source: OECD/WTO TIVA Database, 2011.

relationship with the EU, because of its role in services exports, offers the important consequences described above for Australia's own overall export performance.

Breaking the domestic content of gross exports down by sectors sheds further light on Australia's services export performance. Mining dominates Australia's exports but is followed by services, as shown in Figure 2.3 which illustrates the greater relative importance of services value-added in total exports than manufacturing value-added. For the UK, services similarly represent a much larger share than manufacturing of exported domestic value-added (see Figure 2.3). The story is quite different however for the EU27, where manufacturing value-added is more important (see Figure 2.3).

This points to the likelihood of a bilateral negotiation between the UK and Australia being strongly dominated by mutual interests in services; but a negotiation between the EU27 and Australia being more focused on EU offensive interests in manufacturing.

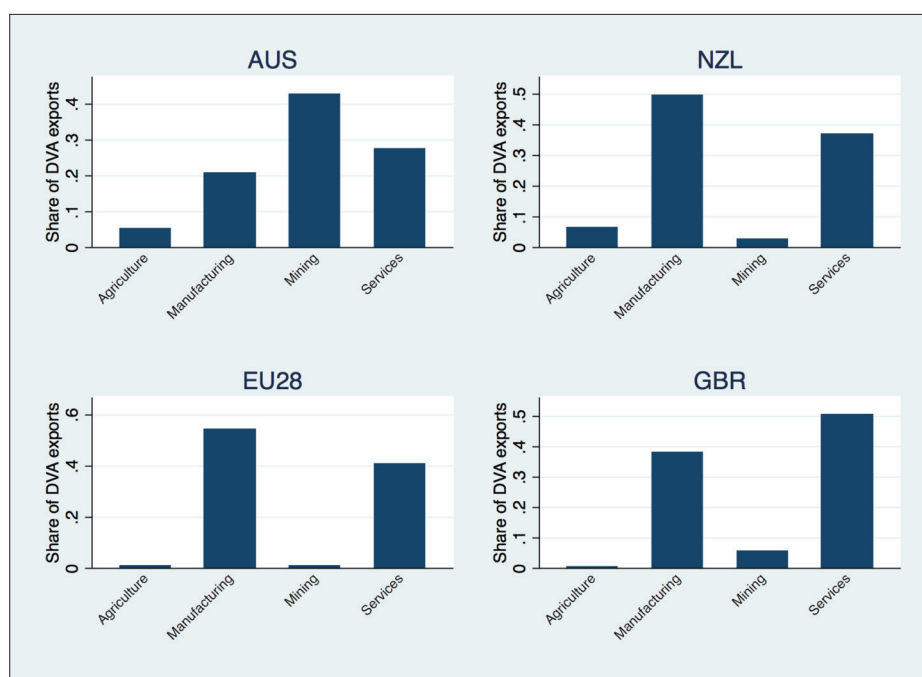


Figure 2.3: Sector shares of domestic value-added in exports (%).

Source: OECD/WTO TIVA Database, 2011.

SERVICES TRADE RESTRICTIONS

The barriers to trade in services tend not to be at located at the border (other than in immigration and foreign investment regimes) but to lie more in the realm of domestic regulation. It has been difficult in the past for trade negotiators to compare the restrictiveness of trading partners' regulatory regimes for services. A new economic tool has recently become available; namely the OECD Services Trade Restrictiveness Index (STRI),⁶ which helps measure levels of services trade restrictiveness across different jurisdictions.

The STRI usefully allows for some comparison between the Australian and EU regulatory regimes for different services sectors. The EU however is made up of 28 Member States and the process of regional integration in services is less well

⁶ The STRI catalogues regulatory information and assigns a scoring system between 0 (open) and 1 (closed) by five policy areas (restrictions on foreign entry, restrictions to movement of people, other discriminatory measures, barriers to competition and regulatory transparency) as well as by mode of supply.

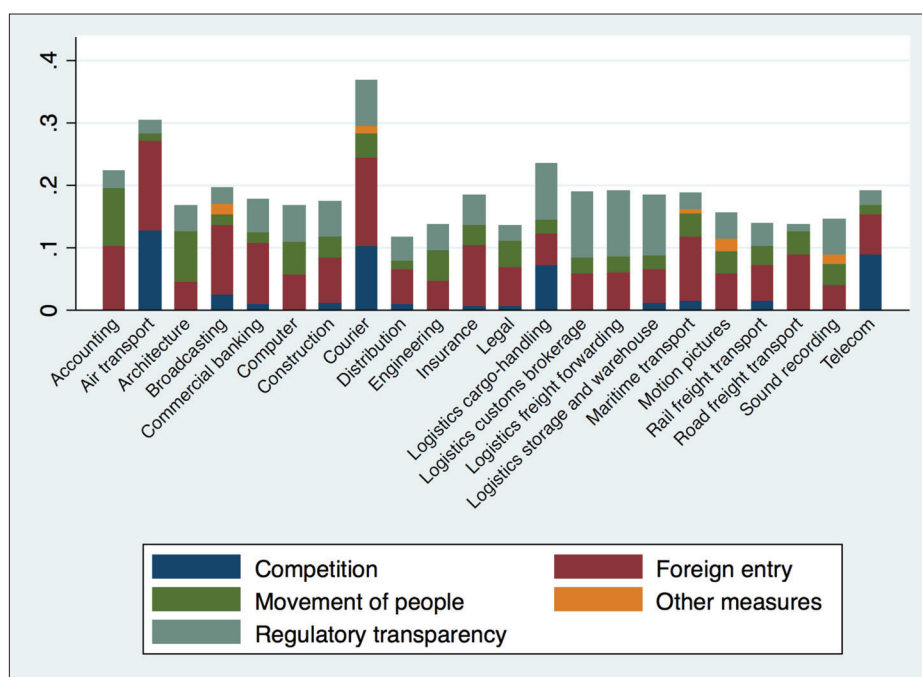


Figure 2.4: Australia: STRI score, by sector and policy area.

Source: OECD STRI Database, 2017.

advanced than in goods, meaning there remains a degree of regulatory heterogeneity across the Member States.

Recent studies using the OECD STRI show there is a particularly high degree of heterogeneity in services sectors which are regulated only by EU directives, which set the objective but allow Member States discretion regarding implementation, for example in professional services. Less heterogeneity is apparent in services activities subject to mandatory EU regulations, for example in telecommunications (Nordas 2017; Drake-Brockman 2017c).

The extent of heterogeneity is still such that it would be difficult for the EU to make a negotiating case that Australia tended to be more restrictive in many sectors than the EU28. Figures 2.4 and 2.5 show the STRI for each sub-sector for Australia and, for rough comparison, France.

Australia's STRI is below the average (across the 44 countries in the database) for 19 out of the 23 services sectors covered by the OECD STRI.⁷ This compares

⁷ The sectors where Australia is more restrictive than the average are; sound recording, courier services, cargo handling and freight forwarding. In no services sector, is Australia at the minimum best practice level but it comes close to that outcome for rail freight.

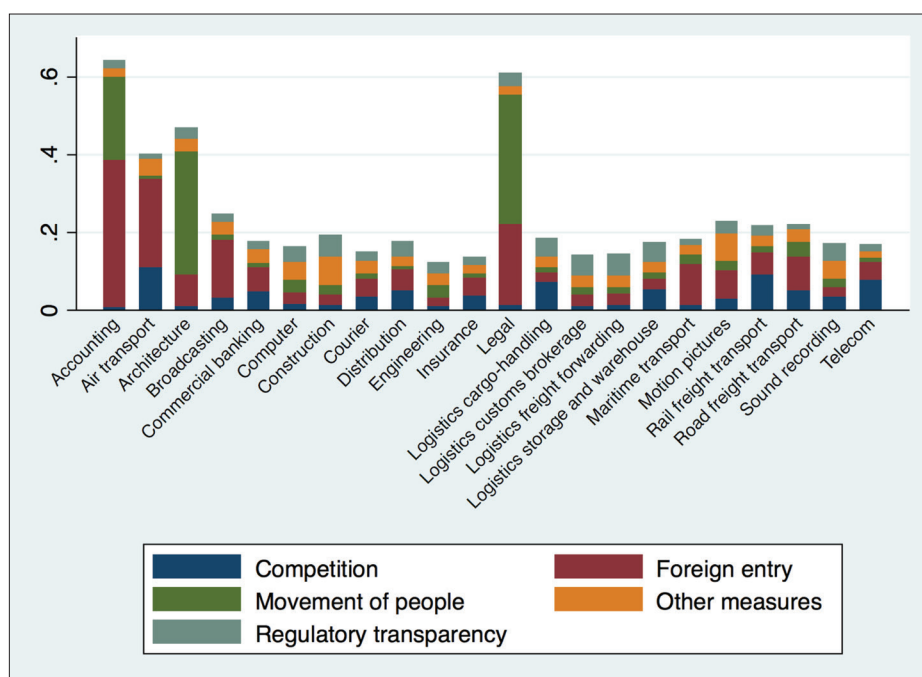


Figure 2.5: France: STRI score, by sector and policy area.

Source: OECD STRI database, 2017.

quite favourably with the EU. On the one hand, Germany, the UK, the Netherlands and Ireland all do better, with their scores below average in all 23 sectors. Spain and Denmark also do better, with scores lower than average in 21 sectors. The Czech Republic scores lower than average in 20 sectors. On the other hand, France scores lower than average in 18 sectors, the Slovak Republic in 17 sectors, Sweden, Portugal and Poland in 16 sectors, Italy and Greece in 12 sectors and Finland in 11. Austria scores lower than average in less than half of the sectors (10) and so does Belgium (8), meaning both these countries score above the average in more than half of the 22 sectors. These differences between the Member States are reflected of course in the EU schedules of services commitments, and specific regulations in specific Member States will certainly be up for negotiation.

These figures give only a very general idea. But they make it clear that without more services sub-sector research, it is difficult to assess which trading partner—Australia or the EU—will have the stronger offensive interest in the services aspects of the FTA negotiations. (Partly for this very reason, this volume includes as many as four additional chapters on services sectors.) For a start it is obviously important to explore the extent to which the STRI is below the average in any particular

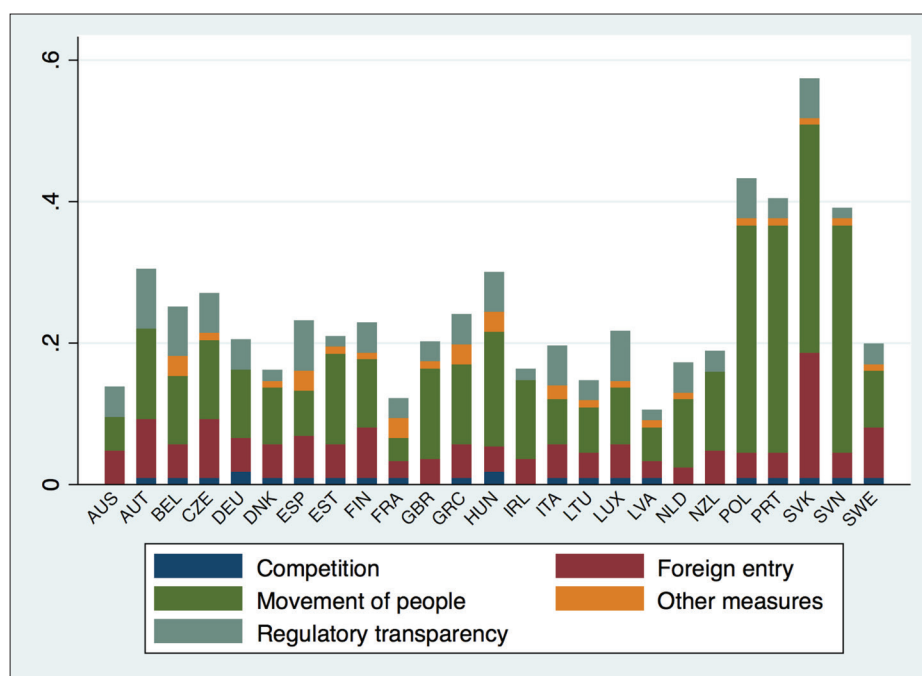


Figure 2.6: STRI engineering services, Australia, EU Member States, NZ.

Source: OECD STRI Database, 2017.

sector by looking at the actual score, and identifying the actual regulations which contribute to a high score.

It is worth making a quick comparison with some of the EU Member States which Figure most prominently in Australia-EU trade in services. In transport services, for example, Australia's STRI score is lower in air transport, as well as road and rail freight transport, than for example Germany, France and the UK. In maritime freight transport, it is on a par with Germany and France but lower than the UK. In professional services, Australia is less restrictive than Germany, France and the UK in accounting and auditing, architecture and legal services. In engineering (see Figure 2.6), Australia is less restrictive than Germany and the UK for example but is more so than France, which is the least restrictive of the EU Member States in engineering.

As shown in chapter 15 of this volume covering financial services, Australia is also less restrictive in commercial banking than Germany, France and the UK but is more restrictive than all of those EU Member States in relation to insurance services. For logistics services, Australia is more restrictive on cargo handling, storage and warehousing, freight forwarding and customs brokerage than Germany,

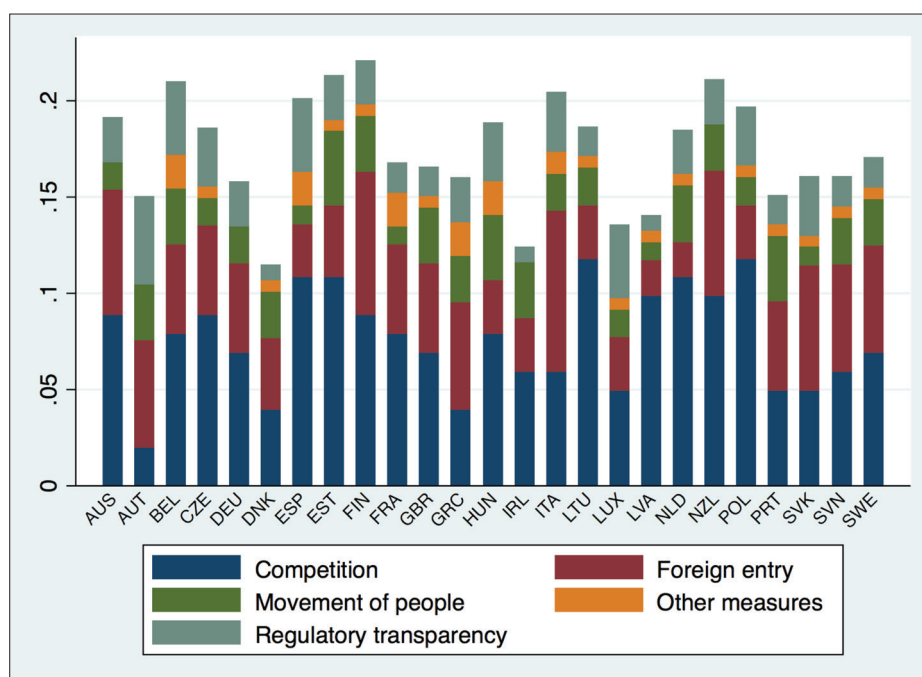


Figure 2.7: STRI telecommunications, Australia, EU Member States, NZ.

Source: OECD STRI Database, 2017.

France and the UK. Australia is also more restrictive in postal and courier services. In telecommunications, Australia's index is higher than for Germany, the UK and France (see Figure 2.7).

This serves as a reminder that unlike trade in goods, where the EU Member States have a common external tariff, the barriers to trade in services are not necessarily all in 'common' across the EU because the internal market remains fragmented by discretionary regulation. Trade in services negotiations with the EU28 requires a great deal of information on Australia's part. It also highlights the importance of increased mutual regulatory familiarity and cooperation, which is often a pre-condition for services liberalisation (Mattoo 2015). Fortunately, the services negotiators on both sides of this FTA already know each other well and much ground work has already been done.

WHAT MIGHT SERVICES NEGOTIATIONS DELIVER?

There have been several calls on the Australian side for a trade deal with the EU (Gosper 2017). The peak business body for the services industries, the Australian Services Roundtable (ASR) called in its 2008 submission to the Mortimer Review

(ASR 2008) for a bilateral agreement on services trade and investment alone, hoping to avoid services issues becoming hostage to traditional disagreements on agriculture. This was picked up in the final review report (Mortimer & Edwards 2008) which noted that the EU was ‘the only major trading partner with which Australia is not negotiating or considering negotiating an FTA’. The review report went on to propose (in recommendation 6.7) that the then Australian Government should consider the merits of negotiating a bilateral FTA with the EU, including the possibility of an agreement focused only on services and related investment, which it thought could deliver ‘considerable benefits’ (Mortimer & Edwards 2008). The review report recommendation was ignored. What was not ignored, however, although it took some time to capture political imagination, was a simultaneous call from ASR in 2008, which achieved early European Services Forum (ESF) support, for a plurilateral agreement on services, which would include the EU (Drake-Brockman 2017a).

Australia and the EU worked closely together over the years from December 2012 to December 2016 in the context of the plurilateral Trade in Services Agreement (TiSA) negotiations in Geneva. These negotiations were temporarily suspended after the US Presidential election in 2016, right at a time when negotiations were almost complete. During the TiSA pause, Australia has continued to work closely with the EU in a concerted effort to take some of their jointly acquired TiSA experience back into the WTO, both via proposals on domestic regulation negotiations in the Doha Development Agenda (DDA) and via efforts to launch a plurilateral negotiation in the WTO on e-commerce.⁸ Both sides are familiar with each other’s perspectives and positions on services, sub-sector by sub-sector and issue by issue. Both have seen each other’s TiSA offers, both of which are based on best FTA commitments, which to a large extent reflect the WTO DDA revised offers of 2001.

Both parties can be expected to already have a relatively clear idea, especially after the joint scoping study and publication of the EU’s impact assessment study (European Commission 2016), on where much of the bilateral give and take on services might land and where the deal makers and breakers might lie. This augurs well for a simplified and fast-tracked negotiation.

It is worth adding that throughout the years of negotiations, as well as during a prior year of lead up to the negotiations, European and Australian services business stakeholders engaged equally closely (Drake-Brockman 2017a) on the substance of the negotiations, considering them essentially a win-win for both sides, given the strong focus on productivity-generating domestic regulatory reform. While it

⁸ For a general introduction to these issues, see Drake-Brockman 2017b.

would no longer constitute a sufficient outcome for twenty-first century business, both the ASR and the ESF are keen to reap, as a minimum, the DDA offers, which after all have been on the negotiating table now for nearly 17 years.

It is essential to add, however, that on the eve of TiSA entering ‘hibernation’ in December 2016, there were several potential deal breakers remaining on the negotiating agenda, all but one being due essentially to difficulties on the part of the EU—and all of which will have relevance for the Australia-EU FTA.

Of these issues, two related to the proposed architecture of the TiSA agreement, which was a hybrid between the WTO General Agreement on Services (GATS) and the increasingly common North American FTA ‘NAFTA-style’ FTA. The first issue was inclusion of a ‘ratchet clause’, by which any future unilateral liberalisation of services would automatically be bound into the agreement. The second was inclusion of a ‘most favoured nation (MFN)-forward’ provision, by which any future preferential deal by either party with a third trading partner would automatically be extended to parties of the agreement. Brexit was partly responsible for this otherwise unexpected EU position on MFN-forward. These two issues will inevitably arise in the negotiations with Australia, because both provisions have become standard practice for Australia and absence of them will detract from domestic services industry support.

Another three issues relate to the digital economy and proposed reflection of CPTPP-type outcomes.

First, the EU appeared unwilling in the TiSA negotiations to undertake not to impose future trade restrictions on ‘new services’. The EU wanted in the TiSA negotiations to retain policy space to impose discriminatory measures, for example on applications of artificial intelligence (AI) to financial services, impacting potentially on for example the fintech sector (Drake-Brockman 2017a). Second, and even more problematically, the EU was not internally prepared at that time to table a negotiating position on freedom of cross-border flows of data (and how this might interact with data protection/privacy), nor on banning of data localisation requirements. These last two vital issues were never fully discussed in TiSA and consequently remained outstanding.

The EU has made some progress over the last 18 months but was still not fully ready, even as negotiations with Australia commenced (Drake-Brockman 2018b). The issue of e-commerce and digital trade is covered fully in chapter 12 of this volume. However, it is essential to note at this point that in April 2018, the Commission finally circulated a draft trade provision to EU Member States. Both the ESF and the ASR reacted negatively to aspects of this draft provision and

joined a concerted Global Services Coalition (GSC) letter to EU Member States.⁹ The Australian Information Industry Association (AIIA) also wrote to EU Member States in a joint letter with other global information technology (IT) associations.¹⁰

As explained in chapter 12 of this volume, the proposed draft European Commission text does not reflect the liberalising thrust of the digital trade provisions supported by Australia in the CPTPP. Australia's *Foreign Policy White Paper* of November 2017 drew attention to the fundamental reinvigoration underway in the Australian Government's approach to trade in services, including in the context of digital transformation. It announced intentions to press for new trade rules to cover e-commerce, to facilitate cross-border data flows, prohibit data localisation, encourage greater development of industry-led standards and ensure technological neutrality.¹¹ The FTA negotiations with the EU will put these intentions to an awkward test. The future of services is unambiguously digital and this issue risks being a negotiating deal breaker.

As with investment issues, Brexit will overshadow the services negotiations. As with investment, the services story is strongly UK-oriented. The UK takes almost half of Australia's exports to the EU (four times more than Germany) and provides more than a third of Australia's services imports from the EU (twice as much as Germany). Of Australia's exports of financial services to the EU, the UK takes nearly 80 per cent. Australian services business priorities will shift after Brexit towards an FTA with the UK, especially given the UK's own anticipated focus on services.

One conjecture is that in negotiating services aspects of an FTA with Australia, the UK, given its traditional leadership role among EU Member States in favour of trade liberalisation, might be readier than the EU27 to concede to market access and regulatory cooperation for big large mutual growth sectors like financial services (banking, insurance, funds management) and technical and professional services. It might also be more likely to agree to CPTPP-type text on cross-border data flows. The UK would presumably be prepared to agree to 'MFN-forward' provisions on services. Coupled with such outcomes, constructive

9 The GSC media release is available at <http://australianservicesroundtable.com.au/media-releases/global-services-coalition-recommendations-to-the-member-states-of-the-european-union-regarding-the-european-commission-proposal-on-data-flows-april-17-2018/>

10 The AIIA letter is available at https://www.aiia.com.au/__data/assets/pdf_file/0011/86825/Multiassociation-Letter-on-EU-Data-Flows_June-2018.pdf. See also a letter from the International Chamber of Commerce at <https://cdn.iccwbo.org/content/uploads/sites/3/2018/05/icc-letter-on-eu-cross-border-data-flows-provisions-may-2018.pdf>. For a further discussion of the trade policy issues involved, see Mattoo & Meltzer 2018.

11 In 2018 the Australian Government also released a discussion and industry consultation paper on *The Future of Digital Trade Rules* (DFAT 2018b). See also Meltzer 2018.

negotiations on investment and for example, a reduction in the wine tariff, means that an Australia-UK deal would likely resonate well with Australian stakeholders.

It is worth noting that the UK also takes 50 per cent of Australia's goods exports to the EU; another 46 per cent go to the Netherlands, Germany, France and Belgium. But as the analysis in the next chapter suggests, given the market access interests of the parties, an Australia-EU27 FTA is relatively more likely to focus on goods than is an Australia-EU28 FTA or an Australia-UK FTA.

For the time being, the Australia-EU FTA is a race against time.

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3

A EUROPEAN PERSPECTIVE ON THE AUSTRALIA-EU FREE TRADE AGREEMENT

Patrick Messerlin and Jimmyn Parc

ABSTRACT

Free trade agreements (FTAs) aim to achieve further economic development for the participants. In this respect, the opportunities offered to the European Union (EU) by an Australia-EU FTA are crucial for Europe's economic future. This is further highlighted by two situations and their consequent effects on the EU economy: (1) the United Kingdom's exit from the EU (Brexit) and (2) the United States' hesitations regarding the EU's global strategy. This chapter argues that the Australia-EU FTA will result in positive effects in the EU for two main reasons. First, Australia is attractive because of its high-quality economic governance—the authors argue that governance is the most important issue in the long run for a mutually beneficial FTA that covers regulation-intensive topics such as technical barriers to trade and services. Second, as Australia has deep political and economic relations with East and South-East Asian countries, the Australia-EU FTA should be used as a key instrument in the EU strategy towards Asian countries with great potential and rapidly growing economies.

INTRODUCTION

In July 2017, Australia and the European Union (EU) signed a new bilateral 'Framework Agreement'. A framework is a 'chapeau' agreement that the EU has imposed on all the trading partners with which it plans to negotiate a free trade agreement (FTA), the only exception being the Transatlantic Trade and Investment Partnership (TTIP) with the United States (US). A typical EU framework agreement deals with a much

wider range of issues than trade, from broad societal issues such as common values, democracy, rule of law, social and environmental sustainability, to political issues such as foreign policy, security, emergency management, education and culture (Markovic 2009). The agreement signed with Australia follows this tradition (Framework Agreement between the EU and Australia 2017). Even its ‘Title IV’, which deals with ‘trade and investment dialogue’, covers a wide range of sectors and topics, such as agricultural trade and marketing, two-way investment, public procurement, technical barriers to trade, sanitary and phyto-sanitary issues, animal welfare, customs, intellectual property, competition policy, services, and trade and sustainable development.

The wide range of topics within the Framework has generated much unease among most EU partners for several reasons. First, it deals with many different topics in one broad text—most of them unrelated to trade. Australia has been particularly sensitive to this aspect. For example, in 1996 when the EU suggested including a human rights clause in its future trade treaty with Australia, the Australian Government ‘deemed it unnecessary to have such links in a treaty with other developed, democratic states’ (Markovic 2012). Indeed, negotiations on this early trade treaty with Australia were never launched; ten years later, the *‘Global Europe’ White Paper* did not even mention Australia as a priority country with which to establish deeper trade relations (European Commission 2006).

Second, EU partners often fear that Frameworks will create disagreements over competence between EU Member States and the EU. In EU law, trade (and foreign direct investment (FDI) since the 2009 Lisbon Treaty on the Functioning of the EU)—is one of a handful of ‘exclusive’ competence domains of the EU.¹ All the other aspects handled within the Frameworks fall under the ‘shared’ competence of the EU and its Member States. That said, the May 2017 Opinion of the European Court of Justice (ECJ) on the Singapore-EU FTA has clarified the competence issue: in summary, only portfolio investment and investor-state dispute settlement are excluded from EU exclusive competence.² However, this legal opinion has not eliminated political forces hostile to FTAs. This is illustrated by the post-May 2017 Opinion battles, such as those that occurred in France and Germany in mid-2017, against the ratification process of the Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU.

Third, there is no clear separation between the topics handled by a Framework and those addressed by its associated FTA. For instance, the 2008 Australia-EU Framework operated as a platform for concluding a comprehensive

1 For further clarification, refer to chapter 6 of this volume.

2 Ibid.

air services agreement, which could have been an FTA transport chapter. Conversely, most existing EU FTAs deal with topics already addressed in their respective Frameworks, such as anti-corruption measures, energy, fisheries or climate change. These overlaps risk generating different interpretations and fuelling legal uncertainty. Finally and maybe decisively, the EU's insistence on negotiating a Framework first was seriously damaged by the US's blunt refusal to follow this process before opening the now-stalled bilateral US-EU TTIP negotiations.

All these factors explain why it took some time for Australia and the EU to finally become 'engaged in an informal process to review each other's policies related to FTAs with a view to strengthening our trade and investment relationship' (DFAT 2015). This move on Australia's part was echoed shortly afterwards in the *'Trade for All' White Paper* (European Commission 2015). In this document, the European Commission requests 'authorisation to negotiate FTAs with Australia and New Zealand (NZ), taking into account EU agricultural sensitivities' (European Commission 2015). In January 2016, a new step was reached in the EU with publication of the 'Inception Impact Assessment' on EU-Australia (and EU-NZ) FTAs (European Commission 2016). This document opened the door to the EU internal decision process, aiming to launch a 'comprehensive and high-quality' FTA (DFAT 2017). In May 2018, the European Council gave the green light to negotiation of an FTA with Australia (and with NZ).

This chapter is organised as follows. The first section shows that the Australia-EU FTA must cope with a crowded EU trade agenda in an increasingly chaotic environment generated by the current US Administration's trade policy. In other words, the importance of this FTA for the EU must be demonstrated, a point examined in the next section. The chapter then examines the potential consequences of an Australia-EU FTA from the perspective of content and the negotiating process, taking into consideration that Australia-United Kingdom (UK) trade and investment relations have comprised a large share of previous Australia-EU relations. The conclusion explores the role that an Australia-EU FTA might play in developing and strengthening economic relations, in particular between the EU and East Asia.

THE CROWDED EU TRADE AGENDA

Table 3.1 lists the main economies with which the EU has entered into bilateral FTA negotiations, or those with whom it has envisaged doing so during the last decade. It excludes countries covered by three specific EU regional initiatives: the Eastern Neighbourhood (Ukraine, Moldova and Caucasus countries); the South Mediterranean and Middle East regions; the African, Caribbean and Pacific

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

Country	Negotiating directive	Negotiations status	Agreement status
A. Enforced agreement			
Korea	2007	Completed	enforced (2011)
B. Completed or well-advanced negotiations			
Singapore	2007	Completed	Council's approval
Vietnam	2007	Completed	formal conclusion (2016)
Canada	2009	Completed	EUMS Parliaments ^[c]
Japan	2012	'agreement in principle'	Council approval
C1. Ongoing negotiations on dismantling barriers			
Philippines	2007	launched (2015)	--
Indonesia	2007	launched (2016)	--
US	2013	'stopped'? (end 2016)	--
China ^[a]	2013	launched (2013)	--
Myanmar ^[a]	2014	launched (2015)	--
Mexico ^[b]	2016	launched (2016)	--
Australia	2017	launched (2018)	--
New Zealand	2017	launched (2018)	--
C2. Ongoing negotiations on creating barriers			
UK	None	launched (2017)	--
D. Negotiations under stress			
Mercosur	1999	resumed (2016)	--
India	2007	resumed (2016)	--
Malaysia	2007	on hold (2012)	--
Thailand	2007	on hold (2014)	--

Notes: [a] bilateral investment agreement; [b] negotiations for the 'modernisation' of the existing EU-Mexico Global Agreement; [c] EUMS: EU Member States.

Table 3.1: An overview of the main EU FTAs (as of July 2018).

Source: European Commission (2018).

countries. It also omits plurilateral negotiations on the Trade in Services Agreement (TiSA) in Geneva, which has been on hold since December 2016, with the election of US President Trump.

The list is long and, as of today, the outcome meagre: only the FTA with the Republic of Korea (Korea) is ratified and fully enforced. The three other deals (Canada, Singapore and Vietnam) are at different stages of ratification, with processes that have been much delayed and full of twists and turns. This situation means that the staff of the European Commission as well as those of the Member States dealing with trade issues, are increasingly stressed. This is not only because they are required to deal with more countries, but also because they have to take care of increasingly numerous, complex and inconsistent demands from the Council and from the EU and Member States' Parliaments which are themselves under pressure from diverse lobby groups.

This brief presentation of the EU FTA agenda deserves two remarks. First, the delays in the ratification process and the incomplete deals have created in some EU quarters a sense of 'fatigue' with FTAs, raising the following question:

should the EU announce a 'pause' and concentrate on the pending ratifications while ceasing negotiations of new FTAs? Official launch of the negotiations with Australia seems to have closed this issue for now but the times are so uncertain that nothing can be taken as granted. It is therefore worth focusing here on a response to this question. At this stage it suffices to stress that the idea of a 'pause' raises its own set of problems. For example, would the 'agreement in principle' with Japan be considered to be close enough to the ratification stage to be out of reach of any proposed pause? Including this 'agreement in principle' in a 'pause' would certainly seem somewhat peculiar for the following reason: given that a 'pause' in the negotiations with the UK is impossible, a 'pause' in other negotiations would mean that only the negotiations deteriorating EU welfare (those with the UK) would escape the decision to take a 'pause'. This raises another crucial question: should the EU be prohibited from opening new markets by negotiating FTAs which could compensate the welfare losses resulting from Brexit?

A second point related to the UK's withdrawal from the EU is that it will generate profound changes in the way the Council of the EU27 (EU after Brexit) will work. It will require a 'shaking up' of the political 'narrative' that has prevailed on trade issues in the Council since the UK's accession to the EU. The standard narrative has been that the UK led the free-trade camp and France the protectionist one, with Germany positioned at the epicentre. These narratives were convenient for the two 'opposite twins'. For example, the UK was relieved when France tempered UK free trade rhetoric by stopping or decelerating some freer-trade initiatives, such as reducing EU farm subsidies. France was relieved when the UK tempered French protectionist rhetoric by putting its weight behind initiatives, ultimately providing better market access for French goods or services, such as through the Japan-EU FTA. Brexit signals the end of this well-oiled narrative at the Council. France, Germany and the other EU Member States must thus reinvent their narratives at the Council as well as reinform their publics.

The necessity for new 'narratives' will occur in a Council subjected to a new balance of voting weights among the Member States. The 'qualifying majority' rule for Council decisions requires approval by a minimum of 55 per cent of Member states, which together represent at least 65 per cent of the EU population. It has been calculated that the UK's withdrawal could increase substantially the relative power of the large Member States (Germany, France, Italy, Spain and Poland, which often have protectionist instincts) and diminish the relative power of other Member States (the Netherlands, Sweden, Denmark, Finland and Estonia, which tend to be strong supporters of freer trade) (Kirsch 2016). If these estimates are correct, pushing through an FTA in the Council may become more difficult than in the past, unless the large Member states recast their trade-related narratives, in

realisation of the need to take initiatives to cope with the collapse of traditional US trade policy.

THE EU FTA WITH AUSTRALIA AND THE EU TRADE STRATEGY

A crowded EU FTA agenda, new dynamics in the Council's narratives and votes, FTA negotiating 'fatigue' in some EU quarters: all these elements make it essential to assess the economic importance to the EU of the FTA with Australia. During recent years, economic motives for negotiating FTAs have become increasingly important in the EU debate. This trend reflects a higher EU demand for FTAs that can boost flagging growth in several Member States. This chapter examines the following two questions (the latter often neglected):

1. Which are the best FTAs from the EU perspective; that is, which FTAs provide the largest economic boost to EU growth?
2. How will the gains expected from an FTA be spread over time?

This section relies on the following proposition: if one sets aside the level of trade barriers between negotiating countries—a point examined later in the chapter—the intrinsic capacity of the EU's trading partners to boost EU growth depends on three main factors:

1. the economic size of the EU27's FTA partner
2. the 'regulatory quality' of the EU27's FTA trading partner
3. the 'hub quality' of the EU27's FTA partner.

First, the economic size of the EU27 partner—a criterion initially stressed by John Stuart Mill—is vital. The smaller the FTA partner, the less likely are wide and large pressures for changes in the relative prices (terms of trade) of the huge EU27 economy; hence, the lower welfare gains for the EU27.

The second factor is the 'regulatory quality' of the trading partner.³ Modern economies rely heavily on regulations: norms on products and production processes, legal provisions for shaping efficient services markets and regulations related to the sustainable dimension of the various components of the agreement. Signing a trade agreement is of little benefit if the signatory government does not adopt the new regulations which allow domestic markets to respond as efficiently as possible to the changes generated by the FTA in question. In such a context, 'regulatory quality' has several dimensions: the intrinsic quality of a regulation; the consistency of the regulation with the country's other regulations; and last but not least, the quality of the enforcement of the regulation (Australian Government 2007, Jacobzone et al. 2007). Then it can be argued that the higher the regulatory

3 Refer to chapter 9 of this volume.

quality of the EU's FTA partner, the stronger the EU's motives for improving its own regulations—hence boosting the efficiency of EU economy.

As improving regulations is not an easy matter, lively regulatory 'emulation' with an FTA partner equipped with good regulations and skilled regulators can be a substantial source of welfare gain. These positive aspects of an FTA are still too often mentioned *en passant*, whereas they are likely to be the most important welfare-enhancing forces from a dynamic and long-term perspective. This point is well illustrated by the EU itself, as the various EU Member States have differing capacities to benefit from the same Single Market directives and regulations. These dissimilarities are related to variations in regulatory quality, despite decades of 'economic integration'.

The third factor to be considered is the 'hub quality' of the EU's FTA partner. The more the FTAs of an EU partner involve countries with which the EU itself does not have an FTA, the more the EU trading partner indirectly offers new opportunities to EU firms. In particular, EU firms can invest in an EU FTA partner, and from this 'hub' they can enjoy better market access to the other countries involved. For example, the FTA between Korea and the People's Republic of China (China) could induce EU firms to invest more in Korea; hence, they can export their 'made in Korea' goods to China, while the negotiations for a direct China-EU FTA are still in their infancy.

The various combinations of these three factors have very different results depending on the time dimension. The size criterion is likely to have a quick impact if the cuts in tariffs and non-tariff barriers happen very quickly—almost an immediate once-for-all economic shock. By contrast, the regulatory quality impact is likely to consist of a succession of regulatory improvements spread over many years: the years necessary to realise the better quality of the partner's regulations; those needed to redesign one's own better regulations; and last but not least, those needed to enforce these regulations adequately and efficiently.⁴

Finally, the 'hub quality' has an impact in the short and long run, depending on the country involved, its relative size, the efficiency of its regulatory environment, and whether these features are present in its FTA partners. In summary, an FTA with a large country that possesses poor regulatory quality is likely to have a strong impact on the EU economy in the short run, followed by no notable long-term positive effects associated with regulatory quality—a risky combination from a political perspective. By contrast, an FTA with a smaller country benefiting from high regulatory quality is likely to have a more limited impact on the EU economy

4 Refer to chapter 9 of this volume.

in the short run, but an increasingly strong impact in the long run, which may be easier to sell politically because of its progressivity over time.

Table 3.2 provides some information on these three criteria. Columns 1 to 3 show the size of the partner country's gross domestic product (GDP) as a percentage of the size of the EU28 and EU27 (EU minus the UK) for 2015 (columns 1 and 3) and for 2030 (column 2) based on the forecast GDP of the main global economies in 2030 (Buiters & Rahbari 2011). As it is very difficult to obtain a good sense of 'regulatory quality', Table 3.2 uses two indicators: the World Bank's Ease of Doing Business Index (column 4) and the World Economic Forum's Global Competitiveness Index (column 5). That these regulatory quality indicators are based on very different methodologies and information delivers a more nuanced sense of the situation. Column 6 presents the hub quality simply by listing the other main FTAs of the EU's partners.

Table 3.2 includes the UK. However, it is clear that the UK-EU trade deal is likely to be radically different from the other FTAs mentioned in the table; it will not be an exercise in liberalisation, but, at best, an effort to limit the increase in trade barriers between the UK and the EU, hence to minimise the losses of consumer welfare in both partners. In other words, the prospective UK-EU trade deal provides an incentive to negotiate other FTAs which can 'compensate' these losses.

Table 3.2 provides a clear direction for prioritisation, and hence a rational answer to the emerging FTA 'fatigue' based on two main lessons. First, Block C1 lists the countries which are the most attractive when the three criteria are combined. In the current context of high volatility in US trade policy (following the meeting between Presidents Trump and Juncker in July 2018), the US has been kept in this Block, despite the fact that negotiations were 'stopped' at the end of 2016 (European Commission 2018). The FTA with the US looks the most attractive—large relative size, good regulatory quality and strong hub quality if the US joins the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). However, it is an option which seems out of question for at least the next four years. Then come the trio of Australia, NZ and Chinese Taipei.⁵ This trio has the capacity to compensate to some extent Brexit's negative consequences. Together, these countries have a global size almost equivalent to the UK, very similar 'regulatory quality' and a much better 'hub quality'.

Interestingly, regarding the regulatory aspect, Australia has a rare and often untold connection with the EU principles: the efforts to improve Australian

5 The size effect is even stronger if activities of firms from Chinese Taipei in China are taken into account.

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	Relative size compared to			Regulatory quality		'Hub' quality (selected partners)
	EU28 GDP		EU27 GDP	(4) ^[d]	(5) ^[e]	(6) ^[f]
	(1) ^[a]	(2) ^[b]	(3) ^[c]			
A. FTA enforced as of November 2017						
EU	100.0	100.0	100.0	3-76 (5-100)	4-81 (4-90)	Korea
Korea	8.2	10.9	9.7	5 (8)	26 (24)	EU, US, ASEAN, China
B. FTAs concluded or close to being concluded as of November 2017						
Canada	9.0	11.3	10.6	22 (13)	15 (12)	US, CPTPP
Singapore	1.7	4.6	2.1	2 (1)	2 (2)	ASEAN, Australia, CPTPP, RCEP
Vietnam	1.2	3.1	1.4	82 (98)	68 (65)	ASEAN, RCEP, CPTPP
C1. The best FTA partners for boosting EU growth in the short and long run						
US	108.5	150.3	128.4	8 (4)	3 (5)	NAFTA, bilaterals with some CPTPP members
Japan	27.6	34.7	32.7	34 (20)	6 (9)	ASEAN, Australia, CPTPP, RCEP
Australia	7.3	9.8	8.7	15 (13)	22 (20)	NZ, US, CPTPP ASEAN, RCEP
NZ	2.0	2.7	2.4	1 (3)	17 (25)	Australia, US, CPTPP ASEAN, RCEP
Chinese Taipei	3.0	10.3	3.6	11 (25)	14 (13)	China, NZ, Singapore
Chiwan ^[g]	5.1	17.3	6.0	(na)	(na)	--
C2. The Brexit case reducing EU growth in the short and long run						
UK	15.5	(na)	18.3	7 (7)	9 (10)	Unknown
D. The best FTA partners for boosting EU growth in the long run						
Indonesia	5.5	14.5	6.5	91 (129)	34 (46)	ASEAN, RCEP
Philippines	1.8	4.8	2.2	99 (136)	52 (75)	ASEAN, RCEP
Malaysia	1.8	4.7	2.1	23 (18)	20 (21)	ASEAN, RCEP
Thailand	2.3	6.0	2.7	46 (17)	31 (39)	ASEAN, RCEP
China	66.6	367.0	78.8	78 (91)	28 (26)	Chinese Taipei, ASEAN, RCEP
Myanmar	0.4	1.0	0.5	170 (--)	134 (--)	ASEAN, RCEP
India	13.2	177.4	15.6	130 (132)	71 (56)	RCEP
Brazil	10.3	26.9	12.2	123 (126)	57 (53)	Mercosur?

Table 3.2: Prioritising FTA negotiations: the EU27 choices.

Sources: [a] World Bank nominal GDP in 2015 with EU28=100; [b] estimates of GDP in 2030 (Buiter & Rahbari, 2011); [c] World Bank nominal GDP in 2015 with EU27=100; [d] Ease of Doing Business Index (World Bank, 2016 [2012 in parenthesis]). The higher the country's rank, the poorer its regulatory performance; For the EU, only the ranks for the lowest (best regulated) and highest (worst regulated) Member States are reported (no information on Malta); [e] overall index, Global Competitiveness Index (World Economic Forum, 2015 [2012n parenthesis]). The higher the country's rank, the poorer its regulatory performance. For the EU, only the ranks for the lowest (best regulated) and highest (worst regulated) Member States are reported (no information on Malta); [f] only the major FTA partners are mentioned; [g] estimates of GDP generated by firms from Chinese Taipei in China and Chinese Taipei. Authors' calculations.

regulatory quality have been based on the famous case law of the ECJ—the *Cassis de Dijon* ruling (Messerlin 2011)—which has been particularly instrumental in creating the Australian ‘single market’ and then the Australia-NZ Closer Economic Relations Trade Agreement (Scollay et al. 2010). Finally, Australia exhibits an attractive ‘hub quality’ since it has FTAs with many countries in the Asia Pacific region, countries with which the EU has not yet achieved agreements. This point is examined in more detail in the next section. In summary, all these features suggest that the EU should ‘prioritise’ its negotiations with Australia, the largest and least problematic (from a political point of view) of this trio.

The second lesson from Table 3.2 is that if there is a need to take a ‘pause’, it should involve FTAs with the countries of Block D. All of these ‘D’ countries are characterised by limited regulatory quality. This implies that negotiating today with these countries will not deliver the long-term benefits generated by enhanced regulatory cooperation—except if these countries improve their regulations quickly—an unlikely proposition. Moreover, the size impact is limited for all these countries, except for China (and for Brazil and India if these last two countries adopt a clear stance on trade).

Table 3.2 also shows the interesting case of China. On the one hand, China’s huge relative size enables an expectation of a strong impact on the EU27 economies in the short run, a benefit that is likely to raise political problems which could be solved by appropriate adjustment policies—though these policies are difficult to design and even harder to ‘sell’ to public opinion. On the other hand, China’s regulatory quality is low, but improving significantly. These two features suggest that any adoption by the EU of a strict ‘pause’ option with China would be a mistake. Rather, the EU should adopt a trade policy of improving its trade relations with China by ‘*petits pas*’ (small steps), that is a sequence of trade deals, each of them giving birth to a series of iterative FTA texts based on a realistic assessment of the possible changes in China’s ‘regulatory quality’, while also allowing the necessary progressivity for coping with the Chinese economy’s rapid growth.

THE AUSTRALIA-EU FTA: HOW CHALLENGING ARE THE BILATERAL NEGOTIATIONS?

This section focuses on the Australia-EU FTA bilateral negotiations. The interactions between these bilateral negotiations and the negotiations the EU has, or may be having with other countries in the Asia Pacific region, are addressed in the concluding section.⁶ As other chapters of this volume examine specific aspects covering the bilateral Australia-EU negotiations, this section focuses mainly on an

⁶ Also see chapter 4, which focuses on Australia-UK bilateral negotiations.

important horizontal feature that may influence them: the UK is by far Australia's most important EU28 trading partner. This point raises first a question of substance and second a question about the negotiating process:

1. Is the Australia-EU FTA less attractive for the EU27 than it was for the EU28?
2. How can Australia, the EU and the UK interact during the negotiations, now that the EU and the UK will negotiate separately?

Is the Australia-EU FTA of more commercial interest for the EU27 than for the EU28? Yes

What follows gives a sense of how importantly the UK figures in EU trade with Australia by identifying the three main types of international transactions: trade in goods, trade in services and investment. Table 3.3 shows that, in the case of trade in goods, the UK's share of exports to Australia is closely in line with its weight in total EU28 GDP, and that indeed Germany may have larger offensive interests in Australia than does the UK. The fact that the UK's share of Australian imports is much higher than its share in EU28 GDP is unlikely to change the EU interest in the Australia-EU FTA, whereas it should boost Australia's interest in gaining better market access to the EU.

However, the situation is very different in relation to services and investment. In services, the UK represents more than a third of EU28 exports of services to Australia and almost half of EU28 imports of services from Australia. This is respectively twice and four times more than Germany, the second largest services trading partner for Australia among the EU28. The differences in regard to investment are even larger: the UK represents more than half of EU28 investments in Australia and two-thirds of Australia's investment in the EU28.

It is beyond the scope of this chapter to examine the causes of such differences. They probably have very little to do with geographical distance—the 'tyranny of geography' faced by Australia is roughly the same for the UK or any other EU Member State—and a lot to do with the 'tyranny of history', which includes cultural as well as political factors. Australia's closer modern commercial relations with the UK date at least from the 1931 'Imperial preference trading system'.⁷ Moreover, both services and investment flows are much more sensitive to regulations than goods flows, and their regulations are evolving more slowly and incrementally. All these are factors contributing to maintaining a higher share for the UK compared to other EU Member States. These differences, as well as cultural factors, including language, are likely to explain the larger Australia-UK trade in

⁷ For further information on the Imperial preference trading system refer to chapter 1.

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	Goods		Services		Investment	
	EU exports	EU imports	EU exports	EU imports	EU inv. in AUS	AUS inv. in EU
EU28 (A\$ million)	46,351	13,007	19,328	10,452	961,445	563,562
Shares (%):						
UK	15.4	29.1	37.6	48.0	52.0	62.7
Germany	26.6	14.4	15.4	12.2	4.3	11.9
France	9.7	8.7	9.3	8.4	2.3	8.1
Italy	12.7	5.8	7.2	5.5	0.3	0.8
Netherlands	4.6	18.1	6.7	4.3	6.6	6.7
EU27 (A\$ million)	39,214	9,220	12,055	5,440	461,515	210,358
EU27/EU28 (%)	84.6	70.9	62.4	52.0	48.0	37.3

Table 3.3: The UK and EU28/27 economic relations with Australia.

Sources: DFAT (2017b), authors' calculations.

services compared to the EU27, and the even larger Australia—UK situation in the decades-long accumulation of capital flows over decades.

This situation does not mean, however, that the Australia-EU FTA is less important for the EU27 than it was for the EU28. As argued above, the value of a trade deal depends on two key factors: the level of protection afforded to each party with respect to the other party's exports, and the intrinsic capacity of each to boost the other's growth. Focusing first on the Australian protection imposed on EU exports, this does not change according to whether it relates to EU27 or EU28. The only difference is that the structural composition of the EU27 basket of goods and services facing Australian barriers is not the same as the structural composition of the EU28 goods and services. This implies that the structure of market access requests and offers, in terms of goods and services, is likely to differ between EU27 and EU28.

Turning to EU protection against Australian exports, the same conclusion prevails for goods. The UK and EU27 have the same tariff schedule and regulatory framework as the EU single market in goods with which negotiators will deal. The EU regulatory 'red tape' in industrial goods, which was much criticised during the referendum campaign for Brexit in the UK, is likely to remain in place in the UK because most of the norms on products and production processes have been decided by larger bodies than the EU, for instance by the United Nations Economic Commission for Europe (UNECE). In fact, the similarity in norms has been reinforced by the Japan-EU FTA deal in some sectors (such as cars) with a convergence of the UNECE and Japanese norms.

The same broad observation is true for agriculture. UK farmers enjoy the same subsidy-based protection as continental farmers. However, and somewhat ironically, UK agricultural protection is among the highest in the EU because UK farm production is more concentrated in EU-subsidised products than the farm production of most other Member States. By contrast, since the Single Market in services is highly incomplete (Messerlin 2015), one cannot exclude the likelihood that services and investment barriers imposed by the UK and the EU27 against Australian exports may differ notably. In such cases, these barriers are likely to be lower in the UK than in the EU27, if only because of the above-mentioned ‘tyranny of history’.

If this is the case, these differences will boost Australia’s interests in an Australia-EU27 FTA, again without changing the EU27’s interest (compared to the EU28’s). This is because the EU27 is facing the same Australian barriers as the EU28, meaning that the level of interest for an Australia-EU FTA remains the same for the EU27 and the EU28. Again, what could change—and probably will—is the structural nature of offers and requests, and hence final concessions, on goods and on services.

In addition to the existing level of protection, the other key factor determining the value of a trade deal is the capacity of Australia to boost the EU’s growth. As argued above, this capacity does not depend on the level of current Australia-EU trade, but on Australia’s economic size and on Australian ‘regulatory and hub qualities’ for the EU27, variables which are largely exogenous to bilateral trade flows. The ‘shrinking’ of the EU28 to EU27 should increase the EU27 interest in an FTA with Australia, as it mechanically amplifies Australia’s relative size compared to the EU, and its potential impact on EU27 growth. In addition, Australia’s ‘regulatory quality’ is becoming more attractive for the EU27. This is because, as the UK was one of the best EU28 regulated countries, the ‘regulatory quality’ in the EU27 overall is lower than its equivalent for the EU28.

The focus of the Australia-EU FTA: services and investment

Table 3.3 deserves a further remark. The data here could be interpreted as meaning that the EU27 trade negotiators should focus on trade in goods, since goods constitute the bulk of today’s Australia-EU27 trade relations. Such a narrow focus would be a major mistake. From an economic perspective, such an approach would ignore increasing evidence of the ‘servicification’ of world trade: services are an essential ingredient for more efficient trade in both goods and services (Kommerskollegium 2016).

From a purely negotiating perspective, focusing on trade in goods is a sure recipe for difficult negotiations in the Australia-EU FTA for the same reason as for any FTA discussions on goods among two relatively open OECD countries. This is because the talks will inevitably be dominated by the limited list of goods that have remained highly protected by tariffs and non-tariff barriers even after 50 years of trade liberalisation—and have hence built huge capacities for lobbying against market opening throughout all this time.

Trade negotiators tend to address the case of goods which remain highly protected after decades by finessing inappropriate instruments for opening markets, for instance substituting tariffs with tariff-rate quotas. Such decisions often lead to outcomes worse than the situation prevailing before the negotiations, especially if the quotas adopted are small and if the non-quota tariffs remain high, as is generally the case.⁸ The additional trade generated by such decisions is then minimal, hence insufficient to impact on domestic prices in the importing partner or to generate welfare gains. On the contrary, such outcomes can generate large rents which ensure resources to those opposed to the future opening up of markets. It is thus critically important to avoid the trap of ‘goods only’ negotiations and to have a wider negotiating agenda covering services and investment.

The UK and the EU 27’s offensive interests: overlapping or not?

Since April 2017, the press reported statements from European Commission officials that the EU27 would like to exclude the UK from EU internal discussions of ‘sensitive information’ on proposed EU27 trade negotiations (Boffey 2017; Motta 2017). Some of these statements were made with specific reference to the Australia-EU27 negotiations. To be interpreted correctly, such concerns need to be understood in the legal context of the Brexit negotiating procedures. As long as the UK remains a full EU member—that is until (in principle) the first quarter of 2019—it has access to all EU documents. At the same time, the UK could undertake ‘preparatory work’ with third countries, although it has no right to conclude its own FTAs until it has officially left the EU. These byzantine procedures have fuelled the fear of ‘rivalry’ in negotiating strategies and tactics between the UK and the EU27 block.

It first needs to be stressed that trade negotiation rivalries are common among EU Member States. Simply, they are subjected to well-oiled EU mechanisms. Potential rivalry between the interests of one EU Member State and those of other EU Member States in an FTA negotiation is generally resolved by intra-EU negotiations that deliver a compromise on the competing trade-related

⁸ For further information on tariffs and tariff quotas, refer to chapter 10 of this volume.

offers and requests. When rivalry cannot be resolved by an intra-EU trade-based compromise, it can be solved by taking into account issues unrelated to the trade negotiations at stake. This could involve, for instance, a change in the drafting of a Directive in a non-trade domain or financial compensations for the affected EU Member State. This is best illustrated by the additional farm subsidies that the EU gave to France as an ‘incentive’ for that country’s agreement on the 1995 WTO Uruguay Round outcome, only a few days before its conclusion.

As a result, the only new aspect of the rivalry between the UK and other Member States is that it will not in future be solved by such intra-EU procedures. Compromises between the UK and the EU27 or between the UK and an individual EU27 Member State could therefore be more difficult to reach. The possibilities of unresolved rivalry may become more common because the UK and the EU27 have to re-examine their detailed lists of requests and offers to be tabled with Australia, compared to the unique list prepared under the EU28 aegis. And, in the case of the EU27, this re-examination implies new compromises among the EU27 Member States, with possible spillover to future Australia-UK FTA negotiations.

This context makes it interesting to have a sense of the extent to which the EU27 and the UK’s offensive interests might overlap and whether these two entities export the same goods or services. It would seem a reasonable proposition to assume that the more overlapping (similar) the offensive interests of the UK and the EU27 (and the higher the likelihood of Australian discriminatory treatment of the UK and the EU), the greater the risk of rivalry between UK and EU27 negotiators.

In relation to goods, Table 3.4 lists the four major exports to Australia from the UK and from each of Australia’s main EU27 partners. The data here suggest possible overlapping offensive interests in three major industries: cars, medicaments and pharmaceutical products. The European Commission Inception Impact Assessment (European Commission 2016) mentions tariffs on cars explicitly as an offensive interest of the EU28. That said, tariff-based discriminatory treatment between the UK and EU27 is unlikely, and Australia has recently eliminated its regulations on car assembly in Australia.

By contrast, the fact that protection in the three other sectors often relies on complex regulations creates easy opportunities for *de jure* or *de facto* discriminatory treatment, hence for rivalry. However, this risk deserves a caveat. All these sectors involve the same large multinationals operating in the UK and in the EU27, opening the possibility for the firms in question to reshuffle their activities between their UK and continental subsidiaries in order to eliminate the negative consequences of discrimination.

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Major exports (A\$ million)				
	Cars	Medicaments	Pharmaceuticals	Printed matters
UK	1,300	462	315	271
Germany	3,120	1,205	314	
Italy	248	296		
France		473		
Netherlands		176	132	
Major imports (A\$ million)				
	Lead	Gold	Alcoholic beverages	Pearls & gems
UK	467	424	387	359
Germany	Gold, precious ores, coal, oil seeds			
Italy	Wool, coal, wheat, beef			
France	Coal, aircraft, oil seeds, measuring instruments			
Netherlands	Coal, other ores, medical instruments, oil seeds			

Table 3.4: Overlapping offensive interests: the case of goods.

Sources: DFAT (2017b), authors' calculations.

Major exports (A\$ million)			
	Personal travel	Prof. services	Other services
UK	1,974	813	
Germany			Transport, IP-related charges
Italy	1,138		Business-related travel
France	946		Business-related travel
Netherlands		420	Transport
Major imports (A\$ million)			
	Personal travel	Prof. services	Other services
UK	2,667	1,351	
Germany	545	135	
Italy	240		Education-related travel
France	410		Transport
Netherlands	128	87	

Table 3.5: Overlapping offensive interests: the case of services.

Sources: DFAT (2017b), authors' calculations.

Table 3.5 provides the same information for services as Table 3.4 for goods. Overlapping potential interests seem fewer and they occur in sub-sectors where the size of the domestic market is usually much larger than the related trade flows. Competing offensive interests may occur in professional services and in business-related travel services, both services where discriminatory measures for opening markets could be taken; for instance, imposing different quotas on the movement of people from the UK or EU27 citizens, or exploiting existing

‘similarities’ between Australian and UK regulations. By contrast, overlapping offensive interests in personal travel do not seem prone to such discriminatory measures for opening domestic markets.

The Inception Impact Assessment suggests other key offensive interests for the EU28: cheese, wine and spirits, geographical indications (GIs), investment and public procurement. The sectors where risks of rivalry are most likely to occur are spirits, GIs and public procurement. For all of these, the risk originates in the liberalisation of these domains being based on technical definitions (spirits) or lists (of products for GIs; of entities for government procurement)—all instruments that can easily lead to discriminatory treatment and hence fuel rivalry. However, there is an internal reason for Australia not to move too far in this direction. Australia has a strong interest in using its negotiations with the UK and the EU27 as a way to simplify and to improve the complex existing set of FTAs (Armstrong et al. 2015; Productivity Commission 2010).

CONCLUDING REMARKS: THE AUSTRALIA-EU FTA’S CONTRIBUTION TO THE EU27 TRADE STRATEGY IN THE ASIA PACIFIC REGION

The European Commission’s *‘Trade for All’ White Paper* made a clear reference to Australia’s role in the EU trade strategy with respect to the Asia Pacific region when it states that ‘stronger economic ties with these countries [Australia and NZ] will also provide a solid platform for deeper integration with wider Asia Pacific value chains. Strengthening these relationships should be a priority’ (European Commission 2015 p. 31). The White Paper also mentioned the necessity to ‘work towards restarting negotiations for an ambitious region-to-region FTA with ASEAN building on bilateral agreements between the EU and ASEAN members (European Commission 2015 p. 32).

Currently, the EU has only one regional forum with Asian countries. The Asia-Europe Meeting (ASEM) was established in 1996, responding to the then six-year old and very successful APEC. After overcoming Malaysia’s opposition, Australia also became an ASEM member in 2010. It is important to recognise that ASEM did not attract much attention in Europe, to the great bewilderment and frustration of its Asian members. It has mostly been seen by the EU as a forum for discussions, covering the same wide range of topics as the EU bilateral partnership frameworks; namely, the environment, arts and culture, human rights, governance, public health and education. It has not focused on trade and economic issues, which were the preferred topics for most Asian members. ASEM’s role in trade is also fundamentally hindered by a membership that is too wide, as it includes Russia, India, Pakistan and Bangladesh—all countries with little inclination, if any, for deep trade integration.

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	Nominal GDP 2015 (US\$ billion)					
	APEC	TPP12	ASEAN	ASEAN+3	RCEP	ASEM
Australia	1,339	1,339			1,339	1,339
NZ	174	174			174	174
Indonesia	862	862	862	862	862	862
Thailand	395		395	395	395	395
Malaysia	296	296	296	296	296	296
Singapore	293	293	293	293	293	293
The Philippines	292		292	292	292	292
Viet Nam	194	194	194	194	194	194
Myanmar			65	65	65	65
Brunei	17	17	17	17	17	17
Cambodia			17	17	17	17
Laos			12	12	12	12
China	10,866			10,866	10,866	10,866
Japan	4,123	4,123		4,123	4,123	4,123
Korea	1,378			1,378	1,378	1,378
Chinese Taipei	519					
Hong Kong	310					
India					2,073	2,073
US	17,950	17,950				
Canada	1,550	1,550				
Mexico	1,144	1,144				
Chile	240	240				
Peru	192	192				
EU27						13,380
Russia	1,326					1,326
Pakistan						270
Bangladesh						175
Kazakhstan						184
Mongolia						12
Total	43,460	28,374	2,443	18,810	22,396	37,743

Table 3.6. Plurilateral trade agreements including Asia Pacific economies.

Source: World Bank data.

Table 3.6 presents a brief overview of the membership of the main plurilateral agreements existing or under discussion in the Asia Pacific region. On the one hand these include APEC and the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), both initially strongly backed by the US; on the other hand, In contrast, ASEAN, ASEAN+3 (China, Japan, and Korea) and the Regional Comprehensive Economic Partnership (RCEP) which exclude the US. Currently, only APEC and ASEAN have delivered tangible results. However, APEC has progressively lost its pre-eminence since 2008, when the US decided to embark on

deeper trade liberalisation and stricter trade disciplines by taking lead of the original TPP negotiations. Indeed, until January 2017, the TPP was widely perceived as a potential natural heir of APEC in economic terms—though radically different from it in geopolitical terms, given its exclusion of China.

The executive order, signed by President Trump in late January 2017, to withdraw the US from the original TPP has changed the situation drastically. After considering the various options available to implement the agreement without US participation (Elms 2017), the remaining eleven TPP members have since concluded the CPTPP. Meanwhile, this change of course has generated a renewed interest in ASEAN and in its two extensions—ASEAN+3 and RCEP—as potential anchors of further Asia Pacific economic integration.

Such a complicated and unstable context requires initiatives for re-establishing direction in trade matters. The EU regional approach to East Asia could rely on two main options that are not mutually exclusive. A first option would be to develop ASEM's capacity to deal with trade issues. The 6th ASEM Economic Ministers Meeting, held under Korean chairmanship in Seoul in September 2017, made some progress towards a more assertive support for the WTO multilateral trading system, and delivered the Seoul Initiative on the 4th Industrial Revolution, which calls for greater regulatory regulation. Although the loose structure of ASEM may prevent more decisive actions, one idea is to create a working group for an 'EU-East Asia Partnership', limited to the EU, Australia, NZ and ASEAN+3 members. Its role would be to define a substantial trade and investment agenda, leading to well-defined and measurable actions.

The second option would be for the EU to 'join' RCEP. Of course, 'joining' RCEP need not mean that the EU would become a member of RCEP. Rather, the idea would be for the EU to focus on key RCEP provisions (existing or under negotiation) and to work on their 'compatibility' with the corresponding provisions of the EU FTAs in the region. This would make the EU a powerful echo chamber for RCEP's progress in trade liberalisation and discipline setting. One condition for the success of such an initiative would be that the EU make clear that 'compatibility' does not mean harmonisation with EU FTA provisions, but rather an exercise in 'mutual equivalence'.⁹

This would require a screening of the RCEP and EU provisions to choose those of genuine common interest for the EU and the Asia Pacific economies, and an assessment as to whether these provisions could be considered as 'different but equivalent.' Candidate topics for such an exercise are numerous: the many facets of the 'digital agenda', trade facilitation, rules of origin, FDI, logistics and the huge

9 For further information on mutual equivalence, refer to chapter 9 of this volume.

domain of services (Findlay 2015). Of course, the EU could envisage a similar approach with the CPTPP countries, especially if the UK seeks to join. However, this move may be more difficult than in the RCEP case because CPTPP countries may fear that accepting such an EU initiative might make future relations with the US more difficult.

These options deserve two final remarks. First, the negotiations for an Australia-EU FTA offer an excellent opportunity for the EU to benefit from the experience that Australia has accumulated when negotiating and implementing the ASEAN-Australia-NZ FTA (AANZFTA). Australia and the EU might envisage the possibility of ‘importing’ some provisions of the AANZFTA, such as the capacity building clause, into their prospective FTAs with ASEAN Members and into a possible future ASEAN-EU FTA. Second, and probably even more importantly, Australia and the EU should make their utmost efforts to design the Australia-EU FTA while taking into account the existing and successful provisions of the Korea-EU FTA (KOREU) and of the Korea-Australia FTA (KAFTA). These efforts could range from ‘standardising’ KOREU, KAFTA and Australia-EU texts (when they are sufficiently close to examining the existing texts) with trilateral scrutiny based on a mutual equivalence approach.

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4

WHAT DIFFERENCE DOES BREXIT MAKE?

L. Alan Winters

ABSTRACT

This chapter considers the effects that the United Kingdom's (UK) leaving the European Union (EU) might have on the Australia-EU Free Trade Agreement (FTA). In terms of Australia's imports, there is no major sector in which the UK is the predominant supplier, but for exports, the UK is a major market in several sectors. In particular, Australian exports of meat face a high average tariff in the EU and nearly half of these exports go to the UK, so the exit of the UK from the EU (Brexit) may reduce the attractions of the EU FTA. Moreover, these exports face a tariff-rate quota and splitting this between the UK and the rest of the EU Member States (EU27) is likely to complicate FTA negotiations. In services, the UK has generally championed liberalisation in the EU, and so its exit may reduce the pressure for a deep FTA. On the other hand, and precisely to demonstrate that its trade liberalisation is not just a British idea, Brexit will increase the incentive for the EU to sign a deal of some sort.

INTRODUCTION

When this chapter was conceived, most people imagined that by mid-2017 the exit of the United Kingdom (UK) from the European Union (EU) (Brexit) would have started to take shape and that we would be able to infer how, if at all, it would affect EU attitudes and positions on the Australia-EU Free Trade Agreement (FTA). Not uniquely in the world of Brexit predictions, this was wrong! By July 2018, nothing had been settled between the UK and the EU; nor had anything practical been settled within the UK cabinet. The Government issued a *White*

Paper in July 2018. However, it has already been modified via amendments to the Trade Bill that was passed that month, significant parts of it have been rejected by the European Commission negotiators and it has attracted serious adverse comment from more or less the whole spectrum of political opinion—see, for example, former-Prime Minister Tony Blair’s comments (Blair 2018). At one end of the range of possible outcomes lies a disorderly collapse in negotiations resulting in an untidy ‘hard’ Brexit, with trade under the EU’s most favoured nation (MFN) regime and minimal cooperation on a few issues. (The UK will seek to replicate the EU’s WTO commitments, so MFN tariffs will apply in both directions). At the other end lies a very ‘soft’ Brexit with the UK adopting, *de jure* or *de facto*, a large amount of the EU *acquis* (the body of EU Directives and Regulations and interpretations thereof). A delayed exit, or even no exit at all, is also possible. A popular ‘parlour game’ places the probabilities across this range, but the truth is that in the middle of 2018, with a deadlocked and fractious cabinet and a minority government, it still seems as if anything could happen.

There are at least two consequences this state of affairs. First, and trivially, this chapter is based on speculation. Second, the nature and balance of the Australia-EU negotiation is likely to be changed. Most obviously, the mercantilist calculation behind the FTA will be disturbed in terms of which sectoral interests might dominate when concluding a trade deal. Related to this is the possibility that a pending UK-EU deal could alter EU positions in the negotiation; for example, in terms of avoiding the establishment of precedents between deals or complicating the calculus of relative benefits from different concessions. Similarly, in order to allow the EU more space to recognise its close relations with the UK, the EU is unlikely to want to include MFN-forward clauses in agreements signed prior to one made with the UK. On the other hand, the EU is starting to lose patience with the UK and may become less willing to accommodate any of its interests in their forthcoming negotiations. In this scenario, tying their hands with an MFN-forward clause may eventually come to have some attractions. It is also likely that Brexit will change the internal dynamics on the EU side, given that historically, the UK’s strong advocacy of (nearly all) trade liberalisation and its resistance to the liberalisation of the movement of people. Brexit clearly creates some political pressure for the EU to show that it can still pursue trade agreements and with greater alacrity and purpose without the UK. As such, a willingness to strike quicker but shallower deals may become apparent.

THE MERCANTILIST CALCULATION

Perhaps the most obvious way in which Brexit affects the Australia-EU FTA is that it reduces the importance (the attractions) of the EU as a partner. Arguably, this is not a sufficiently large change to have an overall qualitative effect, but it

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HS2		Imports \$US millions	UK share %	Tariff (%)		
				Simple mean	Weighted mean	Std. dev.
	All products	36,917	14.5			
'87	Vehicles other than railway or tramway rolling stock, and parts and accessories thereof	6,718	16.9	3.4	4.7	2.2
'84	Machinery, mechanical appliances, nuclear reactors, boilers; parts thereof	6,711	13.0	2.8	2.7	2.5
'30	Pharmaceutical products	4,863	11.3	1.1	0.5	2.5
'85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television	2,735	16.3	2.7	1.9	2.5
'90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical	2,299	14.3	0.7	0.7	2.0
'22	Beverages, spirits and vinegar	856	24.7	4.0	3.8	2.4
'29	Organic chemicals	785	15.2	0.7	0.8	1.8
'39	Plastics and articles thereof	780	16.3	4.6	4.9	1.4
'73	Articles of iron or steel	727	12.6	4.4	4.9	1.6
'33	Essential oils and resinoids; perfumery, cosmetic or toilet preparations	588	16.5	3.3	4.8	2.3
'94	Furniture; bedding, mattresses, mattress supports, cushions and similar stuffed furnishings	533	11.4	4.3	4.7	1.9
'48	Paper and paperboard; articles of paper pulp, of paper or of paperboard	500	7.9	4.1	4.5	1.8
	Sum of top 12	28,095				
	Share of the 12 in total	76.1%				

Table 4.1: Australia's merchandise imports from the EU, 2014-2016, US\$ millions.

Source: Author's calculations from the International Trade Centre (ICT) Trade-Map (<https://www.trademap.org/Index.aspx>) and UNCTAD's Trade Analysis Information System (TRAINS) <http://unctad.org/en/Pages/DITC/Trade-Analysis/Non-Tariff-Measures/NTMs-trains.aspx>.

could clearly be important in specific cases. Tables 4.1 and 4.2 illustrate Australia's top 12 import and export flows of goods from and to the EU, the share that the UK accounts for and the tariffs levied on them by the respective importer. Row 1 reports the total and the rest report the data for the 12 HS2 sections with the largest EU trade.¹

1 HS is the Harmonized System of Commodity Description and Coding; 2 refers to the 2 digit chapters of the system, which divide goods into 97 groups.

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HS2		Exports \$US millions	UK share %	Tariff (%)		
				Simple mean	Weighted mean	Std. dev.
	All products	11,524	39.3			
'71	Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad	2,865	84.9	0.6	0.4	1.3
'27	Mineral fuels, mineral oils and products of their distillation, bituminous substances, mineral	2,037	8.4	0.6	0.4	2.0
'26	Ores, slag and ash	793	3.9	0.0	0.0	0.0
'12	Oil seeds and oleaginous fruits, miscellaneous grains, seeds and fruit, industrial or medicinal	733	0.3	7.9	0.3	41.4
'90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical	684	41.2	2.0	1.1	1.9
'22	Beverages, spirits and vinegar	484	63.1	6.3	7.7	9.0
'84	Machinery, mechanical appliances, nuclear reactors, boilers, parts thereof	437	29.9	1.7	1.1	1.5
'02	Meat and edible meat offal	367	47.3	28.1	52.6	33.8
'85	Electrical machinery and equipment and parts thereof, sound recorders and reproducers, television	360	34.3	2.6	1.7	2.8
'78	Lead and articles thereof	328	91.4	2.2	1.5	2.1
'30	Pharmaceutical products	295	30.4	0.0	0.0	0.0
'88	Aircraft, spacecraft and parts thereof	250	28.0	2.0	1.4	1.9
	Sum of top 12	9,633				
	Share of the 12 in total	83.6%				

Table 4.2 Australia's merchandise exports to the EU, 2014-2016, US\$ '000.

Source: Author's calculations from Trade-Map and TRAINS, see notes to Table 4.1.

In terms of Australia's imports, the only sector in which the UK has a significantly above-average share is beverages. The larger share reflects UK exports of whisky—this is an extremely well-organised export sector and lobbying force—and it is possible that without UK pressure, the ardour of EU spirit producers for liberalisation will cool. However, in general, and in mercantilist terms, it is difficult to see Brexit making much difference to the European politics behind an FTA.

That is, while the EU will be 15 per cent smaller as a market than anticipated when discussions began, this reduction is spread quite evenly across commodity classes and so makes little qualitative difference. This lack of effect is reinforced by the fact that for these major classes Australia's tariffs are generally fairly low. Therefore, the returns to European producers from lobbying to reduce them to zero are not particularly high.

The position regarding Australia's exports is different. Here, the UK accounts for nearly 40 per cent of Australia-EU trade, and among the top 12 product classes, the UK share ranges from 0.3 per cent to 91 per cent. The former refers to oils and seeds, and has relevance only to hops, where the UK takes around US\$1 million of Australia's exports and imposes a tariff equivalent of 5.8 per cent. The latter refers to lead, with the next highest share being for gems. On both of these the EU levies what is basically just a nuisance tariff.

The only two products for which both EU protection and the UK share are significant are beverages (wine) and meat. These are both major export interests for Australia and are sensitive for the EU. For wine, the UK's absence will reduce both the relevance of the FTA to export interests in Australia, as well as the chances of significant concessions being offered. For meat, the former applies but the latter may not. This is because meat is also sensitive in the UK—not least because production is biased towards non-English nations—and so the UK may also have resisted liberalisation if it had remained in the EU.

EU imports of meat also touch a potentially raw nerve in the UK-EU Brexit negotiations. Perhaps the trickiest issue to arise in the disaggregation of UK rights and obligations in the WTO from those of the EU concerns tariff rate quotas (TRQs). As part of the limited liberalisation of agricultural trade in the Uruguay Round, the EU agreed with its partners to import specified quantities of certain agricultural goods at low or zero tariffs, even though their MFN tariff was much higher. These quantities pertained to the EU as a whole, and will need to be broken up between the UK and rest of the EU on Brexit. Some of these committed imports have been allocated to specific exporters, including Australia. One such case is sheep meat.

The negotiated sheep meat TRQ for the EU15 (the EU as constituted at the end of the Uruguay Round in 1994) was 284,000 tonnes, of which 225,000 were allocated to New Zealand (NZ), 18,500 to Australia and smaller amounts to other exporters.² The total and the TRQ for NZ do not bind; but that for Australia

² Winters (2017) offers more detail on the sheep meat quota issue. When this analysis was conducted the latest WTO certified schedule for the TRQ referred to the EU15. Since then the schedule for the EU25 has been agreed; it increases the quota a little but makes no difference to the message of the analysis.

does so tightly. There are effectively no imports into the EU outside the TRQ (that is, at the MFN tariff) and so any enlargement of the quota will come at the expense of local EU production (that is, the trade restrictions have material effect within the EU and are thus politically salient). The TRQs are of political interest in Australia as well. The amount of current trade is small but there is a (well-founded) belief that exports could expand strongly. Additionally, the Australian Government professes strong opposition on principle to any interference in international markets in agricultural products. The UK and EU made a formal offer to their WTO partners on 11 October 2017 in which they proposed to split the TRQs according to historical data and with no uplift at all in the total. Seven countries immediately objected (and actually did so in advance)—the United States (US), Canada, NZ, Argentina, Brazil, Thailand and Uruguay—and Australia recorded its objections later. Given that the split is EU policy as much as UK policy, this will presumably complicate Australia-EU negotiations, although the problem will be laid at the door of the British to solve, and is, anyway, small enough to be managed with political will. Hence, it should not be an insurmountable barrier.

Using country of entry into the EU15, rather than the final destination (which we do not know), Figure 4.1 reports the allocation of Australian exports between the UK and the remaining EU14. The Figure shows the TRQ limit of 18,500 tonnes at the top and the exports to the EU measured upwards from the horizontal axis, with exports to the UK measured downwards from the TRQ limit. The space between the two is the unexhausted quota in any year. Prior to the conclusion of the Uruguay Round, Australia exported sheep meat only to the UK among the EU15 countries. Following the institution of the TRQ, exports to the EU14 began and exports as a whole approached the TRQ limit of 18,500 tonnes. From 1996 (and excepting 2010 to 2014, when the exchange rate was very high), Australia had effectively exhausted its TRQ. Moreover, exports to the UK and to the EU14 show a marked negative correlation (even excluding the blip in 2001). Both observations strongly suggest that the quota is binding.

When the TRQ is divided between the UK and the EU14, Australia will lose the flexibility that it currently possesses to switch exports between the UK and the EU14 according to market conditions. It will become more difficult to fill the quota; the quota will become less valuable. Examining the flows in Figure 4.1 shows there is no fixed division of the 18,500 tonnes that would have permitted the historical pattern observed for actual trade. Therefore, Australia might claim that any division of the sheep meat TRQ disadvantages them and thus demand compensation of some sort. Any such compensation will be small—the trade flow itself is small—but the issue will highlight the current parlous state of agricultural trade policy in the world at present.

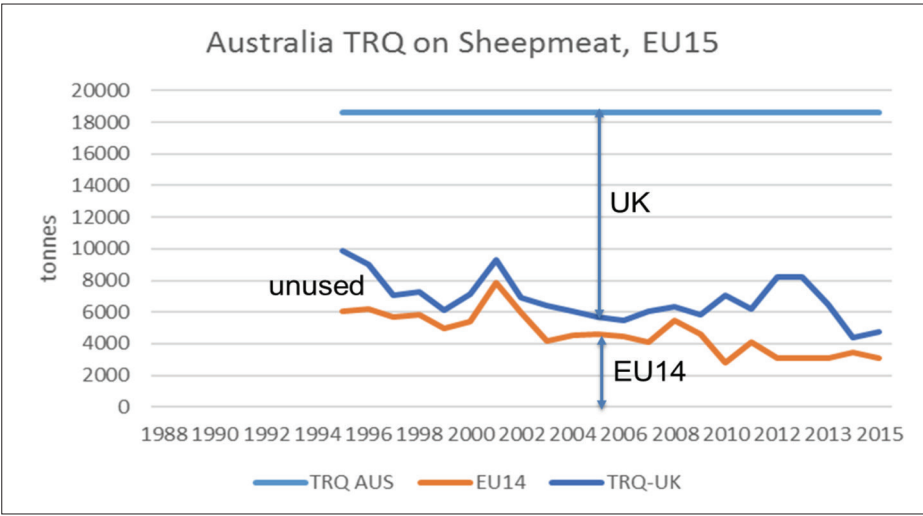


Figure 4.1 EU15 Imports of sheep meat from Australia (tonnes).

Source: Eurostat: Comext (<http://ec.europa.eu/eurostat/web/international-trade-in-goods/data/focus-on-comext>).

This issue will overflow into the negotiation of the Australia-EU FTA. In the absence of Brexit, a normal negotiation would see Australia demanding, and very likely receiving, an increase in its quota and some sort of best-efforts commitment to address the issue prior to considering a general liberalisation in the future. But with Brexit, while Australia may press for an enlargement of the TRQ bilaterally with the EU, the latter will not be keen to settle the issue until it is clear that the maximum has been extracted from the UK in terms of gaining the acquiescence of the WTO community.

The amount of trade concerned here is small and the loss of economic welfare much smaller. However, that is true of many agricultural issues and yet they have been a thorn in the side of trade negotiations for decades. Thus, resolving this issue will complicate the negotiation of an Australia-EU FTA materially.

Table 4.3 repeats the mercantilist analysis for services trade. Although the disaggregation is rather crude, the first message from Table 4.3 is that the main service trade between Australia and the EU does not offer many obvious targets for an FTA liberalisation to stimulate trade strongly. Travel services comprise 60 per cent of Australia's exports and 40 per cent of imports. The bulk of these are personal non-educational flows that are largely unconstrained at present and so would not be directly affected by FTA-induced changes in policy (tourist visas are readily available currently, for example). The second largest import, and fourth

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	Australia's exports			Australia's imports		
	Mean	Shr in total	UK share	Mean	Shr in total	UK share
TOTAL	10,249		46.8%	18,678		37.5%
Maintenance & repair services	4	0.0%	16.7%	100	1.0%	29.4%
Transport services	754	7.4%	39.0%	3,938	38.4%	14.5%
Travel services	6,163	60.1%	40.5%	7,883	76.9%	38.9%
o/w Business	944	9.2%	45.0%	748	7.3%	43.5%
Personal	5,219	50.9%	39.7%	7,135	69.6%	38.4%
o/w Education-related	1,268	12.4%	15.5%	317	3.1%	32.6%
Other	3,951	38.5%	47.5%	6,818	66.5%	38.6%
Construction services						
Insurance & pension services	19	0.2%	67.9%	511	5.0%	92.0%
Financial services	895	8.7%	78.6%	693	6.8%	81.5%
Intellectual property charges n.i.e.	185	1.8%	40.0%	1,707	16.7%	13.3%
Telecom, computer & information services	602	5.9%	51.6%	736	7.2%	44.9%
Other business services	1,352	13.2%	56.6%	2,340	22.8%	57.6%
Personal, cultural & recreational services	125	1.2%	73.4%	566	5.5%	56.3%
Government services	140	1.4%	30.1%	204	2.0%	41.2%
Services trade balance	-8,429	-82.2%	26.3%			

Table 4.3 Australia-EU trade in services, 2014-2016, A\$ millions.

Source: DFAT (2016).

largest export, is transportation services. This is largely comprised of the costs of carrying goods and people between Europe and Australia. The portion related to shipping goods is mainly responsive to growth in the goods trade. Although reducing costs by stimulating competition in transportation would help, such costs make up only part of the overall cost of imports.

The portion of transportation stemming from air transportation is already subject to an agreement between Australia and the EU, one that entered into force on 2 July 2009. This agreement aims at a reciprocal opening of market access within a framework that ensures fair competition and high standards of safety, security and environmental protection. An FTA could possibly negotiate improvements in

this agreement, although air transportation has always been a sensitive sector that lies outside the ambit of global trade liberalisation and has been a difficult problem to solve. So far as Australian imports of transportation services are concerned, the UK is a minor player and its absence will not make much difference to the negotiating dynamic of an Australia-EU agreement.

Table 4.3 also shows that the Australia-EU services trade relies heavily on trade with the UK, which accounts for 47 per cent of Australia's exports and 38 per cent of its imports. Financial and insurance services have two-thirds or more of their trade with the UK, so Brexit is likely to result in major effects on trade and the incentive to pursue liberalisation. The two-way nature of financial services trade suggests that it stems at least partly from a financial-centres effect. This reflects the partners' global and regional roles, rather than merely the intermediation of savings between Australia and the EU (or the UK). Despite accounting for over 7 per cent of UK gross domestic product, there was, at the beginning of December 2017, no clarity about what Brexit would entail for the UK financial sector, nor even what outcome the UK government wished to pursue for it.

It is universally accepted that the clearing of Euro transactions, currently conducted largely in London, will migrate back to one or more of the remaining EU Member States, thus eliminating one significant piece of the City of London's business.³ The UK Government has conceded that Brexit will also not include the continuation of the 'financial passport' which allows financial firms registered in one EU Member State to trade freely in any other without establishment. This 'passport' essentially permits financial firms to be regulated in only one EU Member State rather than in every one in which they trade—a considerable efficiency. The EU rules for 'equivalence' whereby this privilege is extended to non-Member States is seen as a poor substitute as it lies entirely through 'the gift' of the EU and may be withdrawn at thirty days' notice. In the future, 'equivalence' will also require close adherence to EU regulations and is thus a slender reed on which to hang an entire industry. A notion of 'enhanced equivalence', which would grant the UK a little more security than this, was (at the time of writing in July 2018) under negotiation.

Although conditions for the City of London seem destined to deteriorate, it is not clear whether Brexit's impact will greatly erode London's position as the leading European financial centre. There are three possibilities. First, financial services may drain out of London into one or more EU centres; second, they may

3 The European Central Bank had already tried to repatriate clearing, and was prevented from doing so only by a 2015 ruling of the European Court of Justice (ECJ); avoiding this court's jurisdiction has emerged as a principal objective of the 'leave' side of the UK debate on Brexit and so there is little chance of the reprieve being repeated.

drain abroad (to New York or Singapore, for example); and third, the economies of agglomeration in the sector may be strong enough for London to maintain its leading position, despite the added costs and uncertainties. In the first case, the EU might favour pursuing financial liberalisation in an FTA with Australia, reckoning that it has business to win. In the last two cases, on the other hand, waning enthusiasm may be anticipated, as the UK ceases to count in internal deliberations. Similarly for Australia: the incentives to include the financial sector in an ambitious FTA presumably increase if the sector increases in size in the EU. Unfortunately, it just is not known how this will all turn out, as currently Brexit casts a long shadow of uncertainty.

Arguably, many UK-headquartered banks already have full commercial establishments (subsidiaries) in EU Member States—created when they entered continental markets—whereas most continental banks opted merely to establish branches in London. Thus, UK banks will not have to undertake relocation to maintain access to EU markets, while continental banks may have to create subsidiaries in the UK. Moreover, London is home to many US banks, which will also need to relocate. More importantly however, economic interests in trade liberalisation will be determined at least as much by the location of activity as by the location of branches. EU authorities have clarified that they will not allow the EU subsidiaries of UK and US banks to be ‘shell companies’ or anything approaching that status, but will instead insist on material amounts of those banks’ EU business being conducted by EU subsidiaries. Whether the relocation of EU business to the continent leads to the UK’s international business similarly migrating is not clear, so the three possibilities outlined above still pertain.

The UK also accounts for over one-half of trade in ‘other business services’. This is an area in which the UK is relatively restrictive, notably because of its resistance to providing visas for professional service providers. The Australian Government has already informed the UK Government that visas will be a major offensive interest in any Australia-UK FTA. Hence, again, despite the preponderance of trade with the UK, it is possible that the UK’s departure from the EU will actually allow fuller liberalisation in professional services. However, the amount of protection in professional services sectors in non-UK Member States should not be underestimated. Borchert (2017) discusses some examples using OECD data.

In summary, the UK clearly provides a disproportionate amount of the benefits of an Australia-EU FTA in a number of key sectors. Removing the UK does not qualitatively affect the mercantilist calculus of the FTA, but its effect is clearly to reduce it and to disturb its balance relative to what was anticipated at the beginning of the process.

THE EU'S INTERNAL DYNAMICS

The British caricature of the EU sees it as bureaucratic, slow, meddling and hostile to openness and trade, in contrast to John Bull's pragmatism, flexibility and fundamental liberalism. The caricature suggests that without the pressure of the UK dynamism, the EU's trade agenda will descend into caution and stasis. The last few years have tested that proposition severely—at least for anyone who is prepared to consider the facts. Germany, not the UK, exports strongly to the rest of the world and admits refugees and migrants. Brexit is, for a large part of the UK population, an expression of anti-globalisation, the suspicion that trade benefits the few rather than the many. Even if the intention of part of the current governing party is the opposite, the UK will struggle to make as much impact on global trade in the next two decades as it has in the last two. Mark Carney, Governor of the Bank of England, characterised Brexit as:

an example of *reculer pour mieux sauter*.⁴ That is because if, as the government currently intends, the UK leaves the European Customs Union and Single Market in order to sign its own trade agreements, it will surrender very deep integration for the half of its trade that is with the EU, yet will be able to sign only relatively shallow agreements to cover the half of its trade that is with third countries. And even if new deep FTAs could be struck with other partners instantaneously, the reorientation of business relationships will take some time. (Carney 2017, p. 17)

Thus, if the EU wishes to make the point that life is better on the inside than the outside (this is undoubtedly a political objective of the European Commission in the Brexit process), what would be better than to sign some new trade agreements, especially with one of the UK's oldest and deepest friends. This is not, as some UK commentators have characterised it, a punishment strategy based in bitterness and recrimination, but a sensible and self-interested approach to dealing with a negative shock. Moreover, that the EU is now emerging from the financial crisis-induced recession makes it an even better time to be expansive in trade policy. Therefore, it seems likely that the European Commission—and indeed, the main EU Member State Governments, will be receptive to trade deals over the next few years. Of course, the old hang-ups and trade-managerialism remain, and the protectionist interests of the past will not disappear, but a new sense of purpose can be observed in the EU's approach. The recent agreement of an outline free trade deal with Japan—after five years of negotiations—is part of this. Although the election of a new US President may slow down an agreement with the US, it might also stimulate efforts to sign agreements elsewhere.

⁴ Literally stepping back in order to jump better.

If Australia is willing to deal on EU terms—and not to try to undercut the EU view of agricultural and food policies—it seems that an Australia-EU FTA could be made politically more likely by Brexit.

CONCLUSION

This chapter has sketched some of the possible implications of Brexit for the Australia-EU FTA. There are far too many uncertainties about the eventual form that Brexit will take to make confident predictions. However, it seems likely that Brexit will, on balance, somewhat reduce the pressure on the EU to reach a deep agreement, but will quite possibly increase its willingness to reach a shallow one. In terms of goods, for which we have reasonable data, the effects are quantitatively comparatively small, and the loss of the UK's relatively liberal attitude to agricultural trade may restrict the possibilities of increasing Australian exports in that sector. In services, where the data on trade flows and trade restrictions are much less good, the effects may be greater because the UK is a major services provider and champion of liberalisation. In addition, eliminating the British aversion to granting visas may enable a greater relaxation of Mode 4 trade than would have been possible before Brexit.⁵

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5 Mode 4 refers to the presence of persons of one WTO member in the territory of another for the purpose of providing a service.

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5

HOW MIGHT THE TRANS-PACIFIC PARTNERSHIP AFFECT THE GAME?

Yose Rizal Damuri

ABSTRACT

This chapter introduces the backdrop of Asia-Pacific mega-regionalism—the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) on one hand and the ASEAN-led, China-inclusive, Regional Comprehensive Economic Partnership (RCEP) on the other. Australia is taking part in both initiatives, which represent potential pathways to the APEC Free Trade Area of Asia-Pacific (FTAAP). The trading rules and disciplines in these mega-regional trade agreements have the potential to become benchmarks for the global trading system, including provisions on data flows. This chapter suggests that for the European Union (EU), the Australia-EU Free Trade Agreement (FTA) could help reduce negative impacts from mega-regionalism in the Asia-Pacific, regain economic share in the region and balance its economic influence. The opportunity exists to achieve broader regulatory coherence and harmonisation of trade governance.

INTRODUCTION

East Asia and the Pacific continues to be one of the fastest growing regions of the global economy, accounting for approximately 42 per cent of global trade and around 40 per cent of global gross domestic product (GDP). This rapidly growing region has also experienced a surge in bilateral and regional trade agreements (RTAs). The proposed free trade agreement (FTA) between Australia and the European Union (EU) will take place in the midst of this so-called Asia Pacific mega-regionalism. Included in this

mega-regionalism are mega-RTAs. These consist of several existing RTAs that cover many important countries in the region. Two mega-RTAs currently underway are of special note—the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Regional Comprehensive Economic Partnership (RCEP), with Australia taking part in both initiatives. From the EU’s perspective, the proposed FTA could be seen to balance out its economic influence in the region and reduce the negative effects of mega-regionalism, as well as helping to regain its share in the regional economy. However, the mega-RTAs could also affect the shape and coverage of the Australia-EU FTA.

Of the two mega-RTAs, the CPTPP could influence other trade agreements in the region as it is considered a high quality FTA with new approaches to commitments in response to the changing trade environment. The original Trans-Pacific Partnership (TPP) began with the expansion of the Pacific 4 (P4), an FTA between Brunei, Chile, New Zealand (NZ) and Singapore, and with the United States (US) in 2008. It turned into a process of negotiation for an RTA after Australia, Peru and Vietnam joined the talks in 2010. Malaysia, Mexico, Canada and later Japan also entered the negotiations. The 12 TPP negotiating parties finally reached an agreement in October 2015. However, this agreement experienced a significant setback when the new US President, Donald Trump (shortly after his inauguration in January 2017), announced the US withdrawal, making the future of this agreement unclear.¹ It was not until November 2017 that the remaining members decided to proceed with the agreement by amending and rebranding it as a CPTPP. Throughout this chapter, for the sake of simplicity, ‘TPP’ refers both to the original formation of the agreement and to the new CPTPP, unless otherwise specified.

This chapter examines to what extent the TPP will be a game changer in regionalism, and how it might shape the future of trade agreements. It starts by looking at the impact of the TPP—especially with respect to non-members—and the influence of responses from other countries towards TPP development. As regionalism in East Asia and the Pacific is more than just a process of the TPP, an assessment of the dynamics of RTAs in the region follows the discussion. The next step is to examine the TPP’s elements. The agreement is considered to offer new ways in dealing with complex issues of twenty-first century trade activities. It is likely that elements of the TPP could influence commitments and provisions in future FTAs. The penultimate section of this chapter investigates how the TPP and

¹ The original agreement required that it should be ratified by at least six countries representing 85 per cent of the TPP’s combined GDP. That means that the US and Japan would both have to ratify the TPP in its current form for it to go into effect.

regionalism in East Asia and the Pacific might influence the Australia-EU FTA, and how the FTA might contribute to a better trade environment in the region.

THE TRADE IMPACT OF THE TPP ON NON-MEMBERS

A major concern about the TPP comes from non-member countries. Just as with many other preferential trade agreements, member countries would reduce tariffs on imports from other members, while maintaining the level of tariffs on imports from economies outside the partnership. Non-parties of the TPP are therefore concerned that increased market access would come at the expense of other countries outside the group. The magnitude of trade diversions depends on two elements. The first is the importance of trade among member countries, as well as between members and non-members. The volume and pattern of trade would shape the impact of this Agreement.

A further issue concerns how successful the TPP countries might be in liberalising their markets among themselves, relative to prolonged trade barriers towards non-member partners. This represents the difference between most-favoured nation (MFN) tariff rates and the agreed tariff reduction under the TPP, often referred to as margins of preference. Higher original MFN rates and a deeper commitment to reducing them would create a greater advantage for member countries. At the same time, it would increase trade diversion for non-members. Yet these effects would be reduced if those countries already had trade agreements with individual, or a group of, TPP members.

Table 5.1 shows trade patterns between TPP countries and the EU, to provide an indication of the potential impacts of the TPP. In general, members of the TPP export around 15 per cent of their total exports to other countries in the group. But for Australia, the group is much more important because it contributes 26 per cent of its exports. EU Member States tend to trade among each other, with more than 60 per cent of exports and imports traded internally. The TPP countries only account for less than 5 per cent of the EU's exports, while exports to Australia are only 0.7 per cent of total EU exports. On the other hand, the EU is quite an important market to Australia, with almost 5 per cent of its exports directed to that region. These figures indicate that the impact of the TPP on the EU might not be significant. However, a US presence in the TPP would definitely change the potential impact, as the US accounts for nearly 8 per cent of the EU's total trade.

Among the 11 TPP members, Mexico and Chile are the only countries with trade agreements in place with the EU, although there are two other countries—Canada and Peru—with trade agreements that have been partially implemented.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

Countries/economies	EU exports	EU imports	TPP members' exports	Australia's exports
TPP-11	4.74	4.59	15.25	26.16
Australia	0.66	0.21	1.77	0.00
Brunei Darussalam	0.02	0.00	0.07	0.02
Canada	0.74	0.63	1.13	0.62
Chile	0.18	0.18	0.27	0.13
Japan	1.19	1.34	4.13	15.88
Malaysia	0.28	0.51	2.43	1.82
Mexico	0.71	0.44	0.93	0.22
NZ	0.10	0.08	0.51	3.33
Peru	0.08	0.11	0.22	0.03
Singapore	0.62	0.42	2.42	2.71
Vietnam	0.18	0.67	1.37	1.39
US	7.79	5.57	34.15	5.31
ASEAN	1.74	2.65	12.57	10.37
EU	61.34*	60.76*	9.02	4.97

* Based on EU internal trade figures.

Table 5.1: Share of trade of EU, TPP members and Australia in 2016 (%).

Source: Author's calculation from Comtrade database.

Countries/economies	Total trade	Agriculture products	Industrial products	Preferential for EU
Australia	2.6	1.4	2.9	
Canada	5.8	19.5	2.4	0.1
Chile	6.0	6.0	6.0	0.1
Japan	8.4	25.6	4.0	
Malaysia	5.6	2.8	6.0	
Mexico	5.7	15.2	4.4	0.9
NZ	2.4	1.8	2.5	
Peru	2.2	2.8	2.2	0.8
Singapore	0.1	0.8	0.0	
Vietnam	10.5	17.7	9.4	
TPP countries	5.1	10.7	4.1	
US	5.0	9.0	4.1	

Table 5.2: Simple average tariff rate of TPP members (%).

Source: Calculated by author from TRAINS database and schedule of tariff reduction of the respective FTAs.

The EU also has three other agreements currently in waiting for implementation. Most of these trade agreements cover more than 95 per cent of trade between the EU and TPP countries.

Table 5.2 shows simple average tariff rates of TPP member countries on an MFN basis, which is applicable to imports from the EU in most countries. In general, TPP member countries have set low MFN rates, with some of the highest

averages observed in Vietnam (10.5%) and Japan (8.4%). Higher rates are also observed in agricultural products for all countries, indicating greater protection for the agriculture sector. Table 5.2 also provides information on preferential tariff rates applied to imported products from the EU in Mexico and Chile. Except for a few agricultural products, those countries apply duty free rates to products from the EU.

Considering that the majority of trade between TPP countries is in industrial products, and MFN tariff rates for those products are already low, it can be predicted that the impact of the TPP on trade might be relatively small. Several studies have examined the potential impact of the TPP on economies inside and outside the trading group. The majority of studies involve conducting various liberalisation scenarios using economic modelling known as Computable General Equilibrium. Researchers quantify the effect of freer trade under the TPP, taking into account linkages to economic activities in the member countries as well as the rest of the world.

Studies on preferential trade liberalisation among TPP countries show that an adverse effect from trade diversion, although present, would be relatively small. The magnitude of the effect would depend on simulated commitments and scenarios. However, most studies still include the US as part of the TPP. Looking at tariff removal among 12 TPP members, Kawasaki (2014) estimates that the agreement will have a negative effect on non-members by reducing their income by between 0.1 to 0.8 per cent. The negative effect is greater when member countries manage to preferentially eliminate their non-tariff barriers (NTBs). Other studies also show similar results (Aichele & Felbermayr 2015; Gilbert et al. 2016).²

Looking in more detail on the impact for European countries, Aichele and Felbermayr (2015) estimate that tariff reduction among TPP members would only result in very small effects. Comprehensive liberalisation in TPP including services liberalisation, however, would bring positive effects to non-members, including EU Member States. The reason is that going beyond tariff liberalisation—such as services liberalisation or greater disciplines in trading rules—might be difficult to implement preferentially and would be likely to bring positive spill over effects to the rest of the world. This notion is also presented by Petri & Plummer (2016), whose study was released after the completion of the TPP negotiations, taking advantage of better information on the coverage of commitments.

While the effect of trade diversions might be small—as described in the various studies—nevertheless implementation of the TPP attracts significant responses

2 Gilbert et al. (2016) shows a small negative effect on trade and income of non-member countries, including European countries.

from non-members. The responses could lead to two possible situations. The TPP could attract more countries to join the group in the future, or non-member countries could form other trade agreements, bilaterally or at a regional level, with members of the TPP. Both responses would change the architecture of trade agreements in the region, as discussed in the next section.

TPP AND THE DYNAMICS OF REGIONALISM IN ASIA PACIFIC

Is TPP a game changer for regional and global trading arrangements? As a mega-RTA involving 11 countries with 14 per cent of global GDP, this partnership would definitely affect the way trading activities are conducted in the future. But the extent of its influence depends on two factors. First is the dynamics of trade arrangements in the region, which have become less predictable during the last few years. Second is how far the trading rules and disciplines being set in the agreement become the benchmark for a wider trading system. This section examines the first aspect by looking at how the TPP is positioned in trading arrangements across the Asia Pacific region.

Regionalism in Asia Pacific

The TPP is not the region's only 'game'. Although relatively new to forming preferential trade agreements, countries in Asia Pacific have been actively forming trade agreements among themselves and with countries outside the region for many years. The 10 ASEAN countries and the US, Canada and Mexico in North America are pioneers, having formed RTAs in the 1990s through the ASEAN FTA (AFTA) and the North American FTA (NAFTA). Both of these arrangements have been vital in defining regionalism in the area. In fact most of the trade agreements in East Asia have been centred on ASEAN, colloquially known as 'ASEAN centrality'.³ In the last 10 years, the process of integration has been driven toward greater region-wide agreements, either as an East Asia-wide regional agreement, or including the Pacific.

In 2012, ASEAN countries launched a negotiation to form the RCEP, a trade agreement with its six East Asian partners. This is an ASEAN-led process based on the existing ASEAN+1 FTAs. While that initiative is a logical next step to create greater and simpler integration in East Asia, it is also obvious that the RCEP launch was driven partly by the TPP negotiation process. Many countries in the region

3 The concept of 'ASEAN centrality' has defined East Asia regionalism in various aspects of the economy and politics. Five RTAs in East Asia are built among ASEAN countries and six of its partners—Australia, NZ, the People's Republic of China, Japan, the Republic of Korea and India. The agreements are known as ASEAN+1 FTAs.

were not part of the TPP. Six out of 10 ASEAN countries had not taken part in TPP negotiations. They were either not eligible for the TPP—whose membership was based on APEC—or were not willing to take deep high quality commitments as described in the TPP. Moreover, the second largest economy and trade engine in the region, the People's Republic of China (China), was not included in the TPP process. This left the impression that the TPP intended, in part, to exclude China.

The RCEP purports to be a 'high-quality' FTA, based on the current existing ASEAN+1 FTAs, but also including greater consolidation of trade liberalisation and harmonisation of rules and practices. The RCEP is expected to simplify the trading arrangements currently existing among those countries, while simultaneously aiming to achieve deeper integration that goes beyond elimination of traditional trade barriers, and narrowing of the development gap.

However, this is not an easy task for the negotiating countries. As of the end of 2017, the countries had conducted 20 rounds of negotiation but had not developed principal agreements on many important issues. The difficulties in reaching an agreement were manifest on many fronts. From a technical perspective, even the consolidation of tariff liberalisation is difficult to achieve. For example, each of the five ASEAN+1 FTAs involves different tariff elimination schedules for each of the individual ASEAN members. Currently, therefore there are 55 tariff elimination schedules existing under the five ASEAN+1 FTAs, with each ASEAN member maintaining five sets of tariff elimination schemes for its trading partners (Fukunaga & Kuno 2012). Consolidating and harmonising these agreements would be an overwhelming task.⁴

Another problem has been the lack of willingness on the part of many member countries to embrace greater openness. One way to consolidate the existing FTAs is to go beyond the current commitments in the most advanced ASEAN+1 FTAs, such as the ASEAN-Australia New Zealand FTA (AANZFTA). However, some countries are reluctant to give such greater concessions. The offers made are even lower than those in the current FTA commitments in their existing FTAs. Some East Asian TPP members also perceived the RCEP negotiation as a distraction from the TPP negotiation process, rather than seeing it as complementary. They preferred to focus on the TPP process first. There is also a concern over potential

4 In addition to five ASEAN+1 FTAs, individual ASEAN countries also have bilateral FTAs with their partners, some of them preceding the associated ASEAN FTAs. To date, 18 bilateral FTAs exist, while several others are under negotiation. Often the commitments in bilateral FTAs are not in line with commitments specified in the ASEAN FTAs. They also often have different arrangements regarding rules of origin (RoOs), which have created much confusion in the business sector. This 'noodle-bowl' syndrome was expected to be reduced under the RCEP, but instead it has made it more difficult to reach significant agreement.

confusion in the implementation of both agreements in the future, especially in dealing with behind-the-border commitments. To make the situation worse, the RCEP lacks trade agreements between partners of ASEAN, especially among the three major Northeast Asian countries, China, Japan and Korea.

Given that the TPP negotiation has been concluded, the RCEP will experience external stimulus to reach more considerable commitments. During the period when the fate of TPP was uncertain following the US withdrawal in early 2017, RCEP tended to be seen as the future of Asia Pacific regional integration. East Asian TPP members feel the need to lift the quality of commitments in the RCEP to levels comparable to those in TPP. There are reports that some TPP members are trying to inject various more stringent provisions into the RCEP in order to improve the quality of this East Asian agreement.⁵ Efforts to increase the level of commitments in the RCEP are likely to continue, even after the eleven remaining TPP members have proceeded with their new formation.

Bilateralism and the noodle-bowl syndrome in Asia Pacific

Besides regional trade groupings, the Asia Pacific also experiences no shortage of bilateral trade agreements, including among the TPP members. Bilateral FTAs have mushroomed rapidly in the region since the turn of the century, starting with the Singapore-Japan FTA in East Asia and the Canada-Chile FTA on the other side of the Pacific. Currently, there are 20 bilateral FTAs which have effectively been implemented among TPP members, while the US has agreements with four TPP members. In addition, TPP members participate in five other regional agreements—three under ASEAN FTAs, NAFTA and the original P4. Figure 5.1 describes the arrangement among TPP members. This is not unique to Asia Pacific countries. Among 248 preferential RTAs listed in the 2013 WTO RTA database, 99 are at least affected by one other RTA, while 78 WTO members (from 131 with RTAs) have at least one bilateral relationship covered by multiple trade agreements (Pauwelyn & Alschner 2014). Nevertheless, this raises the question of how the TPP addresses the issues of different concessions and rules harmonisation among the existing bilateral agreements, and how commitments in the TPP would be implemented effectively in relation to commitments in other agreements.

⁵ While the issues being negotiated in the RCEP are kept confidential, reports indicate that since early 2017, after the US withdrawal from the TPP, Japan, Australia and NZ pushed for the adoption of TPP-like provisions in e-commerce (see for example: <https://www.eff.org/deeplinks/2017/07/rcep-discussions-e-commerce-gathering-steam-hyderabad>). Other reports suggest that issues around state-owned enterprises (SoEs) and competition would be raised to include norms and principles regarding SoE practices in member countries.

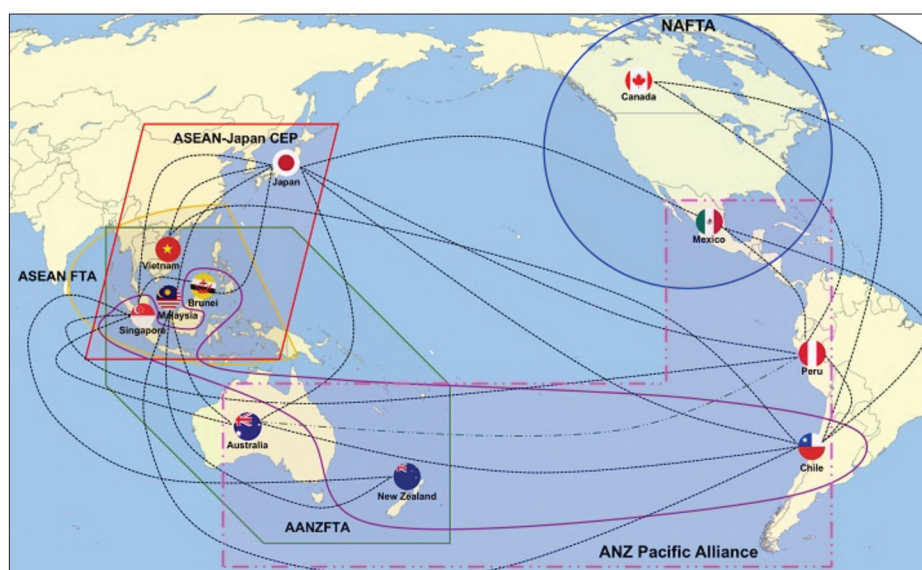


Figure 5.1: Bilateral and regional agreements among CPTPP members.

Source: Author's compilation from various sources.

Two scenarios might appear in the present overlap of FTAs. Either both of them coexist or the later agreements consolidate the rules and concessions of the earlier ones. There is a tendency for the TPP to allow existing bilateral or regional agreements to coexist with similar provisions in the TPP.⁶ While this would not create problems where the TPP is more liberalising, confusion would arise where TPP commitments are less demanding; this is the case, for example, with respect to the TPP provisions on investment protection and rules of origin (RoOs).

In a preferential trade agreement, imports from one member to another member country are subject to RoOs to define products qualifying for lower tariff concessions. The TPP defines the eligible products for lower tariffs in three ways. They are either produced fully in a TPP country; meet the requirements of regional value content (RVC) according to a complex calculation, or have been processed in a substantial way in TPP countries.⁷ Problems arise when RoOs for various

⁶ Legally, in various parts of the TPP there are clauses mentioning that the partnership would not in any way undermine or annul other agreements set out by member countries.

⁷ There are two ways to deem whether a product has been through in a 'substantial transformation' process. The first one is the Change in Tariff Classification (CTC) between materials and final product, normally the change of subheading classification in the Harmonized Commodity Description and Coding Systems (HS), e.g. from woods to furniture (both are classified under different subheadings), or through substantial production process—although remaining in the same tariff classification.

products are different than the rules specified in other agreements. Some are even considered to be more restrictive. One example is the RoO on motor vehicles, one of the largest of Australia's imported goods, with only a third of them coming from TPP countries. The RoO chapter in the TPP defines eligible automotive products to have a RVC of not less than 45 per cent or 55 per cent depending on the calculation method, while the rules in the AANZFTA and Australia-Japan FTA stipulate only 40 per cent. This would require importers to Australia to seek the arrangements that provide them with the most advantage from agreements, therefore affecting ways of doing business and also international production.

TPP AS A BENCHMARK

Coverage of TPP

The TPP has been lauded as a 'twenty-first century agreement' with high quality commitments among members to address more recent development in trade. Indeed, the development of information and communication technologies in the last 40 years has transformed trade into a complex activity involving not only exchange of goods, but also intensive intertwining with services, investment and the internationalisation of supply chains. Faster and more reliable telecommunication and coordination allows production to be decomposed into various tasks that can be located in distant places, based on the comparative advantage principle. Baldwin (2016) describes the process as the second unbundling, allowing the locational separation of production and knowledge generation, just as the first unbundling separated the production and consumption of goods in the nineteenth century. Baldwin (2016) argues that this process will continue, as the world is entering its third unbundling. Here, trade in services will become more widespread as advances in technology allow further separation of the production and consumption of services.

The complex trade situation requires complex rules and disciplines. The current trade and business environment in East Asia and the Pacific requires a new set of rules to provide governance in regional economic interdependence and to facilitate seamless international trade and business activities. In this context, behind-border issues, including regulatory coherence, need to be an integral part of the negotiations. This includes consistent implementation of various disciplines and rules related to commercial and economic activities, such as intellectual property protection, competitive regulatory frameworks, services regulations and government procurement. At the same time, the new disciplines also need to look at the future of trade by setting rules for more technology-intensive trade, such as rules on e-commerce.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

Anti-Corruption*					28
Textile and Apparels					
Environment**				26	
Labor Standards					
State-Owned Enterprises					
Government Procurement					
Transparency					
Export Duties					
Regulatory Coherence			20		
Trade and Sustainable Development					
E-commerce		18			
Competitiveness and Business Facilitation					
Small and Medium Enterprises	16				
Competition Policy					
Intellectual Property					
Dispute Settlement					
Economic Cooperation and Capacity Building					
Financial Services**					
Telecommunication**					
Temporary Entry for Business Person					
Trade in Services/Cross-Border Trade in Services					
Investment					
Trade Remedies					
Technical Barriers to Trade					
Sanitary and Phytosanitary (SPS) Measures					
Customs Administration and Trade Facilitation					
Rules of Origin					
Trade in Goods					
	ASEAN+1	RCEP	AEC	EU FTAs	TPP

Note: * Included in RCEP; **Not in EU FTAs, except with Canada.

Figure 5.2: Elements of various trade agreements.

Source: Author's compilation from various texts of agreements.

These are the important elements that the TPP tries to offer, including defining a new set of rules and governance for economic activities in twenty-first century globalisation. The fact that the partnership was originally led by the US gives it a better chance to influence the future of trading systems. Various provisions described in this agreement are set to deal with the important issues of a complex trading environment. Figure 5.2 provides a snapshot of the issues discussed and defined in the TPP, along with a comparison with other trade

agreements, including the proposed coverage of RCEP and FTAs between some TPP members and the EU.

The pre-existing trade agreements in East Asia had tended to omit certain provisions discussed in TPP. The FTAs between the EU and countries in the region do not specifically touch these issues either, except for the CETA with Canada. The issues include those of e-commerce and financial services. RCEP also omits discussion on several sensitive issues, such as state-owned enterprises (SoEs) and government procurement, while the original TPP had placed much emphasis on these issues. It is likely that provisions on such topics might be covered in the future or in on-going trade negotiations. Negotiating parties of the RCEP specifically decided to address e-commerce not from the start of the negotiations, but only after the negotiations had been underway for three years, in the spirit of achieving similar levels of commitments as in the TPP.

The breadth and depth of commitments

The TPP is not only about introducing an extended coverage of commitments (as described in Figure 5.2), but also about taking those commitments to another level. Various new provisions are introduced in the agreement that had not been discussed in earlier FTAs. Even in traditional trade areas, such as market access and services, deeper commitments exist than in many other agreements. Measures related to export, for example, are explicitly prohibited, including the use of export duties and licensing requirements, except for several exempted cases negotiated by some member countries.

Three types of approach can be found in the agreement. First, many provisions are basically an extension of widely known provisions with deeper commitments. Various provisions in the ‘investment chapter’ of the TPP provide examples. The definition of ‘investment’ in this chapter, and its coverage, is different to many other investment agreements in Asia Pacific FTAs, except for a few US FTAs concluded after 2005. This definition includes pre-investment activities as well as having sub-national regulations as subjects under the agreement. Investment protection and dispute settlement provisions in the TPP also cover government contracts and works. Provisions on performance requirements are also extended to include some new elements, such as preventing countries to force or prohibit the use of ‘homegrown’ technologies. It is important to note that while some of these extensions may affect the trade and investment environment significantly, the majority might be merely legal innovations to define the provisions more specifically.

Second, there are new provisions which are rarely addressed in other agreements. Provisions to ensure free movement of electronic information between TPP members are examples of new elements. The commitments prohibit countries, both virtually and physically, from interfering with the flow of digital data, except in certain extraordinary circumstances. Member countries are not permitted to disrupt the transfer of data electronically and are not permitted to require localisation of data centres. While many governments may still retain an inclination to seek to control data, as more business is conducted through the internet, it is likely that these new measures—ensuring freedom of cross-border data flows and prohibiting data localisation—will become the new norm for future FTAs.

Third, there is a novel approach towards relevant issues and commitments. While establishment of disciplines on SoEs has been tried in various commitments, the TPP SoE chapter can be considered to offer a novel approach. The commitments do not seek to prohibit SoEs, but rather to create a non-discriminating environment towards them. The agreement prohibits the use of special treatment and assistance, such as subsidies, in order to create level playing fields for competition. Accordingly, it also ensures that SoEs are subject to competition principles. The agreement contains an innovative approach to transparency in that it requires the countries to provide lists of information regarding their SoEs and any special treatments that they might receive. In addition, the provisions ensure that SoEs are also subject to dispute settlement mechanisms.

These new elements in the TPP may be adopted into future agreements, particularly as the current trading environment requires new governance perspectives and approaches. However, after the US withdrawal, the remaining TPP members have also had a chance to reflect on the importance, and the associated expenses, of implementing such measures and provisions.

TPP AS A GAME CHANGER AND IMPLICATIONS FOR THE AUSTRALIA-EU FTA

The TPP is likely to change the face of trade agreements and regionalism in East Asia and the Pacific. In terms of regional arrangements, the relation between the TPP and other agreements is still in transition. With the fate of the TPP becoming clearer it is likely that the TPP will affect completion of the RCEP negotiations and increase the quality of that agreement—by giving new stimulus to member countries. The TPP might also act as a bridge to the creation of the FTAAP, a mega-RTA envisioned by APEC to cover its members on both sides of the Pacific.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

Chapter/area	Provisions in original text	New text of CPTPP
Investment	The definition includes contracts and agreements between government agencies and investors, and is subject to ISDS.	These kind of contracts are no longer subject to ISDS.
Government procurement	Member would start further negotiations no later than three years after the TPP implementation, to extend the coverage, such as to include sub-national levels.	Further negotiations would not be commenced earlier than five years.
Intellectual property rights	Adjustment and extension of patent terms as a compensation for procedural delay in granting patents.	Members do not need to provide such compensation.
	Members are required to extend the term of protection for copyright from 50 years to 70 years.	No obligation to extend protection for copyright.
	Protection of undisclosed data and test of medicine, for at least five years after the date of marketing approval.	There is no such protection required.
	Requirement to place criminal sanction for circumvention of technological protection measures; i.e., digital locks.	The provision is suspended.

Table 5.3: Major revisions of TPP original text.

Source: Annex II of TPP Ministerial Statement 11 November 2017 (DFAT 2017).

While there are no negotiations as yet, APEC members are keeping the intention alive by including it in their annual summit declarations.

Two more matters require attention in considering the impact of the TPP agreement on East Asian and trans-pacific regionalism. First is the absence of a major economic power in this agreement, after withdrawal of the US. With 67 per cent of the combined GDP of the 12 original members, the US was a trade magnet for many other countries to join the partnership. Indeed, several countries no longer demonstrate interest in joining TPP following the US departure.⁸ Thus, while the TPP might offer concrete and necessary commitments and trade disciplines, it lacks attraction for other countries in the region, especially in terms of market

⁸ A few months before the original TPP negotiation was concluded in October 2015, the Philippines and Thailand made clear statements about their intentions to join the TPP. See for example <https://thediplomat.com/2015/09/does-thailand-really-want-to-join-the-tpp/>. After the TPP negotiation concluded, Indonesia also expressed its interest to join the proposed agreement. See <https://www.reuters.com/article/us-usa-indonesia/president-says-indonesia-intends-to-join-tpp-trade-deal-idUSKCN0SK2JY20151027>. There is no indication this interest continued after the US left.

access benefits. Meanwhile, the cost of joining—in terms of commitments and adjustments to regulatory settings—might be significant.⁹

Second is the level and coverage of commitments in the TPP. As discussed previously, the agreement contains various new and innovative provisions necessary for the future of trade environments. However, those provisions have many potential consequences, including the modification of various regulatory settings in member countries that often find themselves in difficult political situations. As part of the new CPTPP deal, the remaining 11 TPP members decided (in November 2017) to tone down several provisions considered onerous. Twenty-two provisions were suspended from the original agreement. Table 5.3 highlights several important changes under the new agreement. These include several provisions on investment protection and intellectual property rights, especially those related to pharmaceutical products.

The above-mentioned modifications might make TPP commitments less frightening for the region's developing countries. They may become less reluctant to join the TPP, given that the benefits may be sufficiently substantial, or they may incorporate such provisions into other trade agreements in the region. Attempts are being made to incorporate several commitments of the TPP in some current negotiations, such as in the RCEP or the bilateral agreement between Australia and Indonesia, albeit in ways that are less demanding.

The Australia-EU FTA in the Asia Pacific context

Given the position of Australia as an active trading country in the Asia Pacific and the EU's intention to have a greater role in the region, two aspects come into consideration. First is the coverage of the proposed FTA. Learning from the Canada-EU CETA, it is quite clear that the EU would embrace many areas that had not yet been discussed in previous EU FTAs and that define future rules and principles of trade governance. Issues such as e-commerce and telecommunications are discussed in detail, in provisions comparable to the TPP. CETA also offers new approaches on investment, especially for dealing with dispute settlement and investment protection. While the original TPP text emphasised the use of investor-state dispute settlements (ISDS); the final text in CPTPP gives members more flexibility.

In more traditional trade issues, the EU's interests are also quite in line with Australia's commitments in the TPP. Trade in services is among the important

9 Indonesia, the Philippines and Thailand have trade agreements, bilaterally or under ASEAN, with at least seven of the TPP countries, accounting for around 70 per cent of the TPP market. Joining TPP might not affect their trade significantly, but would increase their commitments.

common interests between the two economies. The TPP commitments in this area are quite progressive, with detailed principles for domestic regulations in the area of finance, telecommunications and internet services. The TPP approaches greater liberalisation of the services sector through use of the so-called ‘negative list’ approach to the scheduling of commitments.¹⁰ While many EU FTAs are completed under the General Agreement on Trade in Services (GATS) style ‘positive list’ approach, the ‘negative list’ approach could be more suitable for the situation and interests of the two economies, just like the approach taken in Canada-EU CETA.

The second is related to the regionalism of East Asia and the Pacific. This has turned into a messy arrangement with overlapping and often conflicting measures. Given Australia and the EU have, or are negotiating, agreements with most countries in the region, both can play an important role in ensuring greater regional harmonisation of trade governance.

One possible issue to start with is the RoO. A simpler, more flexible and less stringent RoO would create more open regionalism and increase the benefits of trade liberalisation. RoO in Australian FTAs tend to be quite diverse; the change in tariff classification (CTC) rules apply only to less than 10 per cent of tariff lines in AANZFTA, while the rules cover around 57 per cent in the Australia-Korea FTA (KAFTA). The rules are also restrictive—almost 40 per cent of tariff lines are subject to CTC at the chapter level (the most restrictive rule) under ASEAN FTAs, although this is only less than 18 per cent in KAFTA (Crook & Gordon 2017).

For these two economies, it is even more important to look beyond market access in goods, to the RoO applying in the services sector—also called denial of benefits (DoB).¹¹ DoB provisions in the TPP tend to be quite liberal, allowing service providers, which are owned and controlled by non-members, to receive preferential benefits if they maintain substantial business operations. This liberal provision is quite common in Australian and EU FTAs (Khumon 2015). However, the DoB provisions in CETA tend to be more restrictive, denying the benefits to third-party services providers, without taking into account their activities in member countries. The RoO under the Australia-EU FTA, both in goods and

10 There are three common approaches. The positive, or GATS-style, approach where countries list the sectors they offer for liberalisation and specify the remaining restrictive measures they want to retain for those sectors. The negative, or NAFTA-style, approach considers all sectors to be liberalised with some listed reservations. The hybrid approach combines these two.

11 RoO for trade in services are normally described in articles related to DoB, defining to what extent services establishments originating from non-members—which operate in the territory of member countries—benefit from the FTA.

services, should be composed with an objective to increase harmonisation of various trade agreements in the region and to minimise the ‘noodle-bowl’ effect.

Various potential areas exist in which Australia and the EU can offer to improve untidy regionalism in East Asia and the Pacific, or at least to not make it more complicated. This is potentially the case with respect to non-tariff measures, such as technical and sanitary regulations. Negotiations on several behind-the-border issues, such as domestic regulations in various services sectors, could also support the objective. The matter of regulatory coherence can also be covered in this proposed FTA, as it is discussed under the TPP. Greater convergence of trade rules across agreements involving these two economies has the potential to create a positive impact on the regional trading environment and have a constructive influence on regional trade governance.

CONCLUSION

The trade agreement between Australia and the EU will be influenced by the dynamics of trade arrangements in the region, which include mega-RTAs such as the TPP. The TPP might not affect non-member economies significantly, given that most countries in the region are actively engaged in bilateral and regional trading arrangements, making the diversion effects of preferential trade barriers smaller. However, it is likely that some provisions in the TPP will become new norms for comprehensive trade agreements, such as those on e-commerce, SOEs, or those that address domestic regulations in major services sectors. These areas of trade disciplines are considered necessary for current international trade and business practices. The absence of the US from the TPP might diminish the influence of this mega-RTA: as it might not be as interesting as it would be if the US were part of it. However, with the contents of this RTA being adopted in many other agreements, a successful TPP process will be crucial.

As part of the renewed TPP, Australia will want to ensure that the level of commitments in an Australia-EU FTA are comparable with its commitments in the TPP. This will also shape the future of trade governance in the region. The EU might also intend to include what it has discarded in several of its new agreements, notably with Canada and with Japan, which otherwise cover most areas discussed in the TPP. It is not too difficult for the two parties to align their common interests with the level of commitments in those agreements. This FTA between Australia and the EU would then play an important role in taking up the commitment for integration in East Asia, while at the same time creating more harmonisation in trading governance.

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6

LIMITS TO EUROPEAN UNION NEGOTIATING COMPETENCE

Pascal Kerneis

ABSTRACT

In November 2015, the European Commission requested an Opinion of the European Court of Justice (ECJ)—Opinion 2/15—on the scope of European Union (EU) powers in relation to the conclusion of the envisaged EU-Singapore Free Trade Agreement, asking whether it fell entirely within the EU's exclusive competence. The EU and Singapore had completed negotiations for a comprehensive FTA on 17 October 2014. The Council of the EU (Council), and the governments of all Member States that submitted observations to the ECJ asserted that the EU could not conclude the agreement by itself, because certain parts of the agreement fell within a competence shared between the EU and the Member States, or even within the exclusive competence of the Member States. The ECJ's verdict clarified the scope of competences in trade policy between the EU and its Member States, and defines clearly what is the exclusive competence of the EU in common commercial policy (CCP). Interestingly, without being asked to do so, the ECJ ended longstanding disputes between the European Commission and the Council on whether commitments made by the EU in maritime, rail, road and internal waterways transport services must be ratified by all 28 Member States and some regional parliaments in EU FTAs. The ECJ stated this was an EU-only matter and only required ratification by ordinary procedure (i.e., through consent of the European Parliament, Article 218[§6]) of the Lisbon Treaty on the Functioning of the EU. The ECJ took the same position on intellectual property rights, public procurement in transport, competition policy and sustainable development.

INTRODUCTION

The European Union (EU) operates under the basic constitutional principle of conferral, which determines that it shall act only within the limits of the competences conferred upon it by Member States in the EU Treaties to attain the objectives set out therein, and that powers not given to the EU remain with Member States. EU powers can be sub-divided into exclusive powers, powers shared with EU Member States, and coordinating and supportive powers. Since the entry into force of the Lisbon Treaty on the Functioning of the European Union (TFEU) in 2009, the Common Commercial Policy (CCP) lists foreign direct investment (FDI) as an exclusive EU power. Portfolio investment, however, is not mentioned. The question therefore arises whether the EU has any powers in this field.

The principle of conferral entails consequences for the ability of both the EU and its Member States to conclude international agreements. If an international agreement covers areas over which both the EU and its Member States exercise their respective competences, the agreement must be ‘mixed’. This means that both the EU and the Member States will need to ratify it jointly. In relation to shared powers, the EU and Member States decide who exercises their powers to conclude that part of the agreement. EU Member States often insist on exercising their powers to ensure that an agreement is mixed. In practice, almost all EU agreements are mixed.

The legal issue of who is competent to conclude such agreements (the EU alone, or together with the Member States) has received considerable public attention. In November 2015, the European Commission requested an Opinion of the European Court of Justice (ECJ)—Opinion 2/15—on the scope of EU powers in relation to the conclusion of the envisaged EU-Singapore Free Trade Agreement (FTA), asking whether it fell entirely within EU exclusive competence. Advocate General Eleanor Sharpston presented her views in an Opinion (confusingly given the same name) in December 2016, which serves as non-binding advice to the ECJ (ECJ 2016b). On 16 May 2017, the ‘Full Court’ in Luxembourg handed down the Opinion of the ECJ on the division of competences between the EU and Member States on the content of the FTA with Singapore (ECJ 2017b).

The EU and Singapore had completed negotiations for a comprehensive FTA on 17 October 2014. The text of the initialled agreement can be found in ‘EU-Singapore Free Trade Agreement’ on the Commission Directorate-General (DG) Trade website (European Commission 2017). The agreement is one of the first ‘new generation’ bilateral FTAs. It is a trade agreement that contains, in addition

to classical provisions on the reduction of customs duties and of non-tariff barriers affecting trade in goods and services, other provisions on various matters related to trade, such as intellectual property (IP) protection, investment, public procurement, competition and sustainable development.

The European Commission submitted a request to the ECJ for an opinion pursuant to Article 218(11)—TFEU—to determine whether the EU had exclusive competence enabling it to sign and conclude the envisaged agreement by itself. The European Commission and the European Parliament contended that this was the case. However, the Council of the EU (Council) and the governments of all Member States which submitted observations to the ECJ asserted that the EU could not conclude the agreement by itself, because certain parts of the agreement fell within a competence shared between the EU and the Member States, or even within the exclusive competence of the Member States.

In summary, the ECJ held that the FTA with Singapore could not, in its current form, be concluded by the EU alone, because some of the envisaged provisions fell within competences shared between the EU and the Member States. It follows that the FTA with Singapore can, as it stands, be concluded only by the EU and the Member States acting together.

The ECJ's verdict clarifies the scope of competences in trade policy between the EU and the Member States, and clearly defines the exclusive competence of the EU in CCP. The Opinion, however, leaves the fate of Investor-State Dispute Settlement (ISDS) in future EU trade agreements open.

WHAT IS THE SCOPE OF THE EXCLUSIVE COMPETENCE OF THE EU?

The ECJ declared that the EU has exclusive competence in so far as concerns the parts of the agreement relating to the following matters:

- **Access to the EU market and the Singapore market** in so far as concerns goods and services (including transport services) and in public procurement, including public procurement in transport services (§219-224), and of energy generation from sustainable non-fossil sources.
- The provisions concerning **protection of FDI** of Singapore nationals in the EU (and vice versa).
- The provisions concerning **IP rights**.
- The provisions designed to combat **anti-competitive activity** and establish a framework for concentrations, monopolies and subsidies.

- The provisions concerning **sustainable development**. Indeed, the ECJ found that the objective of sustainable development now formed an integral part of the EU's CCP. The envisaged agreement is intended to make trade liberalisation between the EU and Singapore subject to the condition that the parties comply with their international obligations concerning the social protection of workers and environmental protection.
- The rules relating to **exchange of information** and to obligations governing notification, verification, cooperation, mediation, transparency and dispute settlement between the parties (State-to-State disputes), unless those rules relate to the field of non-direct foreign investment.

Clarification on transport services

Interestingly, the ECJ findings put an end to longstanding disputes between the European Commission and the Council by providing long explanations on whether commitments made by the EU in the area of maritime (§175-194), rail (§195-203), road (§204-212) and internal waterways (§213-216), needed to be ratified by all 28 Member States and some regional parliaments in EU FTAs. The ECJ stated this was an EU-only matter and only required ratification by ordinary procedure (i.e., through consent of the European Parliament, under Article 218(§6) of TFEU). The ECJ takes exactly the same position on IP rights, public procurement in transport, competition policy and sustainable development.

In contrast, domestic and international air transport services are not covered under the FTA, as stated in Articles 8.3(c) and 8.9(e) of the FTA. As such, it is not clear if the two parties would have negotiated air transport services for merchandise (i.e., freight by air cargo), or whether that would also have been considered covered by the exclusive competence. One could argue that existing commitments related to leasing and maintaining aircraft and those to express courier services do include already air transport services. Therefore, it is likely that the air transport services for goods are part of the EU's exclusive competence. In future, these provisions could come into force the moment the Council agrees on a trade deal by a qualified majority, and the European Parliament ratifies it by a simple majority.

The ECJ also settled a particularly contentious issue between Member State capitals and the Commission: FDI including investment protection, which falls under the exclusive remit of EU CCP. FDI is understood as an investment made by a foreign investor with a view to participate in the management of the business in which it invests, and which is commonly accepted as involving at least 10 per cent of that business's equity share.

WHAT IS NOT WITHIN THE EXCLUSIVE COMPETENCE OF THE EU?

Ultimately, the EU is not endowed with exclusive competence in only two aspects of the agreement, according to the ECJ, namely:

- The field of non-direct foreign investment (portfolio investments made without any intention to influence the management and control of an undertaking).
- The regime governing ISDS (Refer to §285-293).

The ECJ confirmed that commitments on portfolio investment are an issue of mixed competence between the EU and Member States. This relates to all investments not made with an intention to participate in the management of the business in which that investment is made, and which are usually investments (as an indication) of less than 10 per cent of the shares (§227). The ECJ added that:

in order for the European Union to have exclusive competence in the field of non-direct foreign investment, conclusion of the agreement would have to be capable of affecting EU acts or altering their scope. As that is not the case, the Court concludes that the European Union does not have exclusive competence. It has, on the other hand, a competence shared with the Member States. (ECJ 2017a, p. 2)

This conclusion also extends to the rules relating to exchange of information, and to the obligations governing notification, verification, cooperation, mediation, transparency and dispute settlement, as regards non-direct foreign investment (that is, portfolio investment). Furthermore:

the regime governing dispute settlement between investors and States also falls within a competence shared between the EU and the Member States. Such a regime, which removes disputes from the jurisdiction of the courts of the Member States, cannot be established without the Member States' consent. (ECJ 2017a, p. 2)

It follows that the FTA can, as it stands, be concluded by the EU and the Member States jointly. This means provisions relating to the EU's Investment Court System (ICS) proposed by the Commission in FTAs, such as in the Comprehensive Economic and Trade Agreement (CETA) with Canada or the EU-Vietnam FTA must be ratified by all Member States separately 'in accordance with their respective constitutional requirements' (Article 218 §8 TFEU).

TERMINATION OF EXISTING BILATERAL INVESTMENT TREATIES

Some legal experts have expressed surprise that the ECJ also ruled, in contradiction with the Opinion of Advocate General Sharpston (ECJ 2016b), that the EU can oblige Member States to terminate their bilateral investment treaties (BITs)—

which cover investment protection—signed previously with Singapore. Twelve BITs cover 13 EU Member States: Belgium, Bulgaria, the Czech Republic, France, Germany, Hungary, Latvia, Luxembourg, Netherlands, Poland, Slovakia, Slovenia and the United Kingdom (UK) (UNCTAD 2018).

The Opinion states:

When the European Union negotiates and concludes with a third State an agreement relating to a field in respect of which it has acquired exclusive competence, it takes the place of its Member States. It has been undisputed since the judgment of 12 December 1972, *International Fruit Company and Others* (21/72 to 24/72, EU:C:1972:115, paragraphs 10 to 18), that the European Union can succeed the Member States in their international commitments when the Member States have transferred to it, by one of its founding Treaties, their competences relating to those commitments and it exercises those competences. (Section 248 of the Opinion)

However, a question remains regarding when these BITs must be terminated, and with respect to the ISDS mechanism in these agreements. Do they have to be terminated as soon as the provisional ‘entry into force’? Or only after the full ‘entry into force’? The ECJ says that the protection of investment is of exclusive competence; however, it also says that the dispute resolution is of shared competence. One could argue that the value of the protection without an effective means of redress is seriously diminished. In this situation, it would make sense to terminate existing BITs only when the FTA had entered into force fully; that is, when all 38 national and regional parliaments had ratified the agreement.

FUTURE STRUCTURE OF TRADE DEALS UNDER DISCUSSION

Opinion 2/15 will open a period in which Member States and the European Commission will think harder about the structure of future FTAs and how to ratify them effectively while ensuring sufficient democratic legitimacy.

The European Commission itself remains careful, stating on the day the ECJ issued the Opinion, that it ‘will now carefully assess and analyse the opinion of the Court and will continue engaging with the European Parliament and Member States on the way forward’. EU Trade Commissioner Cecilia Malmström first tweeted: ‘About the ECJ opinion on the Singapore trade agreement: This gives us very welcome & much-needed clarity about how to interpret EU Treaties’. She seemed a bit more optimistic later in the day: ‘Opinion should put us on solid footing for the future. I look forward to working with governments & European Parliament to define way forward’ (Malmström 2017).

The European Commission later managed to get EU Member States to split the agreements (concluded and future) into two parts: one covering the traditional

trade issues which the ECJ had confirmed were of full exclusive competence and another covering the investment protection section (including the protection of FDI, despite the ECJ admitting that it was of exclusive competence). The Council took a certain time to accept the European Commission's proposal for this new architecture. In the conclusions of its meeting (on 22 May 2018), the Foreign Affairs Council (Trade) took 'note of the Commission's intention to recommend to splitting between separate agreements provisions related to investment, which would require approval by the EU and all its Member States, and other trade provisions falling under the exclusive competence of the EU' (Council 2018a).

On the same day, the Council accepted therefore that i) the EU-Japan Economic Partnership Agreement (EPA) (which on the day of conclusion included only trade-related issues) could be considered as an EU-only trade deal, ii) that the EU-Singapore FTA would be split into two parts, iii) that the future EU-Australia FTA and EU-New Zealand FTA would be EU full exclusive competence, since the European Commission, in a first phase, did not ask for a mandate to negotiate investment protection. On the other hand, the Council noted that the Association Agreements, depending on their content, should be mixed. An EU Association Agreement is a treaty between the EU, its Member States and a non-EU country that creates a framework for co-operation between them. It covers areas beyond trade like the development of political, social, cultural and security links. The legal base for the conclusion of the association agreements is provided by art. 217 TFEU: 'The ones that are currently been negotiated, such as with Mexico, Mercosur and Chile will remain mixed agreements' (Council 2018b).

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PART 2

21ST CENTURY BILATERAL NEGOTIATING CHALLENGES

7

GLOBAL VALUE CHAINS

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ABSTRACT

A feature of international economic relations in the twenty-first century is the increasingly fine levels of specialisation within global value chains (GVCs). The emergence of GVCs has centred especially on Europe and East Asia, largely bypassing Australia. This chapter argues that an Australia-European Union (EU) Free Trade Agreement (FTA) promoting deep integration could stimulate Australian participation in EU-centred value chains and provide a possible link between EU and East Asian chains. GVC participation is closely related to the more general phenomenon of business-to-business (B2B) trade, and services value chains are becoming increasingly important. We do not address these phenomena directly, but do emphasise that a prerequisite for GVC participation is low cost of international trade, which is likely to involve efficient service activities. For Australia, distance and high trade costs have deterred fine degrees of specialisation in areas where Australia's comparative advantage has been less pronounced than wool, coal or minerals. Nevertheless, Australia has produced a variety of world-class companies, and in the twenty-first century, the tyranny of distance is being neutered by information and communications technology innovations that make real-time communication inexpensive. Following a quantitative overview of Australia-EU trade, this chapter analyses the role of an Australia-EU FTA from the perspective of GVC participation, infrastructure improvements and servicification. A final section integrates these interconnected themes.

INTRODUCTION

A feature of international economic relations in the twenty-first century is the increasingly fine levels of specialisation within global value chains (GVCs). The emergence of GVCs, which are more commonly regional rather than global (Johnson & Noguera 2012), has centred especially on Europe and East Asia, and has largely bypassed Australia. This chapter argues that an Australia-European Union (EU) free trade agreement (FTA) promoting deep integration could be a catalyst for Australian participation in EU-centred value chains (and a possible link between EU and East Asian GVCs), and that this would be a win-win outcome. The reduced cost of international trade is a prerequisite for such an outcome, which is as likely to involve service activities as merchandise trade. It is noted that GVC participation is closely related to the more general phenomenon of business-to-business (B2B) trade, and that services value chains are becoming increasingly important. However, we do not address B2B phenomena directly.

On the policy front tariff protection to low levels in the major trading nations. Since the establishment of the WTO in 1995, the policy focus has shifted to more difficult areas of trade negotiations. While the WTO has had some successes—for instance, the Information Technology Agreement (ITA) and the Trade Facilitation Agreement (TFA) within the Doha Development Agenda (DDA)¹—it is generally seen to have fallen short in multilateral trade negotiations (as reflected in the never-ending DDA). The twenty-first century focus (at least with respect to trade in goods) has shifted from the WTO to the World Customs Organisation and to regional or bilateral trade agreements.

In the 1980s, Australia belatedly joined the move to tariff elimination, but it has largely failed to participate in modern GVCs. This can be explained by history and distance. Characterisation of the Australian economy as ‘a farm on top of a mine’, is simplistic, but captures the essence of the country’s twentieth-century economy. When other high-income countries pursued GATT-led trade liberalisation, Australia remained aloof, relying on primary product exports and nurturing import-substituting industries behind high protective barriers (Pomfret 2015). The negative consequences of this strategy were postponed by the minerals boom in the 1960s, but were clear by the 1970s. Substantial reforms were undertaken between 1983 and 2003, when Australia was once again saved from the need for further reform by a resource boom. One legacy of this history was the dominance of the manufacturing sector by uncompetitive industries with large

1 The 82 participants in the ITA, including the EU and Australia, have removed tariffs and taxes on a specified large range of IT-related goods. The TFA that entered into force in 2017 contains provisions for expediting the movement, release and clearance of goods, including goods in transit, and sets out measures for effective cooperation between customs and other appropriate authorities on trade facilitation and customs compliance issues. Both agreements clearly support GVC participation.

plants in politically sensitive locations, most notably the car and steel industries. Reform of communications was also hampered by the strength of legacy public enterprises (for example, Qantas Limited and Telstra Corporation), even after these companies were privatised in the 1990s.

Distance and high trade costs deterred fine degrees of specialisation in areas where Australia's comparative advantage was less pronounced than wool, coal or minerals. Yet, Australia has produced world-class companies in a variety of areas. In mining, unlike automobiles, the biggest operators are not foreign-based transnationals: both Broken Hill Proprietary Limited (BHP) and Rio Tinto Zinc (RTZ) have Australian origins, and some of the country's wealthiest families owe that wealth to mining. Where transport costs are less relevant, Australian entrepreneurs have created global giants: in media services (for instance, Rupert Murdoch and Kerry Packer); in retail services (Westfield²); or infrastructure financing services (Macquarie Group³). In the twenty-first century, some small consumer-goods companies with niche products have succeeded in going global (e.g. Billabong, Rip Curl and Aesop⁴), as have internet-based companies such as Real Estate Advertising Group (REA).⁵ Not one of these companies is in a complex GVC, but they illustrate that in the twenty-first century the tyranny of distance is reducing due to innovations in information and communications technology (ICT) that render real-time communication inexpensive. Air-based connections are also set to improve. In 2018, the first non-stop passenger flights between Australia and Europe began to operate with Qantas' 787 Dreamliner.⁶

The next section will provide a quantitative overview of Australia-EU trade. The remainder of the chapter will consider the role of an Australia-EU FTA

2 Westfield's flagship European malls are in London. Westfield Milano, scheduled to open in 2019 with Galeries Lafayette as anchor, will be Italy's largest shopping centre.

3 Macquarie's EU holdings include Condor Ferries (UK-France), the Baltic-2 wind farm (in German waters) and power stations in the UK. The group's acquisition of the UK's Green Investment Bank in 2017 faced criticism in terms of the 'vampire kangaroo', based on its 10-year ownership of Thames Water, which had been linked to reaping profits at the expense of poor service (ironically, the most vocal critic was Rupert Murdoch's *Sunday Times*).

4 Billabong and Rip Curl each has stores in seven EU Member States; the third big surf wear company, Quiksilver, was founded in Australia but is now based in California.

5 REA operates Australia's leading residential and commercial property websites, realestate.com.au and realcommercial.com.au, as well as European sites casa.it, atHome.lu and immoRegion.fr

6 EU-Australia negotiations on a comprehensive air transport agreement aim at a reciprocal opening of market access within a framework that ensures fair competition and high safety standards, security and environmental protection. Agreements that the European Commission negotiates on behalf of the EU Member States do not limit themselves to 'open skies' models entailing the mere opening up of markets; the EU model also seeks to establish processes of airline ownership liberalisation and regulatory convergence in areas such as safety and security, competition, environment, passenger protection and labour.

from the perspective of GVC participation, infrastructure improvements and servicification. Improved infrastructure, both physical and ICT-based, has been both the cause and result of falling costs in international trade. The rise of trade in services (and stimulus of some non-traded services) is in part driven by the role of services in GVCs. A final section integrates these interconnected themes.

AUSTRALIA-EU TRADE⁷

Australia-EU trade remains dominated by relations with the original six Member States (Belgium, France, Italy, Luxembourg, Netherlands and West Germany) and the United Kingdom (UK). However, a striking feature has been the rapid increase in trade between Australia and some Eastern European countries that joined the EU in 2004. Analysis of these new EU members' trade with Australia highlights intra-EU regional value chains as a pathway by which new EU members rapidly become exporters of manufactured goods such as cars. Thus, the 2004 EU enlargement benefited Australia by providing cars assembled in Eastern Europe by Volkswagen (VW), Peugeot and General Motors (GM), cars that aligned with many Australian consumer preferences and budgets (Pomfret & Sourdin, 2017). In addition, rapid economic growth in Eastern European markets provided markets for Australian exports. Australian exports to the EU nevertheless remain concentrated in a handful of primary products.

Concentration in primary products explains why the value of Australian exports to the EU soared in the first decade of this century and then fell by almost 40 per cent between 2010 and 2015 as commodity prices dropped. Australian imports from the EU have been more stable, but are associated with a widening bilateral trade deficit. Despite the domination of primary products, Australia's trade patterns have been changing; the share of manufactured goods in the Standard International Trade Classification (SITC) 5-8 gradually increased from about one-quarter in 1990 to two-fifths in 2015, with exports of medical equipment especially strong (Pomfret & Sourdin 2016). Australian imports from the EU are dominated by manufactured goods.⁸

Part of the reason why EU countries are considered attractive trade partners is that the costs of international trade between Australia and EU countries have remained low relative to trade costs between Australia and other countries. This is an issue to which we will return in a further section of this chapter.

⁷ Pomfret and Sourdin (2016) contains more detailed data on Australia-EU trade since 1990.

⁸ In 2015, over half of Australian imports from the EU fell into four Harmonized System (HS) 2-digit categories: 84 nuclear reactors, boilers, machinery and mechanical appliances; 85 electrical machinery and equipment and parts; 87 vehicles other than railway or tramway rolling-stock; and 30 pharmaceutical products.

GLOBAL AND REGIONAL VALUE CHAINS

International value chains have a long history. The European industrial revolution centred on a textile trade that used cotton grown in the United States (US) and harvested with African labour. The phenomenon of production coordinated across national borders, rather than an arms-length trade in intermediate goods, is more modern. In the 1960s, Fairchild (later National Semiconductor) offshored the assembly stage of semiconductor production from the US to Singapore. The 1965 US-Canada Autopact created a cross-country integrated car industry in North America. By the 1970s, the rapid growth in exports of clothing, footwear, travel goods and other labour-intensive manufactures from the newly industrialising Asian economies was often coordinated by stores or buying houses in high-income countries. These sectors—electronics, cars, clothing and footwear—remain at the heart of GVCs, but particularly since the late 1980s, the extent and nature of GVCs have evolved.

GVC measurement is hampered by definitional and data difficulties. We can recognise GVCs by the fragmentation of production across national borders and explain the phenomenon by the falling costs of international trade and communications, permitting finer international division of labour. However, a precise definition is difficult. Conceptually, the best way to capture the phenomenon would be through input-output tables (for example using the Trade in Value-Added (TiVA) data described in chapter 2). Such evidence suggests that the GVC phenomenon emerged in the late 1980s and accelerated after the mid-1990s. The input-output evidence also suggests that GVCs are predominantly regional. The phenomenon is strongest in East Asia, followed by Europe and then North America. GVC participation has been conspicuously absent from other parts of the world. The headquarter firms that control brands and marketing of final products are located in high-income countries, while physical production is increasingly concentrated in a handful of emerging economies.

Empirical work based on input-output tables is hampered by their aggregation level, which is poorly suited to capturing the fine levels of specialisation within many GVCs. An alternative approach to measurement, developed by Prema-Chandra Athukorala, calculates:

- the share of parts and components in a country's international trade and
- the concentration of a country's trade flows in the sectors most closely associated with GVCs—motor vehicles, electronic goods and textiles clothing and footwear, which he refers to as 'network goods' (Athukorala 2010, 2014).

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	Value (X+M)		Exports (share)		Imports (share)	
	2015	2016	2015	2016	2015	2016
Australia	28	26	0.10	0.09	0.13	0.13
Austria	55		0.23		0.20	
Belgium	66	67	0.10	0.10	0.12	0.12
Bulgaria	6	6	0.18	0.18	0.14	0.14
Croatia	4	4	0.21	0.20	0.13	0.12
Cyprus	<1	<1	0.05	0.10	0.09	0.08
Czech Republic	88	91	0.35	0.34	0.32	0.32
Denmark	23	23	0.17	0.17	0.17	0.17
Estonia	3	3	0.15	0.15	0.14	0.13
Finland	16		0.14		0.19	
France	181	187	0.20	0.21	0.22	0.22
Germany	460	466	0.22	0.22	0.23	0.22
Greece	4	4	0.09	0.09	0.09	0.10
Hungary	61	62	0.37	0.36	0.36	0.35
Ireland	17	16	0.07	0.07	0.14	0.13
Italy	129	130	0.20	0.20	0.16	0.15
Latvia	2	2	0.10	0.11	0.12	0.12
Lithuania	5	5	0.14	0.15	0.13	0.13
Luxembourg	4	4	0.17	0.17	0.13	0.14
Malta	1	1	0.31	0.25	0.15	0.13
Netherlands	102		0.16		0.18	
Poland	76	77	0.25	0.26	0.22	0.22
Portugal	17	18	0.20	0.20	0.18	0.18
Romania	32	36	0.34	0.36	0.26	0.26
Slovakia	37	40	0.24	0.24	0.33	0.35
Slovenia	9		0.22		0.19	
Spain	88	90	0.17	0.18	0.23	0.23
Sweden	46	1	0.20	0.02	0.20	0.02
UK	181	175	0.20	0.22	0.19	0.18
EU-28	620		0.20		0.19	

Notes: value in billions of US dollars, share as a percentage of manufactured imports and exports.

Table 7.1: Parts and components trade, Australia and EU Member States, 2015 and 2016.

Source: Authors' calculations from UN-COMTRADE data.

These measures highlight the extent to which GVC production is dominated in East Asia by the People's Republic of China (China), Hong Kong, SAR, the Republic of Korea (Korea), Thailand and Malaysia, and in Europe by the Czech Republic, Poland, Hungary and Slovakia (Pomfret & Sourdin 2017).⁹ The driving force is a combination of differing factor endowments and prices between potential production locations and headquarter countries, and the reduced costs of organising production on a regional or global scale.

⁹ For more detailed results see Pomfret and Sourdin (2014). The method is described in Athukorala (2010, 2014). Although useful indicators, these measures are rough approximations. Much trade in parts and components is arms-length B2B trade or replacement sales to consumers rather than fragmented production along a GVC. Also, GVCs exist in many sectors beyond the three main network goods sectors.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	Value (X+M)		Exports (share)		Imports (share)	
	2015	2016	2015	2016	2015	2016
Australia	36	38	0.14	0.12	0.17	0.19
Austria	39		0.15		0.16	
Belgium	93	101	0.14	0.15	0.16	0.17
Bulgaria	4	4	0.07	0.07	0.13	0.13
Croatia	2	3	0.08	0.08	0.11	0.13
Cyprus	1	1	0.24	0.06	0.13	0.17
Czech Republic	51	55	0.23	0.24	0.14	0.15
Denmark	12	13	0.05	0.05	0.12	0.13
Estonia	2	3	0.08	0.08	0.13	0.14
Finland	11		0.09		0.14	
France	196	204	0.25	0.25	0.21	0.22
Germany	447	455	0.25	0.25	0.17	0.17
Greece	5	5	0.14	0.14	0.10	0.11
Hungary	31	32	0.22	0.22	0.16	0.16
Ireland	24	23	0.06	0.04	0.28	0.29
Italy	95	102	0.12	0.12	0.15	0.16
Latvia	2	2	0.08	0.08	0.13	0.14
Lithuania	3	4	0.07	0.07	0.12	0.14
Luxembourg	5	5	0.13	0.13	0.27	0.26
Malta	1	1	0.08	0.07	0.18	0.25
Netherlands	56		0.08		0.11	
Poland	45	52	0.15	0.17	0.13	0.15
Portugal	16	17	0.16	0.16	0.19	0.20
Romania	17	19	0.20	0.20	0.13	0.13
Slovakia	33	36	0.31	0.32	0.19	0.19
Slovenia	9		0.20		0.20	
Spain	103	111	0.27	0.29	0.20	0.21
Sweden	36		0.15		0.17	
UK	175	178	0.18	0.22	0.20	0.19
EU-28	468		0.18		0.11	

Notes: value in billions of US dollars, share as a percentage of manufactured imports and exports.

Table 7.2: Network trade, Australia and EU Member States, 2015 and 2016.

Source: Authors' calculations from UN-COMTRADE data.

Tables 7.1 and 7.2 provide data on Athukorala's above two measures for EU members and for Australia in 2015 and, where available, in 2016. The largest EU traders in parts and components are the four largest economies (Germany, France, the UK and Italy). However, comparison of the share of parts and components in a country's trade in manufactured goods gives a different picture, with Hungary, Romania, Poland, Malta, Slovakia and Austria having larger shares than Germany (see Table 7.1). The picture is one of the more recent EU Member States exploiting their comparative advantage, largely derived from lower wages, by participating in international value chains.

The parts and components measure suggests that EU Member States participate in GVCs; about one-fifth of the EU's trade with non-members in manufactured goods in 2015 consisted of parts and components. However, the

share of these goods was larger in Germany's trade, and was much larger in Hungary (36% of exports, 35% of imports); the Czech Republic (35% of exports, 32% of imports); Romania (36% of exports, 26% of imports); Slovakia (24% of exports, 35% of imports); or Poland (26% of exports, 22% of imports). This indicates that regional value chains are more significant than GVCs for European countries. By contrast, the share of parts and components in Australia's trade in manufactured goods (9% of exports, 13% of imports) indicates very limited participation in GVCs.

The share of 'network goods' in trade in manufactures (see Table 7.2) is less useful in the current context. The important role of cars is reflected in the high values for Slovakia and Spain, which are major assembly locations within the EU car industry, with electronics and apparel being less important in EU value chains than in East Asia. However, Table 7.2 does suggest that Australia's low values for GVC indicators (see Table 7.1), are not simply driven by the composition of its trade in manufactured goods. That might be the case if Australia specialised to a much lesser degree in network goods, but the shares in Table 7.2 for Australia are the same as for Italy, equal seventeenth among the 29 countries listed.

AUSTRALIAN PARTICIPANTS IN GVCs

Australia has not been a major participant in GVCs but it has been affected by the phenomenon. This is clearest in the car industry. Australian car assembly—always heavily protected and artificially competitive since the 1940s—became unsustainable when faced with competition from imported cars assembled in GVCs. Some skilled workers from Melbourne-based Toyota and GM factories found alternative uses for their skills at the nearby Fisherman's Bend facility making components for the aerospace industry at Boeing Aerostructures Australia.¹⁰ Other car-making facilities may remain as suppliers along GVCs managed by headquarter firms such as GM. In 2017, Australia's local GM brand, Holden, was supplied by cars assembled in Korea, Mexico or Poland, although the GM Opel Polish plant was sold to Peugeot during the year.

Australian manufacturers have found niches in GVCs, although the evidence is anecdotal and does not appear profuse. Since introducing its LaunchPad package of a comprehensive range of products and support services in Adelaide in 2012 and in China in 2014, the Detmold Group has supplied high-quality end-to-end packaging for a multinational food company, responding rapidly

10 Boeing Aerostructures Australia employs 1200 people and includes design and engineering capability, research and technology departments, as well as manufacturing wing flaps for the Boeing 787 and components for the 777.

to specific requests regarding design, prototyping, sample-making, artwork and printing. With its customised equipment and software, it can deliver samples with actual production materials minutes after design concepts are completed.¹¹ Australian Numerical Controls and Automation (ANCA) multi-axis grinding machines deliver integrated solutions for automated factories. In a Japanese factory, ANCA machines are fed parts from a separate conveyor line, reading a linked radio-frequency identification chip. The program automatically generates the required grinding program with tolerance and corrections applied as required (CSIRO 2016). Thus, ANCA's Machine Management Suite allows for remote control of current operations with real-time production monitoring, as well as data collection for future process enhancement or predictive maintenance activities—the initial trade in intermediate goods is followed by trade in services.

It is noteworthy, however, that these three examples (Boeing, Detmold and ANCA) are not far removed from traditional trade in intermediates, although they do involve collaboration across boundaries. In these examples, the primary partners are in the US, China and Japan, but there is no reason why EU headquarter companies or other GVC coordinators could not involve Australian firms with valuable skillsets.

INFRASTRUCTURE AND TRADE COSTS

For Australian firms and individuals to benefit from GVC opportunities, international connectivity is essential. Australia is far from the EU and from East Asia but the tyranny of distance is much reduced in the twenty-first century, to the extent that Australia by culture, recent economic history and geography can become part of a triangle with Europe (the prime source of Australian culture and international connections from 1788 to the mid-twentieth century) and East Asia (the major trading partner and source of immigrants in recent decades).

Trade costs, defined as the additional cost of trading internationally relative to trading domestically, are difficult to define (Pomfret & Sourdin 2012). They consist not only of money and time costs, but also lack of reliability and certainty, and they occur 'behind' as well as 'at' the border. The relative importance of the different aspects varies by transaction. A common feature of GVCs is that they depend on just-in-time reliable delivery to minimise inventory costs at each stage of production.

11 Since the introduction of the LaunchPad concept, Detmold has experienced 50% growth and a large increase in new clients (CSIRO 2016, p. 30; based on Food Innovation Australia Limited, *Celebrating Australian Food and Agribusiness Innovations*, 2016). For more details of the LaunchPad package, see <https://www.detmoldgroup.com/innovation/about/>

Money trade costs have fallen steadily in recent decades. Measured by the difference between free-on-board (FOB) values at the port of departure for exports to Australia and cost-insurance-freight (CIF) values at the Australian port of arrival, Australian trade costs fell continuously and substantially from 8 per cent of the FOB value of imports in 1990, to less than 5 per cent in 2007. This was despite the huge increase in the price of oil after 1998 (Pomfret & Sourdin 2011). This is consistent with the longer-term trend in Hummels (2007), who identified containerisation for sea transport and the jet engine for air cargo as major drivers of a long-term decline in trade costs. In the twenty-first century, the trends have been reinforced by improved logistics.

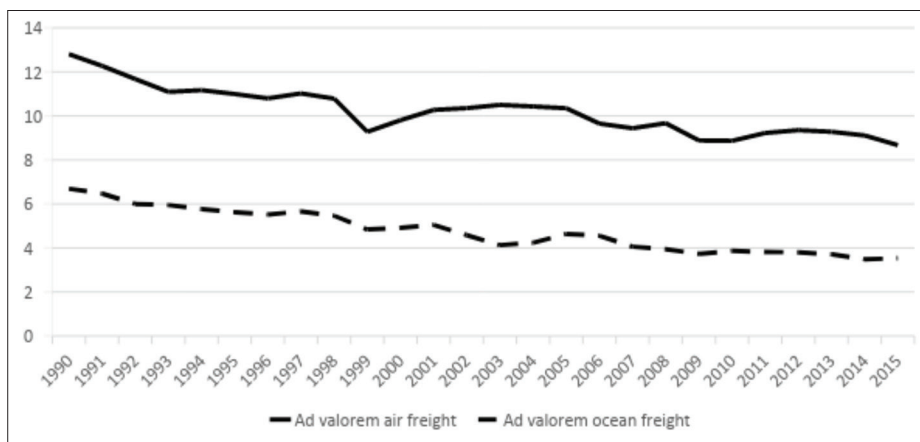
Trade costs on Australia's imports from the EU followed the global pattern between 1990 and 2014 for both sea and air transport (see Figure 7.1). Maritime trade costs between the EU and Australia are slightly higher than the average for all Australian trade partners, which is unsurprising given the distance, but air freight trade costs have been slightly lower for imports from the EU than the average for all Australian imports. A striking feature at the country level is the rapid convergence of trade costs from some Eastern European countries that joined the EU in 2004; average ad valorem trade costs on Australian imports from the Czech Republic (14%), Hungary (8%), Poland (10%) and Slovakia (11%) in 1995 were well above the EU average; by 2007, these figures had fallen to 8, 4, 6 and 3 per cent, respectively (Pomfret & Sourdin 2016). For Hungary and Slovakia, post-accession trading costs with Australia are very low for landlocked countries on the other side of the world.

In contrast to research based on the detailed data available to calculate the CIF-FOB estimates of monetary trade costs, there has been little research on the time costs of Australian trade. Time taken may have changed little in recent decades, but modal shifts—as airfreight steadily becomes more important and sea freight less so—must be to the benefit of Australia-EU trade. The increased efficiency of freight forwarders and others has surely reduced the time and increased the reliability of airfreight between the EU and Australia.

The importance of uncertainty has been emphasised by Büge (2013) and Handley and Limao (2017). In the FTA context, Lakatos and Nilsson (2017) show that once the EU-Korea FTA (KOREU) had been agreed, the effect on bilateral trade began years before the FTA was formally implemented. This was because the FTA credibly promised to 'enhance predictability and stability of the trade policy environment in the two markets' (Lakatos & Nilsson 2017). They relate this predictability not just to traditional trade policy instruments, but also to 'provisions on issues ranging from services and investments; competition and

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

(a) EU exporters



(b) All exporters

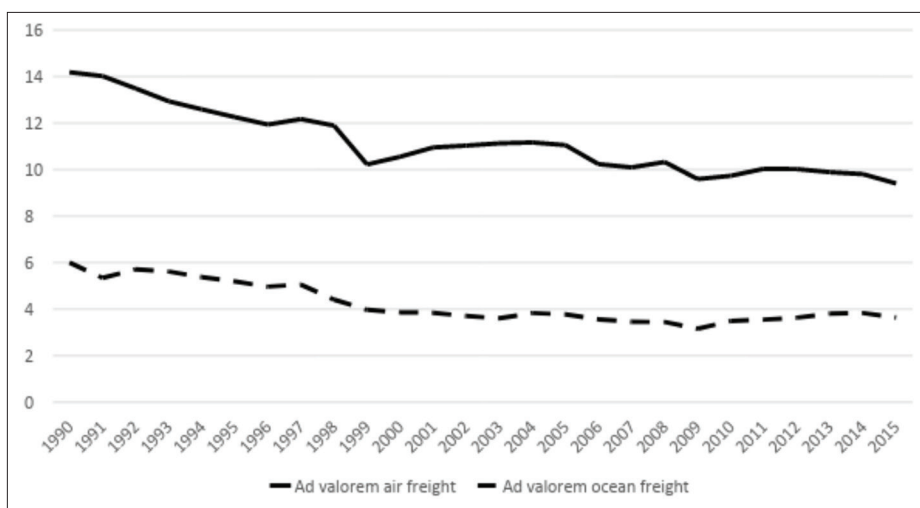


Figure 7.1: Costs of international trade, percentage of values of Australian merchandise imports.

Source: Pomfret and Sourdin (2016 p. 24).

government procurement to intellectual property rights’ and highlight the ‘specific focus on the automotive, pharmaceuticals, medical devices and electronics sectors’ (Lakatos & Nilsson 2017). In sum the KOREU, the deepest integration agreement between the EU and a non-neighbouring country (until more recent negotiation of the EU-Canada Comprehensive Economic and Trade Agreement [CETA] and the EU-Japan Economic Partnership Agreement [EPA]) provided the greatest benefit in areas of GVC significance by promoting predictability and stability across a range of ‘deeper integration’ areas.

SERVICIFICATION

GVC niches are not always easily observable. One feature is the increased importance of services when trade in value-added is calculated. At a minimum, services inputs are needed to coordinate production along GVCs; Gereffi and Fernandez-Stark (2010) describe services as the glue of GVCs, and the OECD (2014), Kommerskollegium (2012) and Lodefalk (2015, 2017) provide evidence of the increasing share of services in trade in value-added, and discuss the implications for trade policy. GVC production is also likely to increase demand for business services associated with ICT, freight forwarding and tracking, legal services and so forth.

Many of these activities may not even appear to be traded, as the service is rendered to a local participant in the supply chain or is provided online. Thus, GVC participation may increase demand for domestic services that do not show up as international trade. This highlights the importance of the ease of doing business in GVC-participating countries, including access to high-quality services. It also reveals the importance of deep integration, so that services can be provided readily across national boundaries. Both aspects are illustrated within the ASEAN Economic Community (AEC), where some small firms, especially from Singapore, Thailand and Malaysia, filled niches as the AEC emerged in 2015 and some new firms were ‘born global’.¹²

Services industries are themselves also fragmenting into value chains, generating new opportunities for cross-border trade in services intermediates. Stephenson and Drake-Brockman (2014) identify the biggest contributors to the growth in services value chains as knowledge-intensive business services. These

12 The *ASEAN Investment Report 2016* (pp. 147-48) provides case studies of small and medium enterprises that operated internationally from the start. Some opened offices in several countries to have face-to-face interaction with clients (e.g. the ADI group, which provides contract management and payroll services from offices in Indonesia, Singapore and India). For others that operate entirely online, however, location is irrelevant as long as ICT connectivity is good.

include telecommunications, IT, research and development, financial, legal, accountancy, management consultancy, architecture, engineering, technical, advertising, market research, media, energy, environmental, and other professional and business-related services. Drake-Brockman (2018) and Drake-Brockman and Stephenson (2017) analyse the world trade implications of this emerging phenomenon, the latter focusing on tourism as well as the above-mentioned business-related services. Transport services are also being broken down into value chains. For example, the land bridge rail services between China and the EU (developed since 2011) have involved rail companies such as Deutsche Bahn and freight forwarders. As an example, the Austrian-based Far East Land Bridge assembles containers for the block trains; couriers, such as the German-headquartered DHL provide consolidation services for customers with less than a full container-load to ship between Europe and China. The joint inputs from these and many other service providers have been critical to the land bridge's commercial success.¹³

GVCs and cross-border B2B trade flourish with deeper integration and without clear national boundaries. This is not just about services or trade in goods, but also concerns investment, short-term labour mobility and connectivity, broadly defined. Arguably, the EU Schengen countries, as well as Australia and New Zealand, through their Closer Economic Relations Trade Agreement (ANZCERTA) have led the way in pushing these boundaries. Further, Australia and many EU countries recognise the importance of maintaining leading-edge ICT activities and supporting this with appropriate government policies.¹⁴

CONCLUSION

The rise of GVCs is changing the nature of international trade. Traditional trade in minerals and farm products still dominates Australian exports, and the leading service exports (education and tourism) can be analysed in national terms. GVC trade is about firms and individuals identifying niches in which they can compete successfully in an international sphere. Australia has not been a major participant in

13 The main European terminus is at Duisburg, a multi-modal logistics centre with rail, river, road and air services, where over 300 companies operate.

14 Vazquez and Winkler (2017) exploit the variation in the timing of telecommunications reforms in EU countries to identify the impact on workplace arrangements; they find a significant increase in employment after reforms were initiated, accompanied by shifts towards part-time and more flexible working arrangements.

GVC trade, but there is some anecdotal evidence of Australian firms participating in GVCs. Falling trade costs are likely to enhance this number.¹⁵

The state can provide a favourable framework in which to do business and trade across borders, but the nationality of the goods or services that cross borders is increasingly difficult to specify and the sources of narrow comparative advantage difficult to identify. Thus, it still makes some sense to identify countries as specialising in labour-intensive or skill-intensive areas, but it is difficult to explain why companies such as Aesop, the Body Shop or Diptyque are headquartered in Australia, the UK or the EU.¹⁶

What are the implications for an Australia-EU FTA? Old-style trade negotiations are relevant to a diminishing number of products (essentially, agriculture) because very few tariffs or quantitative restrictions encumber trade between Australia and the EU. Any implementation issues in these areas can be addressed appropriately through the WTO dispute resolution mechanism. A country's participation in GVCs depends on the ease of doing business and crossing international borders, or on what is usually referred to in trade policy contexts as 'deep integration'. Twenty-first century FTAs go beyond tariffs, as in KOREU that entered into force in 2015, CETA that entered into force provisionally in September 2017 and the Japan-EU EPA signed in July 2018.

A meaningful Australia-EU FTA will focus on deeper integration. This should not be a huge challenge, as both parties have relevant experience—the EU through the single market program, Schengen and the Eurozone, and Australia through ANZCERTA, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) with 10 other countries as well as the negotiations on the Regional Comprehensive Economic Partnership (RCEP) with 14 Asian countries. How successful such FTAs will be in promoting GVC participation will, of course, also depend on the quality of infrastructure and the ease of doing business with the FTA partners.

15 Athukorala and Talgaswatta (2016, p. 64), using similar methods, conclude that 'Australia is still a minor player in production sharing' but found examples in aircraft parts, earth-moving and mineral-processing machines, medical equipment and instruments for chemical analysis. They remark on Australia's absence from the major GVC sectors of electronics and apparel and minor participation in automobile GVCs. Drake-Brockman (2014) reach similar conclusions by a different path, and emphasise possible niches for Australian services suppliers.

16 Ownership is, however, subject to change. In 2017, The Body Shop, like Aesop, is majority-owned by the Brazilian company Natura.

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8

GOVERNMENT PROCUREMENT

Bernard Hoekman

ABSTRACT

Procurement is an important element of the discussions around an Australia-European Union (EU) free trade agreement (FTA), given that Australia uses public purchasing to support small and medium-sized enterprises, indigenous communities and Australian industry more generally. Procurement liberalisation is more complex than tariff reduction or removal, as it involves regulation and may affect specific sectors. This chapter briefly discusses procurement policy in Australia and the EU and provides an overview of the content and approach taken in trade agreements towards public procurement. It argues that the implications of the Australia-EU FTA for procurement practice will be limited given Australia's decision to join the WTO Government Procurement Agreement, along with existing trade agreements that include procurement and empirical evidence suggesting that trade agreements do not result in major changes in sourcing behaviour by government agencies.

INTRODUCTION

Procurement is an important element of discussions on an Australia-European Union (EU) free trade agreement (FTA). This is a policy area where Australia pursues multiple objectives, as do many other countries. In addition to seeking to ensure the government obtains the best value for taxpayer-provided money when buying products used to provide public goods and services, Australia also has a focus on using public purchasing as an instrument to support small and medium-sized enterprises (SMEs), Indigenous communities and Australian industry more generally. Such procurement favouritism is, in principle, not applied to bids by firms originating in countries, such as Chile,

Japan and the United States (US), with which Australia has signed a preferential trade agreement (PTA) that includes the relevant goods or services procured. This is because the procurement chapters of the PTAs assure national treatment of firms from partner countries for products sourced by government entities that are included in annexes to the respective agreements. Neither do discriminatory policies apply to firms from New Zealand (NZ), which are treated as Australian firms as a result of the Australia and NZ Government Procurement Agreement (ANZGPA).

In general, export politics are a major factor driving the inclusion of procurement in bilateral or plurilateral market access negotiations. In this respect, the political economy of agreeing to commitments on procurement are the same as those for negotiations of trade policy more generally. In all countries there are political incentives for government agencies to ‘buy national’ or ‘buy local’, given that domestic constituencies (taxpayers and voters) prefer to see tax revenues spent on local companies. However, national firms and their workers that can export will have an interest in selling to foreign governments, therefore seeking to place opening up of the procurement market onto the trade negotiation agenda. A quid pro quo exchange of access to government markets may allow the signatories to a trade agreement to avoid policies that restrict foreign competition and implement pro-competitive procurement reforms. This can be welfare- and profit-enhancing, as well as job-creating for productive exporters that can successfully compete for contracts. This is because the greater participation of foreign firms should (in principle) lower prices for the government and increase choice and quality.

Reciprocity is at the core of efforts to liberalise procurement markets through trade agreements, as the loss of a sheltered home market by domestic firms may be offset by an increase in support by exporting firms and industries which anticipate winning tenders opened by trading partners. However, procurement liberalisation is more complex than tariff reduction or removal, as it involves regulatory regimes—the systems that governments put in place to allocate contracts—to ensure that winning bidders are capable of delivering a product or a project; to reduce the scope for collusion or corruption; and to hold firms and procuring entities accountable for performance. How a government procures goods and services, including the decision to ‘make or buy’, is a regulatory decision in the sense that it is a conscious act of social (and economic) ordering (Macdonald 1985). Opening of procurement policy also differs from tariff liberalisation; as the latter is a negative shock for all goods import-competing firms, whereas a reduction in procurement favouritism is negative for the firms with a track record of winning, or with the capacity to win contracts. Whether these are the more efficient firms in the relevant industries or

the better connected ones, the set of negatively impacted firms is likely to be much more concentrated than the set of firms affected by tariff liberalisation.¹

This chapter contains the following sections:

Section 1 briefly discusses procurement policy in Australia and the EU, with an emphasis on elements of the Australian procurement regime that could potentially bias government sourcing away from foreign companies.

Section 2 provides an overview of the content and approach in trade agreements towards procurement. It describes the state of play in this area in the WTO and recent PTAs signed by the EU and Australia. The WTO is relevant in this regard as Australia has engaged in talks to join the WTO GPA, which are expected to be concluded in 2018 and will make it subject to a baseline set of rules and disciplines. The same is true for PTAs that both parties have recently entered into and that include procurement disciplines.

Section 3 discusses the evidence on the impact of procurement disciplines on the sourcing behaviour of signatory governments, i.e. whether trade agreements are effective instruments to enhance access to markets.

Section 4, in lieu of a conclusion, discusses some options that could be considered to complement standard quid pro quo market access bargaining, with a view to improving procurement processes and outcomes.

STATE OF PLAY IN AUSTRALIA AND THE EU

Australia

The procurement market in Australia is significant in size, although smaller than other countries where the state plays a larger role in the economy. Annual total procurement by the Commonwealth (federal-level) Government was A\$47 billion in the 2016-2017 fiscal year (some €32 billion).² Detailed statistics for the states and territories are not available, but the Australian Government (2017) notes that transfers from the commonwealth to the sub-central governments were some A\$120 billion in 2015-2016. Assuming that 40-50 per cent of this gives rise to procurement, sub-central procurement is at least as large as commonwealth purchasing. Taken together, all government procurement is estimated to be the equivalent of 6.5 per cent of gross domestic product (GDP) (Bosworth 2017).

1 The impact of procurement favouritism depends on a variety of factors, including market structure, the degree of competition and the size of government demand relative to domestic industry supply capacity. See Evenett and Hoekman (2005) for a discussion.

2 <https://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>

Most Commonwealth procurement (87% by value) is allocated in contracts valued at A\$1 million or above, implying that much of federal procurement will be large enough to be of interest to international (EU) firms. According to AusTender—the Commonwealth Government’s procurement information system—15 per cent of federal government procurement by value is allocated to foreign companies. As discussed below, this is a relatively high share in comparison to other OECD countries.³ In part, this reflects the situation that much defence-related equipment is sourced from partner countries. The bias towards foreign sourcing is primarily for goods purchases—some 30 per cent of total commonwealth goods procurement is from foreign companies.⁴ In contrast, over 90 per cent of services are sourced from Australian-based companies. The Australian Government (2017) reports a Figure of 97 per cent. As is true of other high-income countries, services represent the largest share of government purchases—57 per cent in 2015 to 2016 for the commonwealth. The top five categories of commonwealth procurement comprised motor vehicles (26.3%), healthcare (17.1%), business services (12.3%), building, construction and maintenance services (8.8%), and engineering, research and technology-based services (7%). Most public infrastructure contracts are managed by the states, accounting for around one-third of total sub-central procurement. Many procurement contracts are allocated through so-called limited tendering procedures in which there is no open competition. Instead, specific firms are approached. In 2013 to 2014, about 50 per cent of procurement, both by value and by number of contracts, involved limited tendering. Although in principle most procurement should be subject to competitive tendering, the high share of limited tendering reflects a range of exceptions that allow entities to use limited tendering. In part this is also explained by the low threshold of A\$80,000 that applies before international open tendering is required (iTnews 2017).

Bosworth (2017) has carefully analysed Australian procurement policy as of 2015. This research reveals that although the policy focus, and the associated implementing legislation, is on achieving value for money, both the Commonwealth and the States seek to use procurement policy to support local economic activity, especially by SMEs.⁵ Often the policy is implemented by providing increased

3 Data reported in this paragraph were obtained from the Australian Department of Finance. They reflect calls published by government entities and do not represent actual expenditures. As non-corporate Commonwealth entities are required to report notices of their procurement contracts and standing offer arrangements with a value of A\$10,000 or more, the data should give a good sense of the pattern of procurement. The 15 % Figure for foreign sourcing is based on contracts identified by entities as primarily or entirely based outside Australia (Department of Finance 2016b).

4 The AusTender website reports a higher Figure of some 40 % (Commonwealth of Australia 2017).

5 This and the following paragraph draw extensively on Bosworth (2017).

weighting for elements in bids that involve SME participation. SMEs were granted almost one-quarter of all tenders by value and three-fifths of all tenders published in 2015: Australian procurement rules require that at least 10 per cent of all purchases are sourced from SMEs. There is a long-standing policy focus on ensuring that procurement supports industrial policy goals. While not part of procurement policy per se, the Australian Industry Participation (AIP) National Framework commits both the Commonwealth and the States to refrain from discrimination within Australia; namely, to treat all Australian firms equally when implementing policies aimed at increasing AIP in public and private sector investment projects. Since 2010, AIP programs have required bidders for commonwealth procurement contracts above A\$20 million to prepare and implement plans that outline proposed actions to provide Australian suppliers (especially SMEs) with the opportunity to supply goods and services to the project. The aim is to maximise opportunities for Australian industry to participate in all aspects of a project. Since 2014, investment projects exceeding A\$500 million, both public and private, must include the development and implementation of an AIP plan. Some 300 AIPs, with a total value of A\$13.9 billion, were approved between 2010 and 2016. There are three other so-called procurement connected policies: the Indigenous Procurement Policy, the Workplace Gender Equality Procurement Principles, and the Code for Tendering and Performance of Building Work 2016. The first of these accounted for almost 5 per cent of total commonwealth procurement in 2015 to 2016 (Parliament of Australia 2017).

State Governments have their own procurement policies. Bosworth (2017) notes that these have evolved to become more complex and administratively burdensome, reflecting a dynamic in which transparent forms of procurement favouritism, such as price preferences and local content requirements, have largely been replaced by discretionary measures that favour local sourcing through a focus on support for SME participation. This is motivated in part by arguments that procurement procedures and requirements are often difficult for SMEs to comply with and that proactive measures are required to ‘level the playing field’. In the case of New South Wales, the policy framework aims to reduce administrative burdens for SMEs and increase their access to government procurement opportunities. Procuring entities must take reasonable steps to obtain at least one written quotation from a prequalified SME supplier for contracts below A\$1 million and report on the impact of their procurement activities on SMEs. The Victoria Industry Participation Plan (VIPP) encourages bidders for government contracts to use local suppliers. The government can declare specific projects and the associated procurement as strategically significant if valued above A\$250 million, or if the capital costs are at least A\$100 million. In such cases, the government may

establish minimum local content requirements. For example, during 2013-2014, eight projects were declared strategic, with a total value of more than A\$11 billion. Winning bidders committed to an average local content of over 84 per cent (Bosworth 2017).

In South Australia, an Industry Participation Policy (IPP) includes the aim of fostering local jobs, investment, and supplier inputs in its procurement. While this IPP maintains the basic goal of value for money, it encourages consideration of a procurement contract's local economic impact, including impact on local SMEs. For contracts in the A\$4-A\$50 million range (A\$1 million and above in regional areas), bidders must submit IPPs that specify how they will provide full, fair and reasonable opportunities for local SMEs to compete for contracts or participate in projects. In 2014, an Employment Contribution Test (ECT) was added for procurements below A\$4 million in Adelaide and A\$1 million in the rest of the State. This requires entities to determine if the goods or services are available within South Australia and if so, all bidders are to state the number of labour hours associated with the primary contract and any sub-contracts.

In Western Australia, a Buy Local Policy includes price preferences for enterprises that employ or are owned or operated by Indigenous people. Tenders of A\$750,000 and above must have a local content evaluation criterion with a minimum 20 per cent weighting. A minimum local purchasing target of 80 per cent applies.⁶ An IPP must be prepared for all public projects over A\$20 million or where the capital equipment exceeds A\$1 million.

Commonwealth Procurement Rules (CPRs) govern how government entities should go about procuring goods and services. These rules apply to non-corporate Commonwealth entities with a value threshold of A\$80,000 for non-construction procurement (the threshold for construction services is A\$7.5 million). CPRs also apply for 20 prescribed corporate Commonwealth entities (Department of Finance 2016a), for which a value threshold of A\$400,000 applies. The states and territories have their own procurement rules which are broadly parallel with those of the Commonwealth but may be more specific, for example calling for entities to operate through a central purchasing state-level body to capture economies of scale or scope. Such procurement pooling is also pursued by government-funded organisations across states, for example a University Procurement Hub that seeks

⁶ There are two price preferences: the Imported Content Impost (ICI), and the Regional Price Preferences (RPP). The price margins are 10 % for the total cost of goods and services (up to A\$50,000) and 5 % (up to A\$50,000) for 'housing and works' purchases. Chief executive officers can raise these caps on individual procurements where further support to regional businesses offers demonstrated economic benefits (Bosworth 2017).

to aggregate the demands of individual universities to increase buyer power (Accenture 2017).

Revised CPRs were adopted in March 2017. These aim at ensuring that ‘the full benefits of Commonwealth procurement flows to the Australian economy’ and ‘to mitigate the disadvantages faced by Australian suppliers accessing procurement opportunities’ (Parliament of Australia 2017, p. 26). They include:

- requirements that tenders demonstrate the capability to meet applicable Australian standards
- contracts listing these applicable Australian standards
- procuring entities ensuring they ‘make reasonable enquiries to determine compliance’ with the standard(s)
- officials making reasonable enquiries that procurement is carried out considering relevant labour regulations, occupational health and safety, and environmental impacts; and
- for procurements exceeding A\$4 million, officials consider the economic benefit of procurement to the Australian economy; factors to determine whether this is the case include providing skills and training that benefits Australian communities or workers, generating tax revenues, benefiting the environment, and accessing Indigenous businesses or SMEs.

These are all qualitative criteria that leave room for discretion. Satisfying the criteria need not involve discrimination against foreign bidders, which is the view taken by the Australian Government in response to concerns raised by the EU and NZ when the rules were proposed (EU Delegation to Australia 2017).

THE EU

A core dimension of creating a single European market for goods and services is the removal of policies that discriminate between national products and producers and those located in other EU Member States. This non-discrimination (national treatment) requirement also applies to EU Member States when allocating public procurement contracts. A number of specific directives lay out the rules of the game, defining in some detail how EU government entities must behave when undertaking public procurement. These provisions are distinct from those applied by any nation state. The purpose of the directives is to discipline the purchasing practices of government entities and to obtain the best value for taxpayer money. Their aim is not to just improve the efficiency of the public procurement process, but to support the attainment of a single EU market. The basic principles that underpin EU procurement directives include competition, non-discrimination and transparency.

Procuring entities covered by the EU regulatory regime span central government agencies and departments, regional and local authorities, and entities governed by public law. These ‘contracting authorities’ include private operators if more than 50 per cent of funding for a project is public. To prevent discrimination in the awarding of sub-contracts, specific disciplines apply to private entities executing construction contracts for public purposes (Cantore & Togan 2017).

EU procurement directives apply only to contracts above a threshold value. At the time of writing, this was €5.186 million for construction works, €207,000 for central government priority service contracts, and €134,000 for supplies contracts.⁷ Calls for tender for contracts that exceed these value thresholds must be published in the *Official Journal of the European Union* and are posted in the online database, *Tenders Electronic Daily*. This database is an important transparency-promoting mechanism as it gives all operators timely access to information on procurement opportunities. Once procurement processes have been completed and contracts awarded, the database also permits the operators to know the identity of winning firms. EU law requires that all bidders be notified and informed about the outcome of a procurement process.

The EU does not have ‘buy European’ laws or regulations, nor does it have requirements that give preferences to certain types of bidders such as SMEs. The main focus of procurement legislation with respect to SMEs has been to encourage greater effort to ensure that they have the opportunity to participate. This has been done by simplifying procedures and reducing the stringency of eligibility requirements, for example regarding past turnover or financial capacity. Enhancing opportunities for SMEs to participate has included permitting contracts to be divided by the purchasing authorities into smaller lots in order to facilitate sub-contracting and participation of these smaller firms.

Binding disciplines that prohibit discrimination apply only to sourcing from EU Member States, and not to firms originating in third countries, creating the possibility that such discrimination may occur. In practice, the incentives for procuring entities to discriminate against a non-EU country will be weaker than for a sovereign nation state because entities will have to treat firms from the other 27 EU Member States in the same way as they treat national firms. Insofar as a

7 Specific rules apply to utilities (contracts in the water, energy, transport, and postal services sectors) as well as to telecommunications; service concessions; and contracts that concern the acquisition, development, production, or co-production of program material intended for broadcasting by broadcasters and contracts for broadcasting time; arbitration and conciliation services; the purchase, sale, or transfer of financial instruments; employment contracts; and research and development services which do not belong exclusively to or are wholly financed by the contracting authority. See Cantore & Togan (2017).

third country (non-EU) firm has a better offer than a next-best offer from a non-national EU firm, an entity has the incentive to allocate a contract to the lowest or most responsive bidder—even if that is a non-EU firm. Thus, in practice the effect of EU procurement regulation acts to benefit third country suppliers, as well as intra-EU procurement.⁸ The possibility of discrimination remains nonetheless, providing a rationale for explicit disciplines to be incorporated into PTAs or the GPA.

The EU has been willing to make far-reaching commitments in the GPA on procurement as this was already part of the single market. However, it has modulated the commitments it is willing to make to other countries in an effort to maintain reciprocity. Thus, the EU excluded the US from coverage of its GPA services procurement commitments for sub-central governments, as well as contracts issued by many utilities it has scheduled. It has done the same for Canada. The reason, in both instances, was that sub-federal procurement in the two countries was excluded from the GPA (European Commission 2013). An additional factor in relation to the US was its ‘Buy America’ provisions and ‘set aside programs’ for SMEs (Woolcock & Grier 2015).

In negotiating an FTA with the EU (and joining the GPA), an important consideration is proposals that have been made by the European Commission (supported by some EU Member States and the European Parliament) that for contracts exceeding €5 million, the EU procurement rules should be changed. The change would permit EU-procuring entities to discriminate against bidders from countries that are deemed not to offer reciprocity to EU firms (European Commission 2012). These proposals were opposed by a number of EU Member States and were not adopted, but suggestions to move down this track have continued and may be adopted in the future. Such a change in EU procurement rules would not apply to countries with which the EU has already concluded a trade agreement that covers procurement.

PUBLIC PROCUREMENT IN TRADE AGREEMENTS—THE GPA AND RECENT PTAS

The inclusion of government procurement practices in trade agreements is relatively recent. Government procurement was excluded from the original General Agreement on Tariffs and Trade (GATT) in 1947. It was not until the completion of the Tokyo Round of multilateral trade negotiations in 1979 that a multilateral

⁸ In practice, most procurement contracts of EU Member States are awarded to national firms, although the share of foreign suppliers rises significantly if account is taken of contracts won by affiliates of foreign companies.

agreement on government procurement was negotiated—the first version of the GPA. This extended the basic GATT non-discrimination rules to the purchases of goods by selected government entities. The third revision of the GPA entered into force in April 2014. Compared to the initial Tokyo Round code of conduct, the current GPA has much broader coverage in terms of both products, services and entities, as well as more detailed provisions constraining the procurement practices of signatories. At the time of writing, there are 17 parties to the agreement, representing 45 WTO members. Of these, the EU and its 28 Member States account for 29; European countries together account for 70 per cent of the membership.

The main discipline imposed by the GPA on covered entities is non-discrimination (GPA Article IV)—both national treatment and most-favoured nation (MFN). The obligation extends not only to imports but also to subsidiaries of locally established foreign firms. The GPA thus goes beyond the GATT, which does not extend national treatment to foreign affiliates, and the GATS which does so only if specific commitments to that effect have been made on a sector-by-sector basis. Under the GPA, all foreign affiliates established in a signatory are to be treated the same as national firms. Moreover, signatories to the GPA may not discriminate against foreign suppliers by applying rules of origin that differ from those they apply in general to MFN-based trade. Once Australia joins the GPA these rules will apply. As discussed below, foreign direct investment (FDI) is an important channel for foreign firms to contest procurement markets, making this feature of the GPA quite important.

GPA signatories are required to ‘conduct covered procurement in a transparent and impartial manner that:

- is consistent with this agreement, using methods such as open tendering, selective tendering and limited tendering;
- avoids conflicts of interest; and
- prevents corrupt practices’ (GPA Art. IV: 4).⁹

The preference for competitive procurement methods is implicit in the agreement. It is reflected in the requirements that notices of intended or planned procurement be published, including information on timeframe, economic and technical requirements, terms of payment and in disciplines on the treatment of tenders and contract awards.

⁹ Open tendering is any method that allows any supplier to bid (e.g. international competitive bidding). Selective tendering is a method where only suppliers that satisfy specific criteria for participation may bid (usually prequalified suppliers). Limited tendering is non-competitive and usually involves a procuring entity approaching one or more potential suppliers of its choice.

The procurement process-related rules in the GPA are primarily aimed at supporting the market access goal and are not designed to help governments achieve their procurement policy objectives. Price-preference policies, local content requirements, offsets and similar discriminatory policies that are often used by governments in the pursuit of social equity or industrial policy goals are, in principle, prohibited by the GPA. However, exclusions are built in to ‘grandfather’ certain domestic content requirements maintained by GPA members, such as US federal procurement preferences for minority-owned small businesses. Although tax and subsidy instruments generally are likely to be more effective in addressing market failures, targeted procurement may be an efficient policy tool as long as there is competition between firms in the relevant target group. A tax or subsidy will be less selective, affecting all firms that satisfy the eligibility criteria, including those that are less productive and thus may be much costlier than procurement targeting. In contrast, competitively allocated procurement contracts will benefit only the most productive (lowest cost) bidder from the group that is the focus of public policy.

Australia is not a member of the GPA, although it has launched the process of acceding to the agreement. For decades, both Australia and NZ took the view that GPA membership was not in their interest. This reflected a perception that their procurement practices were equivalent to, if not better than, those required by the GPA in terms of fostering transparency and competition. It also reflected a concern that GPA reporting and institutional requirements were cumbersome and redundant (wasteful), given the hard budget constraints and oversight imposed on procuring entities. An additional perception was that neither country had a strong export interest in this area. The inclusion of procurement disciplines in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), revisions to the GPA and the prospect of the People’s Republic of China’s (China) accession to the GPA changed this calculus. NZ joined the GPA in 2015 and Australia is expected to do so in the near future.

Australia’s accession to the GPA will establish a baseline for talks with the EU. Australia holds that GPA accession will not have any implications for its procurement practices as the Government believes these are consistent with GPA requirements. The Government is also of the view that the GPA does not go beyond its existing PTA commitments, and thus will not require significant changes to current practices and legislation (Parliament of Australia 2017). An implication of accession to the GPA is that any improvement in market access for the EU from a PTA will be limited to whatever additional commitments it can obtain from the Australian Government. News reports suggest that Australia

is offering GPA members what it has already included in its bilateral PTAs and CPTPP commitments.¹⁰ These are quite comprehensive, spanning most goods and services and covering both central and most sub-central entities. GPA incumbents are looking for further improvements in Australia's offer with respect to the coverage of sub-central governmental entities, preferences for SMEs and contract threshold values.

Australia has one of the deepest extant preferential agreements on procurement with NZ: the ANZGPA. The Agreement creates and maintains a single Australian and NZ government procurement market in which firms from both countries are treated as national firms, including in sub-central government procurement where incentives for local firms are applied. The ANZGPA also commits the two Parties to work towards achieving the greatest possible consistency in contractual, technical and performance standards and specifications, as well as simplicity and consistency in the application of procurement policies, practices and procedures. The PTAs that Australia has negotiated with Japan, Korea, the US and several other countries are less far-reaching than the ANZGPA.¹¹ However, they do cover goods, services and works by both central and sub-central government entities, impose national treatment and non-discrimination, including for foreign affiliates, and prohibit the use of offsets or local content. Threshold values tend to be aligned with those that apply in the GPA and thus are higher than those that apply to government entities under the CPRs and State procurement rules.¹²

Australia's PTAs with, among others, Japan and the US and its commitments in the CPTPP, together with its GPA accession offer, can be expected to provide a minimum baseline for what will be covered in an Australia-EU PTA. It is unlikely the EU will be willing to offer Australia more than it has in its other PTAs and the GPA, given the asymmetry in size and the fact that the EU already has a rather open procurement regime. An important feature of Australia's commitments in its PTAs is that they include sub-central government procurement (on a reciprocal basis). This implies that the extent of potential preferential procurement market opening will be less than was in the case for Canada, given that sub-central procurement was not already covered in Canada's GPA commitments. Presumably, the lists of covered

10 <https://trade.djaghe.com/?tag=australia-gpa-accession>

11 Bosworth (2017) summarizes the coverage of all of Australia's PTAs that include procurement commitments.

12 The threshold in the GPA for central government purchases of goods and non-construction services is Special Drawing Rights (SDR) A\$130,000 or A\$170,000, as compared to the A\$80,000 under the CPRs. The latter threshold was introduced in 2005 as a result of the PTA with the US. Thresholds imposed by the States range between A\$150,000 to A\$250,000 and thus are more consistent with those of the GPA for central governments.

central and sub-central government entities found in the CPTPP and in Australia's PTAs with Japan and the US will be the basis for discussion with the EU. It can be expected that a specific focus will be placed on areas that Australia has excluded from these agreements, such as research and development (R&D) services, motor vehicles, certain State-owned utilities, SME preferences and measures taken under the Australian industry capability program, which Australia's PTAs exempt from national treatment and non-discrimination articles (Bosworth 2017).

It is important to note that most of Australia's government business enterprises are not included in the entity lists of the various PTAs, which is consistent with the CPRs applying only to non-corporate public entities. The extent of government involvement in the economy has fallen in recent decades as a result of privatisation at both the Commonwealth and State level (for example, telecom operators, airports, the electricity grid and the Commonwealth Bank). Government business enterprises (state-owned enterprises), however, are prevalent in sectors such as water, sewerage, energy, power, rail track, postal services, broadcasting and forestry. In this, Australia is no different from EU Member States and other GPA signatories. The exclusion of these entities from the PTA procurement chapters is not surprising and reflects the presumption that these are corporate entities that operate in the market-place on a commercial basis, with management having a strong incentive to source goods and services to obtain value for money. Whether there is a *de facto* bias in the sourcing decisions of these corporate entities is an empirical matter, but they are formally not under any obligations or guidance to source locally.

What is likely to result from negotiations with the EU is of course unknown. Recent EU PTAs have all included chapters on procurement, with provisions on the publication of procurement opportunities, procurement disciplines, award processes and commitments by signatories to open specific categories of procurement to competition. These tend to be modelled on, or are consistent with, the GPA as far as rules are concerned, including the requirement that national treatment and non-discrimination extend to EU FDI (Woolcock 2012). The EU-Canada Comprehensive Economic and Trade Agreement (CETA) is important in the context of Australia-EU discussions both because it is recent and because Canada is a federal state. CETA is noteworthy for the extent to which the sub-federal Canadian procurement market was opened to competition by EU businesses, beyond what was available from Canadian commitments under the GPA.

CETA applies to procurement by the Canadian Provinces and Territories, as well as contracts issued by provincial Crown Corporations, utilities, mass transit

bodies, municipalities, school boards and publicly funded academic, health and social service entities (including corporations or entities owned or controlled by one of the preceding). CETA commitments on opening procurement were unprecedented and exceed those made in other Canadian PTAs.¹³ Canada had long resisted opening access to sub-federal level procurement. Its commitments under the GPA are limited to federal-level procurement. As a result, the EU—which has made commitments on sub-central procurement in the GPA—excluded Canada from eligibility to bid on such contracts in the EU. The overall package negotiated in CETA allowed the Canadian Government to move forward where this had not been feasible in the GPA context. This was made possible because of a general understanding that opening provincial and other sub-federal procurement was a key objective for the EU.¹⁴ These dynamics are also likely to prevail in negotiations with Australia, although as mentioned, there is less of a protected bilateral ‘market access’ opportunity, given that Australia has been willing to include sub-central procurement in its recent PTAs and can be expected to do so to a more limited extent in its accession to the GPA.

Australia already has agreements with major players such as the US and Japan that give firms from these countries some preferential access to procurement opportunities. Australia has similar commitments in the CPTPP and is likely to do the same upon accession to the GPA. As such, one can assume that the outcome of negotiations with the EU will be similar. This implies that the main impact of the procurement dimension of a PTA with the EU will be a reduction in the potential trade diversion costs incurred by extant PTAs, and not a significant change in procurement policies. Moreover, any such trade diversion effects will be reduced following GPA accession. While the extent of the current trade diversion is unknown, any reduction would be beneficial for Australia, although such effects are likely to be small given that the extant PTAs are with large countries that are home to globally competitive firms. Assessing this is beyond the scope of this chapter. What follows focuses on a related relevant question: how much of an

13 They could even imply that EU firms would have better access to Canadian procurement opportunities than Canadian firms, given the continued prevalence of barriers to cross-border procurement within Canada. This possibility triggered a revision of the (internal Canadian) Agreement on Internal Trade that aims to reduce such internal barriers. This Agreement was replaced in 2017 by a new Canadian Free Trade Agreement (Barter 2017).

14 Absent international trade agreements such as the GPA, CETA, The North American Free Trade Agreement (NAFTA) and the 2010 bilateral with the US, foreign participation in procurement is limited through a Canadian Content Policy that is motivated by industrial policy objectives. The Canadian Content Policy applies to procurements carried out by Public Works and Government Services Canada that exceed C\$25,000 (Lalonde 2017).

economic payoff is likely to be associated with procurement-related market access commitments in trade agreements?

ON THE VALUE OF NON-DISCRIMINATION DISCIPLINES FOR PROCUREMENT

The basic features of the GPA, CPTPP and the EU and Australian PTAs that include ambitious provisions on procurement are very similar. They require national treatment for products and for firms established in the respective markets—whether or not foreign-owned. They define coverage on the basis of lists of entities, the goods, services and works to which these entities must apply the rules, and the minimum contract threshold value above which the rules apply. The negotiating process centres on these three dimensions as well as on the extent to which a country can maintain policies that are inconsistent with national treatment, such as preferences for national or local firms (such as SMEs). The basic goal is market access to increase the opportunity for foreign firms to win tenders. Do the agreements make a difference in this regard?

The evidence on this is not very encouraging. Many current PTAs include chapters on government procurement policies (Anderson et al. 2011; Bourgeois et al. 2007; Rickard & Kono 2014; Ueno 2013), including commitments that are enforceable through domestic bid-challenge type mechanisms.¹⁵ As mentioned, the EU has far-reaching rules on procurement, essentially prohibiting procurement favouritism within the single market. This non-discrimination rule is in practice extended to third countries—the EU does not have ‘buy local’ rules of the type found in the US and other countries.¹⁶ As previously referred to in this chapter, the EU maintains a comprehensive website and database—*Tenders Electronic Daily* (TED)—that includes data on all types of procurement opportunity announcements in the EU. This database also registers the outcome of calls for tender. TED includes information such as the year and date of an award, the type of award procedure used, the type of product or service procured, the awarding authority, and the geographical location where the contract is performed. It also includes information on the nationality of the contract winner. Combining this information permits an assessment of cross-border procurement in the EU as a whole and by EU Member States. PwC and ECORYS (2011) find that on average, about three per cent of the value of all procurement contracts in the EU are allocated to foreign companies, including other EU countries. GHK (2010) conclude that

15 In a recent assessment of some 270 extant PTAs, Shingal & Ereshchenko (2018) find that only about one-half have any language on public procurement.

16 What follows draws on Hoekman (2017).

cross-border procurement accounts for 1.5 per cent of all contracts awarded in the EU and 3.7 per cent of the total value of above-threshold contracts. As to be expected, smaller countries engage in more cross-border procurement, and local and regional authorities engage less frequently in cross-border transactions than central government entities and public utilities. The latter have the highest share of covered entity foreign sourcing. SMEs account for 60 per cent of all above-threshold contracts awarded and around one-third of the value of all contracts awarded from 2006-2008 (GHK 2010). As noted above, the EU does not maintain SME preferences.

The picture changes if account is taken of sub-contracting and of bids won by subsidiaries of foreign companies. TED does not identify whether a winning bidder is an affiliate of a foreign firm, but this can be assessed by using other databases on business ownership and cross-holdings. An effort to do so by Ramboll Management Consulting and HTW Chur (2011) concluded that 'indirect' cross-border procurement (awards allocated to affiliates of multinational enterprises) is substantially greater than direct cross-border procurement. This study also concludes that direct cross-border procurement (as measured by number of contracts and total value) was 1.6 and 3.5 per cent, respectively in 2009, as compared to 11.4 and 13.4 per cent, respectively, for indirect cross-border procurement through foreign subsidiaries. These findings confirm the theoretical prediction that commercial presence is a means of responding to (circumventing) de facto discriminatory procurement policies as well as often being a more efficient channel through which to supply foreign governments, for example for services and construction projects (Evenett & Hoekman 2005).

Messerlin (2017) uses the *World Input-Output Database* (WIOD) to calculate the public sector import penetration ratio for countries. These data indicate that for the EU27 (the EU without the United Kingdom [UK]), this ratio averaged 4.5 per cent from 2007 to 2009. This is somewhat higher but quite consistent with observations in the TED database. This suggests that WIOD can be used to compare procurement sourcing across countries. Table 8.1 reports WIOD data for a selection of countries for three periods: 1995-1997, 2007-2009 and 2010-2011.

The data indicate that import penetration ratios for the US are very similar to those of the EU. Both of these behemoths import less than the world as a whole. This is to be expected given that large economies are better able to source domestically from efficient firms. The sample of non-GPA members sourced more from abroad than the GPA members during the first two periods—4.9 versus 3.9 in the mid-1990s and 6.6 versus 5.7 per cent on average during 2007 to 2009. The same is true if the GPA members are compared to the world average.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	1995–97 simple average	2007–09 simple average	2010–11 simple average	% change 1995–2009 (simple average)	% change 2007–11 (simple average)
Non-GPA members					
Australia	5.2	5.7	5.6	9.6	-1.8
Brazil	2.1	3.0	3.5	42.9	16.7
China	3.4	6.4	4.6	88.2	-28.1
India	4.2	6.1	6.5	45.2	6.6
Indonesia	7.9	7.9	7.4	0.0	-6.3
Mexico	5.0	6.1	7	22.0	14.8
Turkey	6.4	11.1	5.4	73.4	-51.4
Average	4.9	6.6	5.7	34.7	-13.6
GPA members					
Canada	4.4	4.7	4.3	6.8	-8.5
Extra-EU	2.7	4.8	5.2	77.8	8.3
Japan	2.1	4.3	4.4	104.8	2.3
Korea	7.8	11.8	13.2	51.3	11.9
US	2.8	4.3	4.6	53.6	7.0
Average	3.9	5.7	6.3	46.2	10.5
World	4.4	6.9	6.6	56.8	-5.1
Memo: Intra-EU27	3.3	4.5	4.6	36	2

Table 8.1: Government consumption import penetration ratios, selected countries, (%).
Source: Calculated from data reported in Messerlin (2017), based on WIOD data.

Significant differences exist across countries, with Brazil only sourcing 3.5 per cent from abroad, as compared to the Republic of Korea, at 13.2 per cent in 2010 to 2011. The Australian Government import share is slightly below the world average and has remained stable over the period considered. On average, GPA members experienced a more rapid increase in foreign sourcing during 1995 to 2011, resulting in a convergence towards the average level of ‘openness’ of non-GPA members in the sample, as well as the global average.

Post-2008, the data suggest that GPA members continued to increase foreign sourcing, whereas in several of the non-GPA countries, import penetration declined significantly. This ratio fell by over 13 per cent post-2008 for non-GPA members, with the greatest declines in Turkey (a drop of over 50%) and China (minus 28%). Conversely, the ratio increased by 10 per cent on average for the GPA members in this sample. The share of foreign sourcing declined only in Canada. Thus, the data indicate that the GPA may play a role in preventing backsliding and a shift in the allocation of fiscal expenditures towards domestic industries. Governments naturally have stronger incentives to engage in this behaviour during recessions and times of crisis.

The upshot of available research is that, at least during the 1990s, the GPA seems to have done little to increase market access for foreign suppliers. Moreover, there is also little evidence that PTAs have had an impact on changing procurement sourcing. While the WIOD data discussed previously suggests a trend of greater foreign sourcing in the 2000s, this is observed for both GPA and non-GPA members. The extant analyses suggest that the increase in foreign sourcing observed in the WIOD data (up until the 2008-2009 crisis) is driven by factors other than the market access features of trade agreements. There are many possibilities. One could be technology: a decline in information and search costs through the use of e-procurement and internet platforms. Another is a more general shift in policy towards greater openness to trade and to FDI that is independent of procurement policy. An increase in the global stock of FDI and two-way flows of FDI may result in foreign affiliates winning more bids. Yet another possible driver is change in procurement regimes and processes, such as a shift towards the greater use of competitive negotiation and dialogue. These may be associated with more intensive scrutiny of government behaviour and performance, tighter budget constraints, and a greater use of outsourcing and public-private partnerships. A common feature of these possible drivers is that they centre on changes in incentives as opposed to top-down international market access liberalisation commitments.

Kutlina-Dimitrova and Lakatos (2016) use statistics for 2008-2012 as reported in the TED database to investigate the determinants of foreign sourcing by EU public entities. They found that the probability of a contract being won by a foreign-based supplier depends positively on the value of the contract awarded and negatively on the number of bids. They also determined that GDP per capita (wealth) and a country's overall openness, as captured by the trade-to-GDP ratio, are positively associated with the probability of cross-border procurement. In addition, they revealed that measures of the 'behind-the-border' investment climate quality—such as the prevalence of entry-restricting product market regulation, barriers to FDI and the share of public enterprises in the economy—all have a statistically significant negative impact on the probability of cross-border procurement.

These findings, in conjunction with the empirical analyses that find little or no effect of trade agreements after controlling for other determinants of government behaviour, suggest there may be only a limited payoff from the type of reciprocal procurement market access focus that is central to the GPA and PTAs. An implication for PTA talks between the EU and Australia is that commitments in other areas of policy—a more general openness towards trade and FDI, pro-competitive product market regulations and a competitive business environment—may have a greater impact. Where agreements may have a stronger impact is as

mechanisms to prevent ‘backsliding’, as suggested by the trends observed in the WIOD data.

Another line of argument concerning the apparent lack of impact of trade agreements on foreign sourcing is that the disciplines associated with these treaties are not very effective in reducing the scope for procurement favouritism. The strong political drivers for sourcing from local firms, as well as potential economic and ‘value for money’ reasons for sourcing from locally-based firms (Evenett & Hoekman 2005), have been prominent in public debate and deliberations around the content of the CPRs. As discussed briefly above, the most recent changes in the CPRs came into effect in March 2017. These new CPRs reiterate the long-standing goal of ensuring procurement benefits to the Australian economy, with the definition of ‘benefit’ including broad-based SME participation in government contracts.

A basic question in this regard is whether such provisions are discriminatory, as opposed to geared towards ‘facilitating’ procurement participation by firms previously overcome with the administrative complexity and ‘fixed costs’ associated with procurement rules. Prevailing procurement procedures have been criticised by Australian SMEs, their associations and their representatives, for ‘de facto’ discrimination in favour of larger companies (Australian Parliament 2017). Abstracting from the legal question regarding whether provisions to support SME participation are consistent with national treatment and non-discrimination obligations, *prima facie*, there does not appear to be discrimination as the rules apply to all firms, independent of nationality of origin. From an economic policy perspective, however, what matters is whether efforts to address specific SME participation constraints are effective in dealing with the associated ‘government failure.’ This is an empirical question. It also matters whether these efforts expand potential supply (increase the number of SME bids) and if so, whether this changes procurement decisions (outcomes), driving greater government consumption of SME products without negatively impacting on the basic value for money goal.

BEYOND RECIPROCAL MARKET ACCESS COMMITMENTS

Transparency (ensuring full information on opportunities and outcomes) and rules that procuring entities must abide by are major dimensions of procurement-related disciplines and provisions in trade agreements. As discussed in the extensive literature on public procurements (for example see Evenett & Hoekman 2005) and the contributions and references in Georgopoulos et al. [2017]), transparency is vital for improving outcomes through encouraging competition (increasing participation) and also for accountability. Transparency includes ensuring that firms

know what is required of them and of the procuring entities, thereby enabling firms to contest instances of perceived non-compliance by government agencies referring to mandated procedures and disciplines. This includes information on applicable standards, whether product or non-product specific economic regulation exists, and the associated conformity assessment procedures.

The EU has established a comprehensive web-based e-procurement system that ensures transparency. Nonetheless, it does not permit a comprehensive view of the extent to which procurement may be biased towards local (or EU) firms because information is not collected on the nationality of ownership of firms. The same is true for Australia. Using the PTA to generate such information would help monitor the extent to which the agreement has an effect over time in changing procurement patterns. It can be questioned of course, whether it makes sense to do this only for one PTA; this is something that is better pursued in the context of the WTO (GPA) so as to span a greater number of countries.

An important dimension of creating an environment in which procurement processes are more likely to achieve value for money goals is the extent to which markets are generally more competitive. Insofar as import tariffs and other barriers to trade are high or there are significant restrictions on inward FDI, there will be less choice (less competition) and it will thus be more likely that the costs of acquiring goods and services for procuring entities will be higher than they would otherwise be, no matter how effective procurement disciplines are. Average import tariffs in Australia are low—around 2.5 per cent—and the country is an above-average performer on OECD product market regulation indicators, often scoring better than many EU countries. However, one policy area where Australia performs relatively poorly is with respect to barriers to FDI, as measured by the OECD FDI regulatory restrictiveness index (see Kalinova et al. 2010). In this area, Australia rates higher than comparator partner countries, including the EU. Barriers to Mode 3 (commercial establishment for services suppliers) as measured by the World Bank Services Trade Restrictiveness Index (Borchert et al. 2014) are also somewhat higher than in the EU (see Figure 8.1).

Thus, one potential area of benefit for Australia from a PTA with the EU could come from reducing FDI restrictions (especially if this is implemented on a non-discriminatory basis). However, much will depend on how binding FDI restrictions are. Australia has some 2 per cent of the global FDI stock of FDI, equal to its share of world GDP. Australia also accounts for some 2 per cent of the total stock of EU outward FDI, suggesting that overall, policies have not resulted in a major under-performance in attracting FDI. EU investment in Australia is already

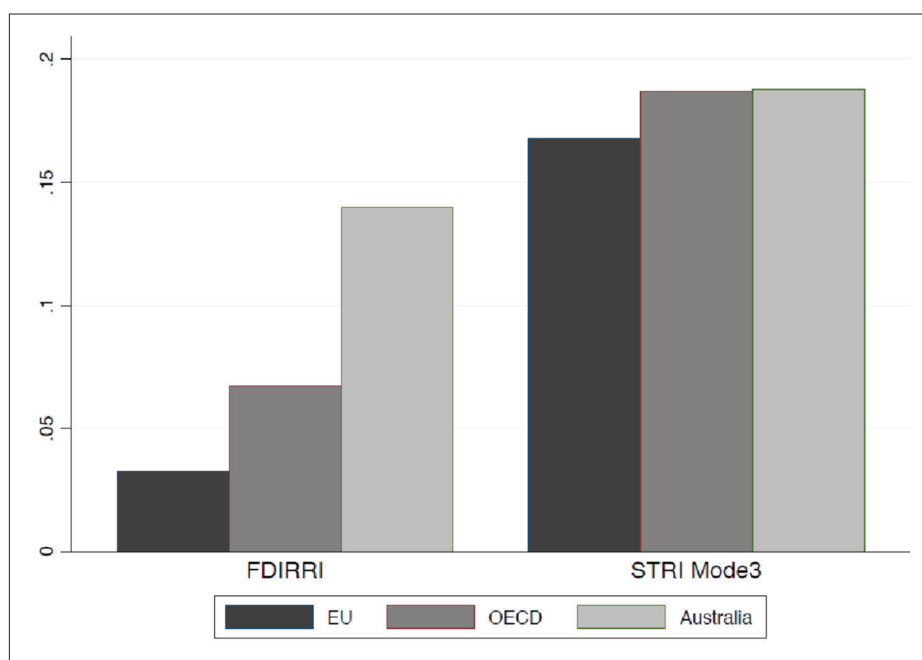


Figure 8.1: FDI restrictions: Australia vs EU and OECD average (FDI 2016; STRI 2008).

Source: FDIRRI data are drawn from the OECD website at <https://stats.oecd.org/Index.aspx?datasetcode=FDIINDEX#>; STRI data are sourced from the World Bank and are available at <http://iresearch.worldbank.org/servicetrade/>.

significant, representing more than 20 per cent of the total inward stock of FDI (DFAT 2016).¹⁷

Given that inward FDI stocks are substantial; that the foreign share of goods procured by the Commonwealth is significant (15 per cent, according to AusTender data); that Australia has signed agreements with major trading partners (the US, Japan), committing it to apply the national treatment principle to public procurement; that Australia was also willing to do this in the CPTPP and will do so on accession to the GPA—it would appear that the Australian procurement market is already quite open. The marginal improvement for Australia from according national treatment to EU firms is therefore likely to be limited, although it is clearly of value to the EU (yet here again it must be noted that GPA accession may address much of the extant discrimination confronting EU firms). Both the empirical and theoretical literature on procurement suggest that effective domestic

¹⁷ The UK accounts for half of total EU FDI in Australia—Brexit will therefore result in a major reduction in the magnitude of the EU share.

mechanisms that permit domestic and partner country firms to petition for the review of decisions by procuring entities will help ensure that non-discrimination, due process and transparency disciplines are applied. Mandating regular analysis of the impacts of procurement policies—both in attaining value for money and in addressing the anti-SME concerns that are reflected in the CPRs and State-level procurement rules—would generate information that is currently lacking regarding the economic impacts of provisions that have given rise to concerns of trading partners. As noted previously, much of what Australia is seeking to do through SME and industry development guidelines does not necessarily imply discrimination. Much depends on how these policies are implemented.

An example concerns the provisions in the 2017 revisions of the CPR, calling for Australian standards to be applied. If they pertain to products, such standards must comply with the WTO Agreement on Technical Barriers to Trade. While the WTO does not have equivalent disciplines on services-related standards (domestic regulations) or on labour and environmental standards, accession to the GPA will imply that GPA standards provisions (technical specifications) will apply. But what matters on this front is to document and assess whether Australian standards are applied in a manner which discriminates. This can only be determined in practice, making it vital that firms have access to mechanisms that allow them to raise concerns in specific instances of procurement tenders and that there be effective independent monitoring and evaluation of the impacts and outcomes. At the moment there is no analogue to the domestic review requirements that are part of the GPA and that call for the availability of independent mechanisms that firms can invoke to challenge instances where firms perceive violations of applicable law and regulations. Instead, companies can only approach the agencies themselves with complaints or invoke the offices of the Commonwealth Ombudsman (Baker & McKenzie 2017). The latter is not very useful as findings take the form of recommendations and are not binding. This lacuna will be addressed as part of Australia's accession to the GPA.

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9

REGULATORY COOPERATION

Peter Mumford

ABSTRACT

Regulatory cooperation involves much more than removing barriers to trade. While this remains an important objective, regulatory cooperation between states is also required to achieve important societal outcomes in areas such as health, safety and the environment. This accounts for the fact that a considerable amount of cooperation takes place outside the framework of trade agreements. While regulatory cooperation can be presented as ‘win-win’, there are significant obstacles to its achievement, to the extent that desirable cooperation is not undertaken. This chapter explores the barriers to regulatory cooperation, making the case that cooperation, specifically within the framework of trade agreements, should focus on what matters most for business, and on identifying favourable conditions.

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INTRODUCTION

Regulatory cooperation is neither novel nor, in many contexts, controversial. For example, nation-states have been cooperating for decades on the norms and rules governing air and maritime transportation, telecommunications and financial markets.

International standards bodies have a long history of developing standards and conformity assessment procedures and many of these have formed the basis of national regulation. The objectives of regulatory cooperation—which have ranged from ensuring interoperability (aircraft do not collide) to sharing scientific and technical knowledge and expertise—underpin both technical regulation and voluntary standards, ensuring that national laws effectively deal with cross-border trade in goods and services, and in facilitating trade.

In other contexts it must be acknowledged that regulatory cooperation has become controversial. Some see it as favouring trade over what are often the primary domestic objectives of regulation: protecting health, safety and the environment, and a diminution of the rights of individual states to regulate in their own interests.

Discussions on regulatory cooperation need to move beyond simplistic characterisations of it being either ‘good’ or ‘bad’. Regulatory cooperation is beneficial in some contexts and inappropriate in others; there are many ways to cooperate. Arguments based on the merits or otherwise of harmonisation as the dominant way are neither accurate nor helpful. ‘Soft’ measures, such as improving communications and understanding between regulators, can be as powerful as cooperation agreements that focus on the rules.

A useful starting point is to assume **three objectives for regulatory cooperation** that are realistic and should be generally accepted. These are to:

- facilitate economic activity while ensuring important societal objectives in the areas of safety, human health, the environment, animal and plant life, health, and security are not undermined (and in many cases, are enhanced). In other words, recognising that economic and social objectives are complementary, not competing.
- focus on areas that offer the greatest return. Proponents of regulatory cooperation can (from time to time) assume that it is always worth doing; they envisage a world where firms can transact freely, unencumbered by regulatory barriers and red tape. They overlook the costs of cooperation, which can be very significant and hence are only warranted when the case stacks up; and
- cooperate in the most efficient way having regard to the full range of options. This keeps open the possibility of equivalence, harmonisation and mutual recognition agreements between countries—but also one country unilaterally aligning its regulations with those of trading partners or of international alignment. It includes countries simplifying their regulations and reducing red tape. It also keeps open the possibility of less formal arrangements between countries, such as information sharing and joint capacity building.

The remainder of this chapter is structured in the following way. After the introduction, section two shows that Australia is very experienced with regulatory cooperation, both as a federation and with New Zealand (NZ); hence, both countries are well placed to cooperate effectively with the European Union (EU). Section three discusses why regulatory cooperation is becoming an important part of the trade policy dialogue to reduce regulatory costs inhibiting trade. But it also asserts that cost reduction is only one of the drivers and benefits of cooperation. Section four illustrates the challenges of reducing regulatory barriers. Sections five and six show how they have been addressed traditionally and more recently. Section seven makes the case for good regulatory practice (GRP) provisions in free trade agreements (FTAs). Section eight also supports regulatory cooperation provisions, but places emphasis on what needs to be done to ensure they are effectively implemented and make a real difference.

THE AUSTRALIA-NZ AND EUROPEAN UNION (EU) CONTEXT

Given that the context for this discussion on regulatory cooperation is the Australia-EU FTA, and acknowledging that NZ and the EU have commenced the negotiation of an FTA, it is important to note that the EU along with Australia-NZ have (by a large margin) the broadest and deepest experience of regulatory cooperation of any regions in the world. It should also be emphasised that Australia is a federation of six states and two territories with legislative powers, and has itself a strong tradition of regulatory cooperation with the objective of creating a single national economy. Some significant Australia-NZ regulatory cooperation initiatives, such as the Trans-Tasman Mutual Recognition Arrangement (TTMRA), have been extensions of these intra-Australian initiatives. This history and experience demonstrate what can be achieved through regulatory cooperation and provides lessons on how to cooperate effectively.

This chapter is written from the vantage point of the Australia-NZ ('trans-Tasman') relationship. It is also informed by experience of the negotiation of the NZ-EU Mutual Recognition Agreement on Conformity Assessment (jointly undertaken with Australia, albeit separate agreements were concluded). Others (see Messerlin 2011) have written on the EU's internal experience with regulatory cooperation, which is beyond the scope of this chapter. Several themes can be identified from the Australia-NZ experience.

As markets and business practices evolve, the focus of regulatory cooperation broadens out from goods to services, and from border controls to domestic regulatory frameworks affecting markets and trade. These range from safety, health and environmental regulation, to competition and financial market regulation. Often, regulatory cooperation is built on a foundation of relationships between

regulators in each jurisdiction, as well as experts, standards and professional bodies. These relationships build trust, confidence and understanding that pave the way for more formal cooperation.

More than one way of cooperating exists. In the Australian-NZ context, it ranges from sharing knowledge to joint standards development, to mutual recognition of regulatory outcomes and court judgements (Department of Finance and Administration & Ministry of Economic Development, n.d.). Formal cooperation arrangements have robust safeguards built into them. These range from excluding goods and services where individual members have strong views that they need to retain their right to regulate, through to opt-out provisions and decision-making checks and balances (discussed below).

An important feature of the Australian landscape is the Productivity Commission (PC). The PC is a statutory body with a mandate to provide quality, independent advice and information to Australia's governments on a range of economic, social and environmental issues affecting the welfare of Australians (Productivity Commission 2017). Over the years, the PC has undertaken several inquiries and studies that have included a regulatory cooperation dimension and in doing so has provided the intellectual and empirical underpinnings of significant national economic reforms within Australia, as well as building political and community support.

The PC experience is relevant not just to Australia's national economic reforms, but also to Australia-NZ regulatory cooperation. The PC undertook studies for both the Australian and NZ governments, including a study of the Australian and NZ competition and consumer protection regimes (PC 2004). It has also undertaken a 5-yearly review of the TTMRA. When NZ established its own Productivity Commission (NZPC) in 2010, modelled on the Australian Productivity Commission, there was an expectation that it would cooperate with the PC in undertaking studies into trans-Tasman regulatory issues. This was done through a joint study: the 'Impacts and benefits of further economic integration of the Australian and New Zealand economies', published in the research report, *Strengthening trans-Tasman economic relations* (PC & NZ PC 2012).

The point of this discussion on Australia and NZ is to show that a pragmatic approach to regulatory cooperation, which has evolved over time, has significantly improved both trade and regulatory outcomes in Australia and NZ, without the controversy that has been associated with regulatory cooperation in other jurisdictions. This experience can be drawn upon in identifying when and how to cooperate on regulatory matters with the EU within the framework of an FTA. It also means that both Australia and NZ will be experienced partners with the

EU throughout this process. Australia and NZ also have the advantage of having highly competent regulators operating within modern and sophisticated regulatory systems and a philosophy of continuous improvement. As regulatory cooperation is generally grounded in trust in each other's regulators and regulatory systems, Australia and NZ are credible partners and the hurdles to regulatory cooperation should be commensurately low.

REGULATORY COOPERATION A NEW FEATURE IN FTAs

Given that regulatory cooperation is not novel, but indeed is the dominant paradigm in many areas of activity, why is it becoming a focus of attention in new FTAs?¹ The dominant reason is that historically, trade agreements have for many people been associated with the reduction of tariffs; notwithstanding the fact that at the multilateral level, and in regional and bilateral trade agreements, there have been chapters such as Technical Barriers to Trade (TBT) and Sanitary and Phyto-sanitary (SPS) Measures that have been predicated on regulatory cooperation.

'Behind the border' barriers to trade have assumed greater importance, both relative to tariffs and—since the reduction in tariffs for most traded goods to what has been described as 'nuisance level'—the cost of collecting the tariff is higher than the revenue it generates (Hoekman & Sabel 2017). According to the OECD, the trade costs of regulatory divergence are largely unknown and are likely to vary by sector (OECD 2017). However, there is consensus that the costs will be significant. For example, the OECD reports that in the services sector they may generate costs equivalent to tariffs of between 20 and 75 per cent.

The *Term of Art* for regulatory barriers to trade in goods is non-tariff measures (NTMs). See UNCTAD 2017 for a definition of NTMs as policy measures other than ordinary customs tariffs that can potentially have an economic effect on international trade in goods, changing quantities traded, or prices or both. The examples they provide are:

- SPS measures that are applied to protect human or animal life from risks arising from additives, contaminants, toxins or disease-causing organisms in food.
- TBT measures referring to technical regulations and procedures for assessment of conformity with technical regulations and standards; and

¹ This chapter makes a distinction between on the one hand the intra-EU and Australia-NZ relationships, where regulatory cooperation is common and has been the focus of considerable attention, and FTAs that have recently been concluded or are being negotiated.

- Contingent trade-protective measures, which are implemented to counteract adverse effects of imports in the market of the importing country, contingent upon the fulfilment of certain procedural and substantive requirements (UNCTAD 2017).

However, a focus on the traditional areas of TBT and SPS measures can be somewhat limited given the opportunities to improve trade and regulatory outcomes through regulatory cooperation more broadly. In this respect, attention is drawn to two specific areas: trade in services and regulatory effectiveness.

Trade in services

While trade in services is often identified as a ‘new’ area for regulatory cooperation, the range of possible services can make all the opportunities to cooperate difficult to identify. These problems cannot be resolved in this chapter. Ultimately, the opportunities will emerge from empirical understandings of the interface between markets, technologies, business practices and regulation. However, for illustrative purposes, a brief discussion of air transport is relevant, as a traditional area for regulatory cooperation.

Historically, regulatory cooperation has been in air transport policy and regulation with the objective of, among other things, improving air safety and connectivity and hence transportation services (ICAO Economic Development 2017). There are also regulatory cooperation agreements relating to aircraft airworthiness, which, while improving regulatory efficiency and effectiveness, can reduce regulatory barriers to both the movement of aircraft parts (goods) and where maintenance (services) can be carried out (Hoekman & Sabel 2017). Regulatory cooperation in a trans-Tasman context has extended to occupations. Under the TTMRA, professional flight crew, maintenance engineers and air traffic controllers licensed in NZ are entitled to be licensed in Australia, and vice versa. This facilitates the movement of skilled people.

While regulatory cooperation in the air transport area largely takes place outside the framework of FTAs (as does much extant regulatory cooperation), it does illustrate the relevance of regulatory cooperation to services. This is pertinent to future looking FTAs.²

² Traditionally, FTAs which cover services include separate chapters covering highly regulated services sectors such as Telecommunications and Financial Services, where regulatory principles of various kinds are already enshrined in, for example, the WTO/General Agreement on Trade in Services (GATS) Telecommunications Reference Paper (WTO 2017b) and the WTO/GATS Annex on Financial Services (WTO 2017a). For a thorough discussion of the case for more comprehensive regulatory cooperation in services, see (Mattoo 2015).

Regulatory effectiveness

Regulatory cooperation is primarily seen as enabling or supporting trade, and helping reduce or remove regulatory barriers. It is important to acknowledge that it also has potential to improve the effectiveness of domestic regulation. Increasing cross-border activity, including e-commerce, can test the limits on the reach of domestic regulators and regulation. Effective domestic regulation provides the predictability and certainty that businesses need to support their activities. It also ensures that the legitimate public policy goals of domestic regulation are not undermined.

Regulatory cooperation, such as enabling regulators to share information or work together on enforcement, could help ensure that domestic regulation works as intended. FTA partners may also have a mutual interest in supporting the effective operation of certain of each other's regulatory regimes.

RESOLVING REGULATORY BARRIERS CAN BE DIFFICULT

NTMs arise out of domestic regulation and for practical purposes, they can be considered as regulatory barriers to trade. Regulatory barriers fall into three main categories: legitimate, unintentional and protectionist.

Unfortunately, it can be difficult to ascertain what category a regulatory barrier falls into. Does it reflect a legitimate barrier because of unique local conditions or different societal risk preferences? Or is it unintentional, an artefact of a different evolutionary pathway, incomplete analysis (the regulation could have been designed in such a way that it did not constitute a barrier to trade) or currency (the regulation is out-of-date)? Or does it aim to protect industry or indeed the domestic regulator?

In theory, it should be possible to construct a persuasive and non-controversial argument that regulations which unintentionally create barriers to trade can and should be changed in such a way that they continue to achieve their primary objectives, while also accommodating trade objectives. This is not, however, as simple as it sounds. Existing laws can be 'sticky' and there are several reasons for this. Existing regulation can favour incumbents, and they may resist change that will lose them privileges. Existing regulation can favour the agencies responsible for their administration—change the rules and those agencies lose resources and sometimes prestige. Limited resources and legislative time can also make it a struggle to amend regulation, even when there is a case to do so.

Finally, there can simply be a preference for the 'familiar' and a concern that change means that something, albeit ill-defined, is being lost. This general sense of concern can be accentuated when one of the arguments for change is to facilitate

trade, and change involves, or is seen to involve, some accommodation of, or alignment with, the laws of another country. This may be a particularly sensitive issue for the smaller country.

It is important to acknowledge that regulatory cooperation is not restricted to existing regulation. New rules are required to address new risks; hence, the process of regulation-making is inherently dynamic. Regulatory cooperation will inevitably be relevant to the stock of existing regulation and the flow of new regulation.

TRADITIONAL APPROACHES TO RESOLVING BARRIERS

Traditional trade agreements implicitly recognise that regulatory barriers can be legitimate, unintentional or protectionist and there can be difficulty distinguishing what category specific regulations might fall into. Such agreements attempt to deal with this through establishing regimes³ comprising principles, norms, rules and decision-making procedures which seek to both inform and discipline domestic regulation-making in specific areas like TBT or SPS measures, with a view to 'getting the right outcome' from a trade perspective. These include:

- Establishing norms for regulation-making, such as:⁴
 - o regulations shall not be more trade-restrictive than necessary to fulfil a legitimate objective⁵
 - o regulations shall not be maintained if objectives can be addressed in a less trade-restrictive manner
 - o regulations should be based on the best scientific and technical information
 - o regulations shall not arbitrarily or unjustifiably discriminate where identical or similar conditions prevail.
- Requiring transparency, such as to notify draft rules.
- Encouraging formal cooperation such as equivalence, harmonisation and mutual recognition of conformity assessment.
- Requiring rules to be based on international standards wherever possible.
- Providing formal dispute resolution mechanisms.

3 Using Krasner's definition of a regime as implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in each area of international relations (Krasner 1983).

4 These are drawn from the WTO TBT and SPS Agreements.

5 Legitimate objectives include protect human, animal or plant life or health (SPS Agreement) and national security requirements, the prevention of deceptive practices, protection of human health or safety, animal or plant life or health, or the environment (TBT Agreement).

It should be noted that some trade agreements contain sectoral annexes to agreement chapters, which include specific cooperative provisions, in effect applying the high-level norms and principles to specific sectors.

NEW APPROACHES TO RESOLVING BARRIERS

More recently, GRP has started to feature in trade discussions, and to a lesser extent in trade agreements. This comes from acknowledgement that GRP principles and mechanisms, while originally developed to improve the quality of domestic regulation, result in regulation that also facilitates trade.

Both the OECD and APEC have codified GRP to include several elements intended to result in regulation that achieves its objectives at least cost. These include:

- regulatory impact analysis (a systematic approach to analysing when and how to regulate)
- cost-benefit analysis
- risk-based analysis
- evidence-based decision-making
- inter-agency consultation
- full and transparent consultation with affected parties or the public more generally
- systematic reviews of existing regulation.

The 1996 TTMRA between the Commonwealth and States of Australia and NZ was possibly the first international agreement to embody the elements that have now come to be known as GRP. A core TTMRA principle is that a ‘good’ that can be legally sold in Australia can legally be sold in NZ and vice versa. Similarly, if someone is registered to practice an occupation in Australia, they are entitled to be registered to practice that occupation in NZ; the reverse also being the case. However, there are safeguards.

One of the safeguards is that if a party considers that mutual recognition will give rise to risks to health, safety or the environment, they can create a temporary exemption (the mutual recognition principle does not apply). Over the exemption period, decision-makers must decide whether there should be mutual recognition, harmonisation or a permanent exemption. In arriving at a conclusion, decision-makers must have regard to formal regulatory impact analysis and GRP principles (Mumford 2004).

The first comprehensive adoption of GRP principles in a trade agreement of the sort contemplated here by the author is the CPTPP Regulatory Coherence chapter

(CPTPP 2018, *Chapter 25*). GRP principles were also proposed for other trade agreements. For example see the Trans-Atlantic Trade and Investment Partnership (TTIP) (European Commission 2017d), the EU-Japan FTA (EU proposal for a Chapter on Good Regulatory Practices and Regulatory Cooperation [European Commission 2017b]) and the EU-Mexico FTA (EU textual proposal for a Chapter on Good Regulatory Practice [European Commission 2017c]). The United States (US) has also signed a Memorandum of Understandings on Regulatory Coherence with both Argentina (Department of Commerce 2017) and Brazil.

Regulatory coherence, good regulatory practice and regulatory cooperation

A range of terms is used to describe trade and regulatory objectives and these can cause some confusion. Regulatory coherence is one such term; it is reasonable to ask how this differs from regulatory cooperation and GRP.

With a view to providing clarity, NZ has articulated an outcome-based description that grounds regulatory coherence firmly at the interface between domestic regulation and international trade (Mumford 2014). In doing so, it reiterates that regulatory coherence is as much to do with what countries do internally, as what happens between countries.

Using this description, regulatory coherence requires a multi-dimensional strategy that has the following inter-related elements:

- **Coherence between domestic and international policy goals:** when developing domestic regulatory policies that may have an impact on trade, these impacts should be identified and considered part of the policy process.
- **Coherence between domestic laws and agencies:** in situations where several domestic regulatory agencies all deal with the same trade—for example, a good or service that must comply with multiple laws and be dealt with by multiple regulatory agencies—a consistent and efficient approach should be taken.
- **Coherence between the laws and agencies of two or more economies:** this third element is generally known as regulatory cooperation. It reflects the goal of reducing regulatory barriers to trade created by different laws in different countries through cooperation between economies.

In effect, regulatory coherence refers to both GRP and regulatory cooperation principles and practices. References to regulatory coherence in FTAs and other documents have elements of both, albeit generally putting more emphasis on GRP.

THE CASE FOR GRP PROVISIONS IN FTAs

Traditional provisions in trade agreements aimed at regulation that is trade friendly, and new GRP elements aimed at regulation that is efficient and effective, with spill over benefits to trade, are complementary. However, the inclusion of GRP enhances trade agreements in two respects:

1. GRP provisions are contained in what are described as ‘cross-cutting’ or ‘horizontal’ chapters, and hence apply to all areas of regulation, not just domain-specific chapters such as TBTs, SPS measures, e-commerce etc.; and
2. GRP provisions materially enhance transparency. Traditional transparency provisions largely require a party to the agreement to notify the other parties, or the WTO, of proposed regulations. GRP provisions require or encourage the parties to expose the full analysis underlying the regulation. This additional body of information can then provide a basis for engagement between the parties on whether the regulation is justified, and whether it is proportional and least trade-restrictive.

In addition to this greater transparency—and the accountability associated with transparency—the benefits of GRP in a trade policy context can accrue from:

- more effective and efficient domestic regulatory systems; that is, systems that achieve their primary objectives while keeping regulatory costs as low as possible.
- assessment of both new regulatory proposals and existing regulation that explicitly take trade openness objectives into account and consider options that will facilitate trade. These could include the unilateral alignment of domestic regulation with international norms or approaches in other jurisdictions (which would improve the interface between different regulatory systems even if differences are not completely eliminated), or provide informal and formal cooperation mechanisms.
- more consultative processes for the development of new regulation or the review of existing regulation, which means that interested groups in other countries can participate and bring their perspectives to bear, in what are normally domestic policy processes.
- greater transparency and engagement by regulators, which may result in increased trust and understanding between regulators in different jurisdictions. This can lead to understanding of the regulatory approaches taken by others, paving the way for greater cooperation, acceptance of

the standards that apply in other jurisdictions, and potentially mutual recognition or harmonisation.

- greater transparency and certainty for those wishing to enter or operating in a market about the regulatory requirements they face (Mumford 2014)

While trade impacts and objectives should inherently be addressed through GRP and general trade-related regulatory principles, this is not always or even often the case (Basedow & Kauffmann 2016).

Therefore, in addition to an expression of the importance of GRP generally, there is a case to emphasise the importance of principles that have specific relevance to trade, such as:

- considering and making transparent material impacts on trade as part of regulatory impact analysis;
- identifying regulatory options that seek to minimise barriers to trade
- providing opportunities for affected parties in other countries to comment on both impact analysis and regulatory options, and to have their comments considered.

THE CASE FOR REGULATORY COOPERATION PROVISIONS IN FTAS

To provide the context for this discussion, it is useful to think about GRP as providing an overarching regulatory assurance framework. It applies generally to all areas of regulation, but does not by itself focus on specific sectors.

At a sectoral level, the objectives of regulatory cooperation include:

- reducing the regulatory burden on firms that seek to bring innovative new products and services to market
- reducing the costs to firms that result when more than one set of rules applies to a single transaction, such as a good or service that is sold in different markets that impose different consumer protection requirements
- removing barriers to the movement of goods and services, investment and people across borders where there are either absolute prohibitions or a regulatory cost is imposed that is so onerous it acts as a prohibition
- ensuring that domestic laws apply effectively to goods and services, investment and people that cross borders.

At one time, it was thought that establishing assurance frameworks for regulatory action in the form of trade agreements and domestic implementing arrangements was sufficient. Experience has shown this not to be the case, as

regulators often have sufficient discretion to take decisions that either support or eschew regulatory cooperation.

Anecdotal evidence suggests that even when assuming goodwill (regulators being willing to consider cooperation), there are four constraints on the level of cooperation, including whether it occurs at all. These constraints concern whether:

- the overarching regulatory approach is outcome- or performance-based and hence permissive of innovation or prescriptive, which tends to constrain innovation
- the law provides sufficient flexibility to accommodate regulatory cooperation; for example, allowing recognition of another country's standards or conformity assessment outcomes
- the regulator considers it has a legal mandate to cooperate
- the regulator has the resources to invest in cooperation.

Legal frameworks that do not clearly provide both the flexibility and mandate to cooperate can act as a binding constraint. Conversely, a legal mandate to cooperate provides a positive signal to regulators and is more likely to result in cooperation.

Resourcing can be a binding constraint even if the other two elements are in place. This is because regulatory cooperation that is dependent on the regulators' willingness to cooperate works most effectively when there is mutual confidence and respect. This can take significant time and investment to develop, and given that regulators are often resource-constrained, this represents a major and sometimes insurmountable opportunity cost.

There are two strategies for reducing resource pressures on regulators:

- focus formal cooperating arrangements on those areas where there is a clear case that cooperation will provide tangible benefits to the parties; and
- encourage informal cooperation, as this can reduce the costs while achieving good results. It also builds trust and confidence and can be a springboard for more formal (and integrated) forms of cooperation over time.

The argument for focusing formal cooperation only on those areas where there is a clear case that cooperation will provide tangible benefits to the parties is based on the premise that GRP is resource-intensive at four levels: negotiation, policy development, legislative design, and implementation. There is, therefore, a need to 'pick the targets' and concentrate effort on those areas that offer the greatest return.

The position taken in this chapter is that within the framework of trade agreements, the greatest return will come from those areas that matter most to business. This explicitly acknowledges that regulatory cooperation occurs in a wide range of domains, and hence trade agreements need to be clear about their advantage and unique place. Their advantage is that they can bring a trade focus and allocate resources to resolving trade difficulties for sectors and firms.

However, for trade agreements to adequately address areas that matter most to business, they must resolve the problem that there has been a gap between the trade-related frameworks for regulatory cooperation and the practical world of business (Hoekman 2015).

It is well understood that the traditional model of a firm that produces a finished product domestically and then exports, has been superseded by trade in intermediate goods, the bundling of goods and services, supply chains and value chains. The scope of regulatory cooperation, forms of cooperation and engagement with business should reflect modern business strategies. A useful starting point is to take the supply and value chains as the ‘units of analysis’ (Hoekman & Sabel 2017).

This can enable identification of the ‘pinch points’ and targeting of cooperation at those areas that, possibly in combination, will contribute most to an efficient supply or value chain. For example, a value chain may include intermediate goods, final goods, services and knowhow and involve transportation, communications and investment.⁶ Regulatory barriers that may be alleviated through regulatory cooperation could arise at any of these points, and the forms of cooperation are likely to vary based on the issues requiring resolution, and on the capacity of the parties to achieve this.

For example, in a particular case:

- domestic regulatory standards can be adopted or amended to facilitate the approval of new technologies;
- differences between some regulatory approaches can be reduced through recognition of equivalence, harmonisation or one party unilaterally recognising the standards or regulatory outcomes of the other party;
- the costs of testing and certification (or in the case of some services, the inability to test and certify prior to delivery) can be reduced through mutually or unilaterally recognising the testing or certification

⁶ APEC has published a set of services sector case studies which took this approach of mapping the value chain to identify choke-points that might call for greater regulatory cooperation (see Annex A of APEC 2016).

conducted in the home country. This can involve both parties accepting international accreditation as the basis for determining the competence of conformity assessment bodies.

- the ‘red tape’ associated with both goods and services trade in the area under consideration can be reduced through one or both parties simplifying their procedures and aligning them to create timely and seamless cross-border processes.
- transparency and certainty can be enhanced through straightforward guidance on what is required to meet regulatory requirements.
- the movement of experts or business people may need to be facilitated.

Given that supply and value chains are geographically dispersed, regulatory cooperation may need to extend beyond the parties to an FTA; therefore, requiring those parties to take a coordinated approach to influencing regulatory settings in third countries.

Some recent trade agreements contain specific regulatory cooperation chapters. By way of example, the EU-proposed chapter on Good Regulatory Practices and Regulatory Cooperation in the EU-Japan FTA (European Commission 2017b) combines regulatory cooperation with GRP. Meanwhile the Comprehensive Economic and Trade Agreement between the EU and Canada (CETA) has a standalone chapter on Regulatory Cooperation and no GRP chapter, although the regulatory cooperation chapter has GRP elements (European Commission 2017a). The CPTPP Regulatory Coherence chapter does not contain a specific regulatory cooperation dimension, but arguably, the innovative Competitiveness and Business Facilitation and Small and Medium-sized Enterprise (SME) chapters are predicated on regulatory cooperation to facilitate the efficient operation of supply chains and allow SMEs to take full advantage of the Agreement (see CPTPP 2018, *Chapter 22* and *Chapter 24*).

These chapters have several common elements:

- a commitment to identify areas for regulatory cooperation
- an expressed willingness for regulators to share information and discuss regulatory issues, ranging from the evidence base underlying regulatory standards to risk-based decision-making
- an expressed willingness to engage with stakeholders, including business
- the establishment of governance to provide oversight of the process of establishing cooperative arrangements.

Businesses will expect that the provisions in such chapters will be implemented in ways that reflect their business realities. They will look for high levels of

responsiveness, particularly in terms of timing and the willingness to accommodate market and technological demands and opportunities.

Policymakers and regulators will also have expectations that must be met. These include a mandate to change regulatory frameworks if required and the allocation of resources to allow them to effectively engage in cooperative activities.

CONCLUSION

There is a case to include GRP and regulatory cooperation provisions in FTAs. Examples from current FTAs that have either been concluded or are being negotiated provide most of the elements one would expect to see in a GRP regulatory cooperation chapter. The challenge is one of moving from design to implementation. This requires accurate targeting of cooperative efforts, creating favourable conditions for cooperation and building support.

From a business perspective, targeting would consider:

- the efficient operation of supply and value chains
- facilitating the adoption of new technologies and the creation of new markets, while managing the public risk
- creating a responsive system that reflects business requirements for timeliness and understanding of business needs and realities.

From a regulator perspective, targeting would consider:

- whether there is a strong mandate to cooperate (both legislative and policy)
- whether resourcing is adequate.

This brings us to the favourable conditions: in addition to mandates and resourcing, the relevant regulatory regimes must be permissive of cooperation—performance-based systems tend to be more permissive than prescriptive regimes—giving regulators an explicit legal authority to cooperate as required.

The trans-Tasman experience demonstrates that regulatory cooperation is a long-term game that works best when there is mutual trust and confidence between regulators. Investing in relationship building inevitably results in a positive environment setting the scene for more formal cooperation in the future. There is a need to build support. Having a solid empirical foundation for regulatory cooperation in specific areas is important. Developing this foundation through both high-quality research and stakeholder engagement is important: productivity commissions have demonstrated value in this area.

Finally, it is important to communicate that regulatory cooperation is not just to do with trade. Cooperation is necessary to deliver high-quality regulatory outcomes; in effect, improving the overall welfare of society.

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10

AGRICULTURE AND FOOD TRADE POLICY

Kym Anderson, AC

ABSTRACT

Bilateral trade flows between Australia and the European Union (EU) have been declining in relative importance for both parties over recent decades; so too has the role of agricultural products in that trade. Farm and food policy interventions continue to contribute to that demise, along with the trade-diverting effects of other preferential trading arrangements involving either the EU or Australia. Nonetheless, each party has several issues concerning the trade effects of the other's agricultural, food and beverage policies that could be addressed constructively in a bilateral free trade agreement (FTA) negotiation. These include meat, sugar and wine market access, as well as regulations on sanitary and phyto-sanitary and technical barriers to trade. These must be considered, bearing in mind that a United Kingdom (UK)-EU27 (EU without the UK) bilateral trade agreement is likely to be negotiated before an Australia-EU27 FTA is finalised. An Australia-UK FTA may also be concluded once the UK-EU27 one is settled.

INTRODUCTION

Traditionally, agriculture has been one of the more difficult sectors in which to reach a liberal outcome in preferential trade agreements; this was also the case with multilateral negotiations under the General Agreement on Tariffs and Trade (GATT) and the WTO (Josling, Tangermann & Warley 1996; Fulponi 2015; Fulponi Shearer & Almeida 2011). While much reform has been undertaken on the European Union's (EU) Common Agricultural Policy (CAP) over the past two decades (Swinnen 2008, 2015), many EU farm trade distortions remain (OECD 2017a; WTO 2017 pp. 78-84, 121-25 and 136-55). As such, opportunities still remain for further reform, even though

these will be challenging to achieve. The Transatlantic Trade and Investment Partnership (TTIP) between the United States of America (US) and the EU had the potential for progress (Josling & Tangermann 2015), but by mid-2016 it faced widespread public opposition, both in the US and numerous EU Member States. The Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU (concluded in December 2016) does not contain a specific chapter on agriculture, but it does include one concerning food safety and animal and plant health. A bilateral FTA between Australia and the EU offers another opportunity to open EU markets for agricultural and food products, beverages and tobacco (a market hereafter referred to as A&F). Australia also has some policies that affect its trade in these products (WTO 2015a pp. 56-60, 85, 91-96). This is despite the long process of reform since 1970 (Anderson, Lloyd & MacLaren 2007) resulting in an overall farm Producer Support Estimate (PSE) for 2014-2016 falling below two per cent, compared with 20 per cent for farmers in the EU28 (EU including the UK) (OECD 2017b).

This chapter begins by summarising the relevant background information on trade flows between Australia and the EU, the evolving role of A&F products in that trade, the extent to which farm and food policy interventions have affected markets in Australia and the EU, and the roles played by other bilateral and regional preferential trading arrangements involving Australia and the EU. The main section of the chapter then focuses on those A&F policies likely to be the subject of bilateral negotiations between Australia and the EU27. It does so while acknowledging that a UK-EU27 bilateral trade agreement is likely to be negotiated before an Australia-EU27 FTA is finalised, and that an Australia-UK FTA may also be concluded once that between the UK and the EU27 is settled.¹ The chapter's final section summarises the key conclusions.

BACKGROUND

This section summarises farm and other trade flows between Australia and the EU, estimates of distortions to agricultural incentives in Australia and the EU, and pertinent aspects of current preferential trading arrangements in both jurisdictions.

Composition and direction of Australian and European Union trade

Australia has always been very well endowed with agricultural and mineral resources per worker and so has had a strong comparative advantage in primary and lightly

¹ This current interest in preferential trade agreements in Australia (Productivity Commission 2017) and in the EU (European Commission 2015, 2017) is partly a response to the emergence of populist politics that ensures it is difficult to undertake unilateral trade policy reform and revive interest in multilateral trade negotiations at the WTO.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	Agriculture	Mining	Manufacturing	Services
1950	86	6	3	5
1970	44	28	12	16
1990	26	41	19	19
2016	15	48	14	23
RCA,^a 2016	2.0	4.8	0.2	1.0

^a RCA is the index of 'revealed' comparative advantage, defined by Balassa (1965) as the sectoral share of Australia's exports divided by that sector's share of the rest of the world's exports.

Table 10.1: Sectoral shares of exports (%) and 'revealed' comparative advantage,^a Australia, 1950 to 2016.

Source: Compiled by the author from data accessed at www.dfat.gov.au on 31 July 2017.

processed goods. The relative importance of agricultural and mining product exports varies with their prices in international markets, along with domestic mineral discoveries (for mining products) and seasonal weather conditions (for agricultural products) (see Table 10.1.) The EU, by contrast, is relatively densely populated with skilled workers and has a comparative advantage in skills-intensive manufacturing and services.

Historically, Australia has traded very intensively with the UK and (a few) other Western European countries, despite the great distance between them. Together, these countries have accounted for more than 60 per cent of Australia's merchandise trade up to the 1950s, while APEC countries accounted for less than one-quarter. By 1990 to 1992, European shares of Australian goods exports and imports had diminished to 16 and 26 per cent, respectively. By 2014 to 2016, those shares were just five and 18 per cent for all goods, and only slightly higher (six and 23%) for agricultural products (see Table 10.2[a]). Meanwhile, Australia has (in recent decades) been a minor part of both the UK and EU27 trade in farm and non-farm goods. This is consistent with Australia accounting for only one per cent of global merchandise trade. In 2016, Australia accounted for 1.8 per cent of EU28 exports and just 0.8 per cent of EU28 imports of goods.

Since Europe's importance in the global merchandise trade has declined, it is useful to examine the index of export (import) trade intensity, defined as the share of a region in Australia's goods exports (imports) and divided by that region's share in the world minus Australia's goods imports (exports). Table 10.2(b) shows Australia's share of trade with the UK in the 1950s was three to five times the UK's share of global trade. Currently, those indexes are only one-fifth as large. Australia's trade shares with the rest of Europe have always been well below that region's shares of global trade, but they too have shrunk in recent decades. Australia has been trading relatively intensively with East Asia since the 1950s; by contrast, the intensity of that trade with Europe has doubled over the past half century (see

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

(a) Direction of trade (%)

		1951–55	1968–72	1990–92	2014–16 ^b
UK	X	36	11	4	1.9 (1.5)
	M	45	21	6	2.6 (3.1)
Other Europe	X	27	11	12	3.5 (4.5)
	M	15	19	20	15.4 (19.8)
North America	X	10	16	12	7
	M	15	27	26	14
East Asia + NZ	X	18	43	61	82
	M	10	22	42	59
Other	X	9	19	11	3
	M	15	11	6	9
TOTAL	X	100	100	100	100
	M	100	100	100	100

(b) Index of intensity of trade^a

		1951–55	1968–72	1990–92	2014–16 ^b
UK	X	3.3	1.7	0.7	0.5
	M	5.0	4.1	1.2	1.0
Other Europe	X	0.8	0.2	0.3	0.1
	M	0.5	0.4	0.5	0.4
North America	X	0.5	0.9	0.6	0.4
	M	0.6	1.6	1.5	1.0
East Asia + NZ	X	1.5	3.0	2.7	2.3
	M	1.1	1.8	1.7	1.9
Other	X	0.4	1.3	1.0	0.4
	M	0.6	0.6	0.6	0.6
TOTAL	X	1.0	1.0	1.0	1.0
	M	1.0	1.0	1.0	1.0

^a Index of export (import) trade intensity is the share of a region in Australia's exports (imports) divided by that region's share in world minus Australia's imports (exports).

^b Final column refers to UK, EU27, All Americas, All Asia + NZ, and all other countries. The numbers in brackets are for just agricultural and food products.

Table 10.2: Direction and index of intensity of Australia's merchandise trade, 1951 to 2016.

Source: Updated from Anderson (1995).

Table 10.2[b]). The natural complementarity between a resource-rich Australia and rapidly developing resource-poor Asian countries ensures this trading trend will continue for the foreseeable future (Anderson & Strutt, 2014).

Only a small proportion of Australia-EU28 two-way merchandise trade involves A&F products. That share has fallen from three per cent in the early 1990s to 1.5 per cent in 2014 to 2016; this is less than 1.2 per cent when services trade also is included in the total.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

(a) Australia's agricultural exports to EU28

	1990–92	2000–02	2005–07	2014–16
Fresh fruit and vegetables	5	3	5	10
Fibres	62	37	18	11
Other unprocessed	13	9	7	39
Meats	8	8	9	16
Dairy products	1	4	3	0
Alcoholic beverages	6	36	55	22
Other processed food	4	3	4	2
All AGRICULTURE & FOOD	100	100	100	100
Value (A\$ million)	2207	2961	2503	2879

(b) Australia's agricultural imports from EU28

	1990–92	2000–02	2005–07	2014–16
Unprocessed goods	10	10	7	6
Meats	1	5	5	8
Dairy products	8	5	4	7
Fish, processed	4	2	1	1
Fruit and vegetables, processed	8	8	8	8
Oils and fats, processed	7	8	8	4
Sugars, crop beverages	9	7	7	9
Alcoholic beverages and other	52	55	59	56
All AGRICULTURE & FOOD	100	100	100	100
Value (A\$ million)	707	1588	2491	4155

Table 10.3: Product shares and value of Australia's agricultural and food trade with EU28, 1990 to 2016 (% and A\$ million).

Source: Compiled by the author from data accessed at www.dfat.gov.au on 31 July 2017.

Among the A&F products Australia sells to the EU28, wool dominated up to the early 1990s, but its share of A&F product exports has since shrunk from above 60 to 11 per cent of the bilateral trade's value. The share of other unprocessed farm products in A&F exports has risen from one-sixth to one-half. Processed food and beverages comprised less than 20 per cent of Australia's A&F exports to the EU before the 1990s; these now comprise 40 per cent (this Figure was 71 per cent just prior to the financial crisis in 2008 [see Table 10.3(a)]). This fall over the past

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

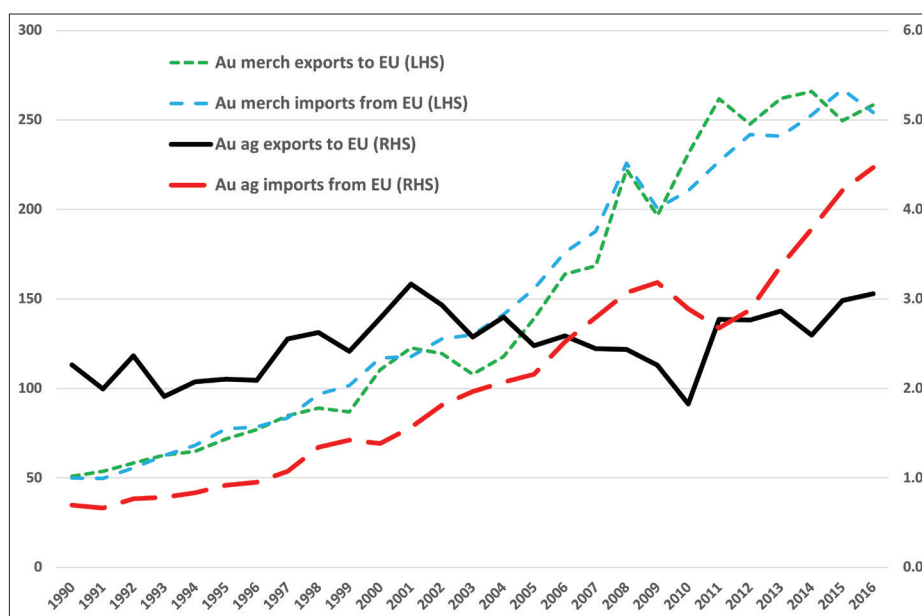


Figure 10.1: Value of Australia-EU28 trade in agricultural and food products and in all merchandise, 1990-2016 (A\$ billion).

Source: Compiled by the author from data accessed at www.dfat.gov.au on 31 July 2017.

decade is mainly due to a decline in the value of Australia's wine exports, although they still make up one-sixth of all A&F exports from Australia to EU28 in 2016.

The A&F products the EU28 sells to Australia are almost all processed goods. Meat and dairy products account for 15 per cent; another 12 to 15 per cent comprise processed fruits, vegetables and oils; nine per cent is made up of coffee, cocoa and confectionary. Around half comprises alcoholic beverages and tobacco products (see Table 10.3[b]). The latter contribution is not surprising, as wine and spirits accounted for one-sixth of the total external exports of A&F products from EU28 in 2015.

Up until a decade ago, the net balance in A&F trade between Australia and EU28 had always been in Australia's favour. This was consistent with the pattern of Australia's trade with the rest of the world.² However, in 2014 to 2016, Australia's exports of these products to the EU28 amounted to A\$2.9 billion, the same as in

² In 2006, Australia's A&F trade with the EU28 was balanced, whereas its A&F exports to other countries were 3.4 times its A&F imports from them. The latter ratio had fallen to 2.4 by 2016, but with the EU28, it had fallen from 1.0 to 0.65. Even with the UK, that ratio for Australia had dropped from 3.7 in 2006 to 1.1 in 2016.

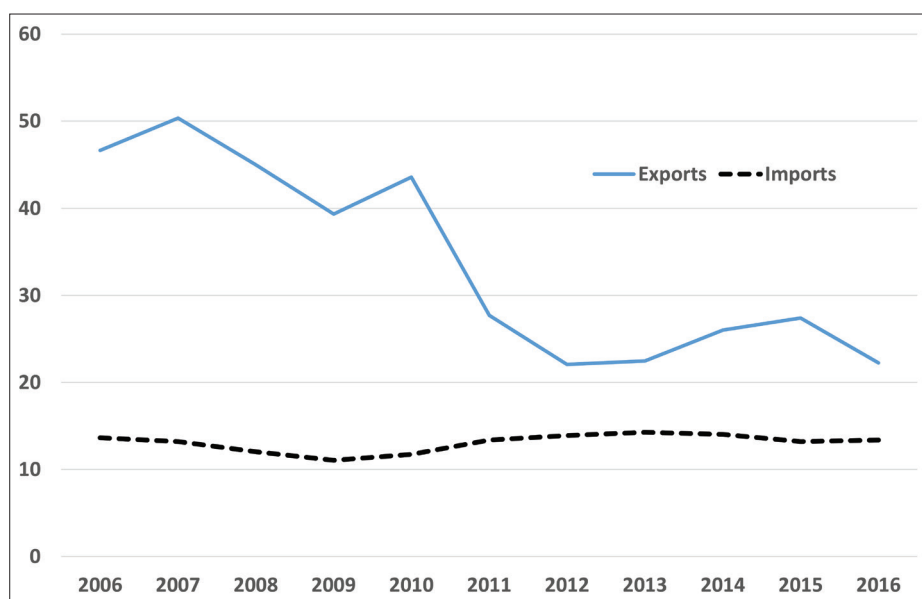


Figure 10.2: UK's shares of Australia's agricultural and food exports to and imports from EU28, 2006-2016 (%).

Source: Compiled by the author from data accessed at www.dfat.gov.au on 31 July 2017.

2000 to 2002. Conversely, its imports from the EU28 amounted to A\$4.2 billion, up from A\$0.7 billion in 1990 to 1992 and A\$1.6 billion in 2000 to 2002 (see Table 10.3). This cross-over of the bilateral trade imbalance in A&F products has also occurred in EU-US A&F trade (Bureau, Disdier, Fours & Felgercarb 2014, Figure 1.1), but contrasts with Australia-EU bilateral trade in non-A&F goods, for which a close balance has been maintained over the past 25 years. This is due to the distinct lack of growth in Australia's A&F exports to EU28 in current A\$ terms (see Figure 10.1).

In short, trade in A&F products is now a minor part of the bilateral trade between Australia and EU28. This will become even smaller once the UK exits the EU, given that the UK in 2014 to 2016 still accounted for one-quarter of Australia's A&F exports to the EU28 (down from one-half in 2007) and one-seventh of its A&F imports from the EU28 (see Figure 10.2).³ The UK shares of Australian exports to the EU are especially high for sheep meat (72%), wine (64%) and beef (40%). However, the shares are low for Australia's two top A&F exports to EU27: wool and almonds (see Table 10.4). While the EU's A&F exports to

³ The UK is also the largest foreign owner of Australian agricultural land, with a 52 per cent share.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

(a) Australia's agricultural exports

	To EU27 countries	To the UK	To rest of world
Wool	291	13	2603
Almonds	286	16	442
Wine	213	384	1571
Beef	182	121	8992
Lamb	39	101	2385
Canola	550	0	882
Chickpeas	1	12	992
Other	791	80	29793
ALL AGRICULTURE & FOOD	2353	727	47660
% of all Australian A&F	4.6%	1.4%	94.0%

(b) Australia's agricultural imports

	1990–92	2000–02	2005–07	2014–16
Unprocessed goods	10	10	7	6
Meats	1	5	5	8
Dairy products	8	5	4	7
Fish, processed	4	2	1	1
Fruit and vegetables, processed	8	8	8	8
Oils and fats, processed	7	8	8	4
Sugars, crop beverages	9	7	7	9
Alcoholic beverages and other	52	55	59	56
All AGRICULTURE & FOOD	100	100	100	100
Value (A\$ million)	707	1588	2491	4155

Table 10.4: Value of Australia's agricultural and food trade with the UK, EU27 and the rest of the world, 2015 (A\$ million).

Source: Compiled by the author from data accessed at www.dfat.gov.au on 31 July 2017.

Australia have kept pace with its exports of non-A&F goods, A&F trade in the opposite direction has grown very little since 1990. One possible reason for this is the changes made to trade-related policies. These changes are the focus of the next section.

Distortions to agricultural incentives in Australia and the EU

Markets for farm products in virtually all countries are altered by national government policies and by supra-national policies in the case of the EU's

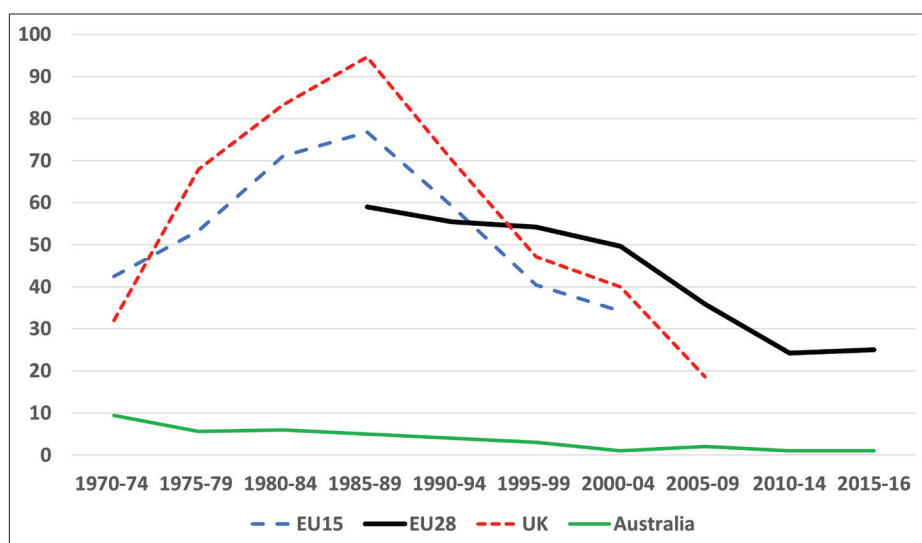


Figure 10.3: Nominal rate of assistance to agriculture, UK, EU15, EU28 and Australia, 1970-2016 (%).

Source: Compiled by the author from OECD (2017) for EU28 and 2012-16 for Australia, and for UK, EU15 and pre-2012 Australia from www.worldbank.org/agdistortions (accessed 2 August 2017) and Josling (2009).

CAP. West European farmers were among the world's most assisted prior to the 1990s,⁴ while Australian farmers have been among the least assisted. The extent to which producer returns are raised above what they would be without those policies is captured in percentage terms by the nominal rate of assistance (NRA). Estimates of NRAs from 1970 for both Australia and the EU are provided in Figure 10.3.⁵ They show that the average NRA for EU15, and especially for the UK, rose from the early 1970s to very high levels in the mid-1980s, but have since declined dramatically. They have also declined for the EU28, although at a slower rate than for the EU15, as assistance for the EU's newly joined countries gradually rose. There has also been considerable re-instrumentation of EU support for its farmers, towards less production, price and trade-distorting measures (see Figure 10.4).

4 Details of the range of policies affecting the EU's A&F trade are available in OECD (2017a, b) and WTO (2017).

5 Measures of the welfare effects of these and other merchandise trade-related policies are estimated using economy-wide models. The latest estimates by Laborde, Martin and van der Mensbrugghe (2017) suggest that these policies reduce economic welfare in the EU28, along with Norway and Switzerland, more than in any other high-income countries, while these policies in Australia (and NZ) are the least welfare-reducing and trade-distorting.

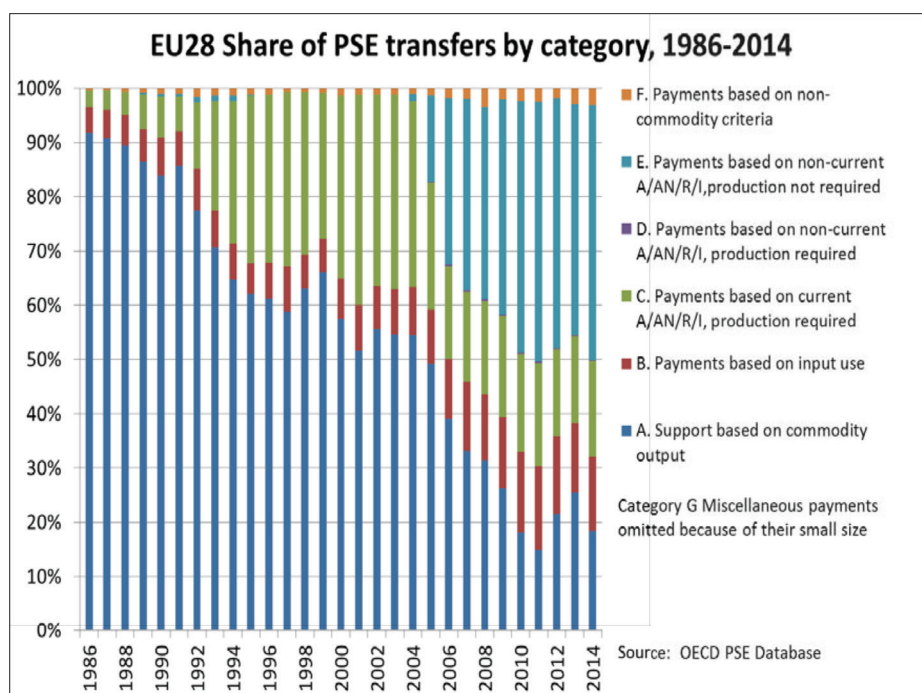


Figure 10.4: Shares of PSE transfers by category, EU28, 1986-2014 (%).

Source: Compiled by Matthews, Salvatici and Scoppola (2017) from PSE estimates provided by OECD (2017).

Cancelling the milk production quota in 2015, and the sugar quota in 2017, are two of the latest reforms, together with the disappearance of export subsidies (Swinnen 2015; OECD 2017a; WTO 2017). Even so, there is still considerable scope to open markets for A&F products in the EU. The simple average of most favoured nation (MFN) applied tariffs on A&F products in 2016 in the EU was 11 per cent (compared with four per cent for non-A&F goods). Fewer than one-third of those tariff lines were duty free (WTO, International Trade Centre and UNCTAD 2017). Tariff rate quotas (TRQs) provide at least some market access at concessional rates for politically sensitive, highly protected products.⁶

As of 2014, the highest tariffs on imports by the EU were applied to dairy products, with 36 per cent and sugar, with 26 per cent. Food preparations were

⁶ TRQs are bilateral quotas that allow a maximum quantity of imports at a concessional (in some cases zero) tariff rate, beyond which imports from that non-EU exporting country are subject to an (often much) higher out-of-quota applied tariff. In the case of the EU, this is often at, or close to, the rate it is legally bound by in the WTO Agreement on Agriculture.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	Simple average (%)	Tariff range (%)	Standard deviation	Share of duty free lines (%)	Share of non-ad valorem tariffs (%)
Meat products	20.2	0–289	29	15	69
Dairy products	36.1	0–635	60	0	99
Fruit and vegetables	13.1	0–183	14	12	17
Coffee, tea, cocoa	12.5	0–65	10	15	51
Cereals	15.7	0–76	12	9	80
Oilseeds, fats, oil	6.4	0–117	13	36	7
Sugars & confectionary	25.7	0–120	30	5	89
Beverages and tobacco	13.6	0–116	18	18	56
Cotton	0.0	0	0	100	0
Wool	0.0	0	0	100	0
Other	5.2	0–86	10	51	22
All agricultural products	14.4	0–635	24	19	47
All non-agricultural goods	4.3	0–26	4	27	1

^a Calculations for averages are based on the 8-digit tariff line level, excluding in-quota rates. Tariff schedule is based on HS2012. Ad valorem equivalents based on 2013 import data at the eight-digit tariff from Eurostat database.

Table 10.5: Summary statistics of MFN import tariffs,^a EU28, 2014.

Source: Compiled by Matthews, Salvatici and Scoppola (2017) from WTO (2015b).

also subject to significant tariffs, with meat preparations averaging at 20 per cent. Other products with significant EU tariffs are fruit and vegetables at 13 per cent and cereals at 16 per cent (see Table 10.5). Wine imports are taxed per litre according to alcohol strength and are taxed differently for bulk and bottled still wine (0.121 and 0.154 Euros per litre if 13–15 per cent alcohol, respectively). At the average prices of wine imports from Australia in 2016, those tariffs were equivalent to six per cent for bottled and 20 per cent for bulk still wine (accounting for more than four-fifths of the volume of Australia's wine exports to the EU). The EU also imposes high tariffs on grape concentrate—20 per cent if the Brix (sugar content) is below 67 and 40 per cent plus 0.206 Euros per kilogram if the Brix exceeds 67. These tariffs are not paid on trade between members of the EU, nor on Chilean wine or a quota of South African wine (under their respective bilateral EU FTAs). By contrast, Australia's ad valorem tariff on imports of both wines and spirits is just five per cent, and beer enters duty free.

Non-tariff measures (NTMs) also limit imports,⁷ and contribute substantially to the A&F average NRA on top of import tariffs. Together with tariffs, they had an ad valorem equivalent for the EU of 54 per cent in 2012 (Bureau et al. 2014). NTMs have been playing an increasing role as tariffs have reduced, and with growing consumer concerns about food safety and quality. Partly, they seek to overcome market failures or correct negative externalities. However, such domestic regulations may also impede imports.

Two main types of NTMs are sanitary and phyto-sanitary (SPS) measures and technical barriers to trade (TBT). The SPS Agreement in the WTO allows member countries to adopt measures to protect human, animal and plant health, as well as the environment, wildlife and human safety. The TBT Agreement in the WTO includes technical measures and norms, as well as testing and certification procedures not included in the SPS Agreement. These technical prescriptions may be implemented for health or safety reasons, but can also be used to standardise products, guarantee their quality, or notify consumers. Unlike the SPS Agreement, scientific elements are only one type of criteria used in assessing risks prior adopting TBT measures, as processing techniques or end uses may also be considered. For example, a treatment of imported fruit to prevent the spread of parasites will refer to the SPS Agreement, while a measure defining the quality, grading or labelling of imported fruit will refer to the TBT Agreement.

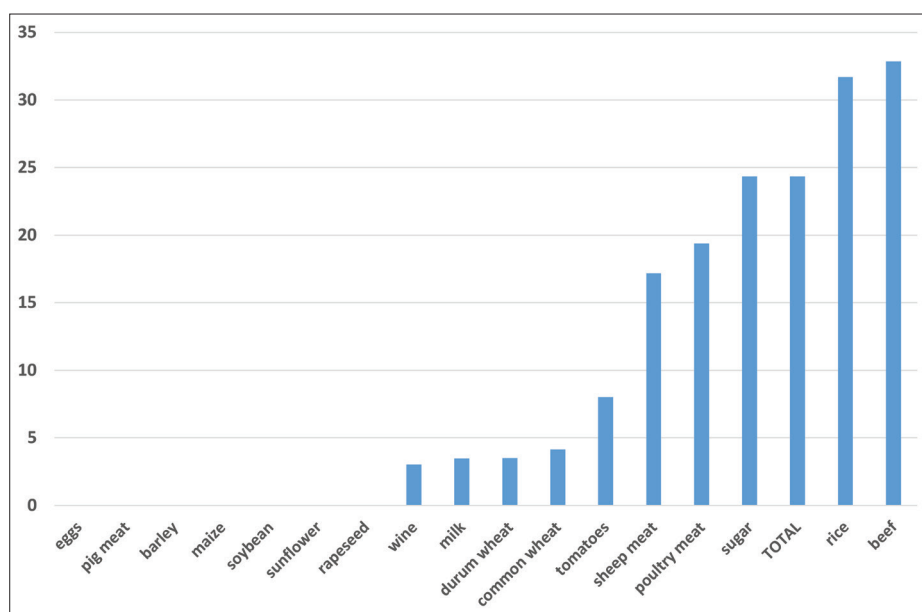
NTMs within the EU have gradually been harmonised across Member States, but some countries impose restrictions additional to the EU-wide ones. For example, tougher restrictions and in some cases, e-bans on imports of products containing genetically modified organisms apply in several EU Member States. This is also true of States within Australia.

The OECD provides estimates of government support to EU farmers that consider both tariffs and NTMs. The effects of TRQs and preferential tariffs are captured by the OECD's estimates through comparing domestic with border prices. They are converted for key products in Figure 10.5 to nominal rates of assistance: the percentage by which producer returns have been raised by those interventions. Even though the 2014 to 2016 NRAs in Figure 8.5 exclude many indirect supports (including those that are not product specific), they are still very high for rice, sugar and meats (other than pig meat), although this is no longer the case for dairy.⁸

7 For a comprehensive set of analyses of the impact of NTMs on A&F trade, see Beghin (2017). See also volume 11, no. 2 of the journal *World Trade Review* for a Special Issue from a symposium on standards, NTMs and trade.

8 The dairy NRA for the EU averaged 70 per cent in 1986-1988, 52 per cent in 1996-1998 and 31 per cent in 2004-2006, but just 3 per cent in 2014-2016.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT



^a The NRA omits a number of indirect forms of support, some of which are not product specific. When they also are considered in the case of wine, the NRA for 2007-2012 has been estimated by Anderson & Jensen (2016) to be 20.4%, compared with the OECD's estimate for those years of 0.3%.

Figure 10.5: Product NRAs^a EU28, 2014-2016 (%).

Source: Author's compilation based on producer single commodity transfers and the overall PSE from OECD (2017).

Current preferential trading arrangements affecting Australian and EU trade

The EU is a customs union with virtually free trade in A&F goods among member countries. This situation will probably change for the UK when it exits the EU. Meanwhile, the EU has many other preferential trade agreements, including with some least-developed countries (Everything But Arms Scheme), with developing countries (the generalised system of preferences [GSP]), and with African, Caribbean and Pacific Islands (ACP) developing countries that were formerly colonies of EU Member States. The EU also has myriad bilateral trade agreements, including the latest Economic Partnership Agreement (EPA) that has been agreed in principle with Japan, one soon to be ratified with Canada (CETA), and one with Chile dating to 2002, which has comprehensive agricultural provisions.

Australia has a much smaller number of trade agreements, mostly with countries in the nearby Asia Pacific region. By far the most comprehensive is with New Zealand (NZ): the Australia-NZ Closer Economic Relations Trade Agreement

(ANZCERTA) was signed in 1983. With subsequent enhancements it allows all goods and most services to be freely traded across the Tasman Sea. It has even fully harmonised food safety provisions such that there is now a joint authority that oversees these. Australia also has an FTA with the ASEAN and some with several ASEAN Member States. Even more importantly, in recent years Australia has ratified bilateral FTAs with the People's Republic of China (China), Japan and the Republic of Korea (Korea). These have freed A&F trade with those crucially important trading partners. Australia is also currently negotiating bilateral trade agreements with Hong Kong, SAR, India, the Pacific Alliance and Peru, and it has recently concluded the Indonesia-Australia Comprehensive Economic Partnership Agreement (IA-CEPA).

Possible effects of future free trade agreements on EU agriculture

New modelling of the potential economic effects of a possible Australia-EU27 FTA has not yet been undertaken to the author's knowledge, and for good reason: great uncertainty remains about what Brexit may involve.⁹ However, a 2016 study by the European Commission has modelled the cumulative effects on EU agriculture of the partial trade liberalisation that might emerge from a sub-set of 12 bilateral FTAs among those being contemplated by the EU (Boulanger, Dudu, Ferrari, Himics & M'barek 2016). In addition to Australia, the others relate to Canada, Japan, Indonesia, Mercosur, Mexico, NZ, the Philippines, Thailand, Turkey, the US and Vietnam. Leaving aside the issue of Brexit (exit of the UK from the EU), two reform scenarios are considered for both the EU and all 12 partner countries. This is an ambitious scenario that provides full tariff liberalisation for 98.5 per cent of HS 6-digit lines, a partial tariff cut of 50 per cent for the remaining (politically sensitive) products, and a more conservative scenario providing full tariff liberalisation of 97 per cent of HS¹⁰ 6-digit lines with a partial tariff cut of 25 per cent for the other products. The modelling results are unsurprising, given the nominal rates of assistance in Figure 10.5 for different EU producers. Key findings indicate that:

EU producers of cereals, pig meat, milk, wine and spirits would benefit from such trade opening, while EU producers of beef, rice, sugar and to a lesser extent poultry and sheep meat would face stronger competition from imports—even though the modelled scenarios included lesser tariff cuts for these politically sensitive products.

⁹ On the uncertainty with respect to Brexit's potential impact on wine trade, see Anderson and Wittwer (2018).

¹⁰ Harmonized Commodity Description and Coding Systems.

AGRICULTURAL POLICY ISSUES BETWEEN AUSTRALIA AND THE EU27

The above discussion clarifies that agriculture and food have been a relatively minor part of Australia's EU trade in recent decades, but that this is partly due to high tariffs and NTMs inhibiting that trade. Both parties have strongly held offensive and defensive concerns that are likely to result in robust FTA negotiations. Certainly, numerous trade-expanding opportunities exist, but strong reform resistance can be anticipated. Additionally, as with other parts of this FTA negotiation, the UK's proposed exit from the EU will complicate some aspects of the A&F talks with the EU27, particularly with respect to splitting current TRQs.

Australia has many more offensive positions than the EU with respect to A&F tariffs, but both parties have strong defensive positions around A&F NTMs. Indeed, the EU and Australia have the dubious reputation of being the subject of more notifications in relation to SPS and TBT matters at the WTO than any other members (Horn, Macrolides & Wickströms, 2013) (no SPS complaints have been made against Australia in recent years [WTO 2015, p. 56]). Regardless, this history suggests each party may gain by exploring opportunities for A&F regulatory cooperation.

On tariffs and TRQs, Australia will no doubt seek lower out-of-quota tariffs or much-expanded quotas to allow more exports of beef, sugar, lamb, dairy products and perhaps rice to the EU. Australia has very small quotas for all four items compared with the main suppliers, most notably NZ for lamb and dairy products. Australia must also ensure that an improvement of access is not limited by safeguard clauses, such those built into the Australia-US FTA.

Australia may also argue for lower EU tariffs on wine, which are currently equivalent to six per cent on an average-priced bottle of still wine imported from Australia, around 20 per cent on bulk wine and more than that on grape concentrate (depending on its sugar content). Undoubtedly, this would require a concession on Australia's five per cent tariff on both wine and spirits imports.¹¹ The EU also may seek to re-open the issue of technical standards and geographical indications (GIs).¹² These are currently covered in an Australia-EU Wine Agreement, first signed in 1994 and refreshed in 2010. This agreement not only protects wine GIs and traditional expressions, but it has also led to harmonised winemaking practices and reduced analytical requirements (such as labelling, blending rules and alcohol levels) for obtaining EU import certification. The Australian wine industry would

11 The Australian tariff is *ad valorem*, so it taxes the EU's relatively highly priced wine in Australia more per bottle than does the volumetric tariff on EU imports of premium Australian wine.

12 On the myriad legal, economic and political aspects of linking products to their location of production via GIs, see Giovannucci et al. (2009).

be very reluctant to renegotiate such a hard-won agreement. Further, other A&F industries in Australia may be equally reluctant to see GIs and tradition expressions imposed to protect the EU's high-quality cheeses, hams, edible oils and other processed foods.

The EU may well take an offensive position on pig meat, imports of which are tightly controlled by Australian SPS measures. Its negotiators will be aware of the estimated effects on welfare and trade of the quarantine regime, as reported by Beghin and Malates (2012). These authors suggest withdrawing the regime would generate an annual welfare gain to Australian consumers of A\$0.4 billion and an import growth of around A\$0.5 billion.

Regarding TBTs, both parties have an interest in exploring opportunities to make deeper commitments to transparency, harmonisation to international standards and mutual recognition equivalence, knowing that this might spread to third countries.

CONCLUSION

While trade between the EU and Australia in A&F goods has declined in recent decades and is now only a small part of the bilateral trade and investment relationship, there are nonetheless various possibilities for expanding A&F trade between the two regions. An Australia-EU FTA negotiation opens an opportunity to explore those options. In the past, Australia would have been the main demander for trade opening in the A&F space, but A&F trade is currently much more closely balanced. This situation is likely to continue, as producers on both sides look increasingly to differentiate their various processed foods and beverages. Presently, that differentiation moves well beyond private branding—it also includes food safety, nutritional and quality standards, and in particular, process standards, such as those affecting organic or gluten-free goods. Just as interest is emerging in the EU to transition the CAP towards a Common Food Policy involving all aspects of the food value chain, so Australian attitudes towards food production, processing and marketing are evolving rapidly (CSIRO 2017). That may nudge Australia further towards exploiting what has been perceived by Daly et al. (2015) as its potential comparative advantage in a wider range of high-value niche food products.

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FOREIGN INVESTMENT AND INNOVATION

Shandre Thangavelu and Christopher Findlay

ABSTRACT

Given that services trade issues relating to commercial establishment are explicitly covered in the European Union (EU) negotiating mandate with Australia, this chapter provides an overview of two-way Australia-EU investment flows and policy irritants. This includes an analysis of Australia's Foreign Investment Review Board investment-screening threshold, which is higher for the EU than for countries that already have preferential trade agreements with Australia. The chapter also discusses the link between investment, economic growth and future innovation.

INTRODUCTION

In this chapter, the features of the investment flows between Australia and the European Union (EU) are examined and current issues identified. Foreign investment can take the form of direct or portfolio investment and both are discussed here. Direct investments are those in which the investor holds ten per cent or more in the ownership of a business, which enables the investor to exercise a significant degree of influence over that business. Portfolio investment involves the purchase of securities in terms of equity and debt.

The next section reviews the data on the flows of each form of investment between Australia and the EU, and the relative importance of each economy to the other. A discussion follows of the policy questions associated with the flows, and therefore the issues which may emerge in negotiations related to trade and investment agreements. The final main section of the chapter discusses the link between capital flows and innovation, and the policy implications of that connection.

AUSTRALIA-EU INVESTMENT RELATIONSHIP

Australia has an important two-way investment relationship with the EU. Table 11.1 shows that in 2016, Australia had a total stock of outward investment of both types—direct and portfolio—to the EU of A\$611 billion (28% of the total Australian outward) and an inbound stock of A\$1072 billion (34% of the total) (DFAT 2016b). The EU is the largest investor in Australia; within that total, the United Kingdom (UK) is about as important as the rest of the EU. The EU is almost equal first with the United States (US) as a destination for Australian investment; within that total, the UK is more important than the remaining EU Member States combined.

In the last decade, the total stock in Australia of investment from the EU has doubled, but the stock from the EU27 (EU minus the UK) has increased four-fold—and investment relationships with the rest of the EU have been deepening (see Table 1). Australia's outbound stock in the UK and the rest of the EU have both more than doubled; and that in the UK has increased a little faster. In 2016, the UK accounted for about 16 per cent of the total stocks of foreign investment, both inbound and outbound. The EU27 accounted for 12% of the outbound and 17% of the inbound.

The share of direct investment in total foreign investment into Australia is relatively small: direct investment accounts for only 15 per cent of the total stock of foreign investment from the EU which is decidedly smaller than the average share of 25 per cent from all sources. The relationship with respect to portfolio flows inbound to Australia is therefore relatively even more important for the EU than it is for Australia's other investment partners. The same applies to investment from Australia, where direct investment accounts for only 17 per cent of the total.

With respect to sources of inbound direct investment, the EU27 is more important compared to the UK. In 2016 the contributions to the total direct stocks in Australia were 9 per cent from the UK and 12 per cent from the EU27. However, the UK is twice as important (13% of the total for all countries) than the rest of the EU27 (6%) as a destination for outward direct investment from Australia.

The Australian Bureau of Statistics (ABS) does not provide data on the economic characteristics of direct investment to and from Australia. Despite this, partner country mirror statistics—collected through Foreign Affiliates Trade Statistics (FATS)—can be used. The latest FATS data, compiled by the EU (Eurostat 2014), refer to calendar year 2014. The EU had 3,033 majority-owned enterprises in Australia and employed 294,700 people. EU affiliates in Australia included 1,114 enterprises from the UK, 648 from France and 407 from Germany, with sales

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(a) Foreign investment in Australia

Country	2006	2016
China, PRC	3.5	87.3
Japan	51.7	213.5
NZ	35.7	74.7
Singapore	27.4	98.9
UK	359.6	515.5
US	383.1	860.9
ASEAN	46.7	127.0
EU28	495.8	1072.2
EU27	135.2	556.7

(b) Australian investment abroad

Country	2006	2016
China, PRC	3.0	87.9
Japan	41.6	108.3
NZ	69.4	106.9
Singapore	15.1	61.5
UK	130.4	350.5
US	352.8	617.4
ASEAN	24.3	97.5
EU28	257.1	611.0
EU27	126.7	260.5

Table 11.1 Total foreign investment stocks (A\$ billion).

Source: Based on ABS catalogue 5352.0 in DFAT 2016a. Table includes author's calculations.

from UK firms of A\$108 billion, Germany A\$45 billion and France A\$33 billion (DFAT 2017a, 2017b). According to sales data, 50 per cent of the EU presence in Australia is in services, 33 per cent in manufacturing and 17 per cent in mining. The services sector investment is dominated by wholesale and retail services (22% of

the total sales of all affiliates in all sectors), followed by finance and insurance (9%) and then professional services (4%). The EU commercial presence in information and communications technology (ICT), as well as construction, is relatively less important (2% each) (DFAT 2017b, p. 4).

According to the FATS data, in 2014 Australia had 1,177 majority-owned enterprises in the EU, with total sales of around A\$47 billion. This is more than double the value of direct exports from Australia to these economies. Large items are manufacturing (150 enterprises with sales of A\$9.8 b), wholesale and retail (266 enterprises and A\$8.8 b) and professional services (189 enterprises and A\$2.4 b). Australians had established 138 ICT-related enterprises in the EU by 2014: sales data are not available, but their industry value-added in the EU is similar to that of Australian-owned manufacturing enterprises. Data on financial services are not available. Even without that data, the services elements of the Australian presence are at least twice that of manufacturing (by value-added data). Most Australian businesses in the EU are located in the UK (41%), followed by Germany (8%) and the Netherlands (5%) (DFAT 2017b, pp. 2-3). DFAT (n.d.[a]) reports that 'Approximately 1500 Australian companies are active in the UK, with a large number using the UK as a base for continental Europe'.¹

With respect to investment other than direct investment, the EU accounts for 38 per cent of the total stock in Australia (of which the UK accounts for half) and for 31 per cent of the total stock held offshore by Australians. In the case of the latter outflow, the UK is relatively more important than the rest of the EU (17% compared to 14%).

The EU is a significant inbound and outbound investment partner for Australia, but the reverse does not apply. Australia accounts for a very small proportion of total EU outward investment. With respect to direct investment, Australia held 0.4 per cent of total EU outward stocks in 2015. Australia also accounts for 1.75 per cent of the EU's stock of all outbound investment (Eurostat 2017). However, even with a small share, Australia ranked ninth among direct investment destinations in 2015.

IMPEDIMENTS TO INVESTMENT FLOWS

Portfolio investment

Portfolio investors can make a transaction via a direct purchase of securities in an offshore market through financial services providers located there, or through a fund based in their home country which meets the local regulatory requirements.

¹ See also Suder (2016).

The EU has facilitated cross-border investment in a number of ways, including through the system of *Undertakings for Collective Investment in Transferable Securities* (UCITS 2009), in which a fund set up in one European jurisdiction is permitted to offer access to investors (retail and institutional) throughout the EU (and Iceland, Liechtenstein and Norway). The purpose of this is to facilitate the cross-border mobility of investment while also providing investor protection. Funds that meet the UCITS conditions are distributed outside the EU, including in a number of APEC member economies (Singapore, Hong Kong, SAR, Peru, Chinese Taipei and Japan) (Ernst & Young 2015).

The UCITS conditions include rules on how the funds are established and managed, what structures are permitted, minimum capital requirements, eligible assets and rules on borrowing, as well as descriptions of how information is to be provided to investors. However, some local conditions remain in these funds since the EU Directive was implemented via national legislation, resulting in ‘minor differences in terms of both implementation and interpretation’ (Ernst & Young 2015, p. 2). This situation leads to differences in preferences regarding where to set up a UCITS fund: Luxembourg is the most popular location, followed by Ireland, France and the UK.

One way to facilitate the flow of funds in both directions is to connect the Australian funds management sector with the UCITS regime. Recently, the Australian regulator agreed that the regulatory process for such investment funds in Luxembourg, is equivalent to Australia’s. As such, the managers of these Luxembourg funds are relieved from any requirement to hold an Australian licence (ASIC 2016; Association of the Luxembourg Fund Industry, 2016). This is significant given the importance of that country as a host for UCITS funds. This regulatory relief lowers the costs of access for Australian investors into the EU.

The ability of Europeans to invest in Australia is also expected to be made easier and more efficient by legislation now under consideration in the Australian Parliament to create a corporate collective investment vehicle (CCIV).² This vehicle would have a similar structure to UCITS, with Australian legislation aligning the regulatory structures to global standards. The documentation of the new legislation also indicates that the tax treatment of CCIV funds has been presented for comment.

The European system continues to evolve. A recent review (European Commission 2018b) reported a continuing home market bias in investment choices: 70 per cent of assets under management are registered only for sale in their home markets; just 37 per cent of UCITS funds are registered for sale in more than

² For more information on the CCIV, see <https://consult.treasury.gov.au/financial-system-division/c2018-t299864/> and <https://consult.treasury.gov.au/financial-system-division/c2018-t310332/>

three EU Member States. Factors include the lack of transparency about marketing rules, differences in fee setting, whether local facilities should be available to support investors and procedures for updating notifications. New regulations have been drafted to make changes to the UCITS system in these respects.

Despite the extent of the current funds flow of funds between Australia and the EU, an opportunity remains to lower barriers to that flow, according to these recent events. The main barriers are those associated with misalignment of regulatory systems and work is in progress in both jurisdictions that will help resolve those differences. However, these systems continue to evolve. Discussion of a bilateral economic agreement provides the opportunity to create a framework within which the parties can routinely, and with wider coverage and application, exchange information, monitor and then respond and align to the changes occurring in each other's jurisdictions.

Both parties also have an interest in the development of the APEC Region Funds Passport (ARFP), which like UCITS, will 'provide significant benefits to investors through more fund choice, while maintaining effective legal and regulatory arrangement for investor protection' (ARFP 2018). Indeed, its establishment prompted the Australian CCIV legislation. UCITS funds, as already noted, are popular in many ARFP-participating economies (lead members are Australia, Thailand, Japan, Republic of Korea [Korea] and New Zealand [NZ], with observers from Singapore, the Philippines and Hong Kong, SAR). The new arrangements may have a diversionary effect on the flow of funds: a situation to which the EU funds management industry would want to respond. Likewise, Australia could benefit from seeking consistency between, or at least benchmarking, the ARFP and its UCITS-consistent structures, facilitating Australian services providers to become intermediaries between Europe and Asia.

A final point in relation to portfolio flow is the taxation treatment of the income flows. Australia imposes a withholding tax on interest and dividends paid to foreign residents (Australian Taxation Office 2018). The tax rates are reduced for countries with which Australia has a tax treaty, and treaties are organised country by country (Treasury n.d.). The opportunity exists to build on the bilateral negotiation with the EU as a whole to widen and align the coverage of those country-level treaties.

Direct investment

With respect to foreign direct investment (FDI), restrictions tend to arise due to:

- foreign equity limitations
- screening or approval mechanisms

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Country	2006	2017
AUS	0.237	0.147
AUT	0.149	0.106
BEL	0.042	0.04
FRA	0.045	0.045
DEU	0.03	0.023
GRC	0.051	0.032
IRL	0.05	0.043
ITA	0.054	0.052
LUX	0.004	0.004
NLD	0.02	0.015
POL	0.076	0.072
PRT	0.007	0.007
ESP	0.036	0.021
SWE	0.079	0.059
GBR	0.056	0.04
OAVG	0.084	0.066

Table 11.2: OECD FDI regulatory restrictiveness index, 2006-2017.

Source: <https://data.oecd.org/fdi/fdi-restrictiveness.htm>.

- restrictions on the employment of foreigners as key personnel
- operational restrictions; for example, restrictions on expansion (through branches) or on capital repatriation or on land ownership.

The OECD FDI Regulatory Restrictiveness Index measures the extent of statutory barriers against FDI in over 60 countries, along with trends in rankings since 1997. Table 11.2 includes a sample of results. The EU has one of the world's most open direct investment regimes; collectively, EU Member States have the fewest FDI restrictions globally. Also of interest is the decrease in the index values for many countries over the decade, including Australia.

The index for Australia was around 0.27 in 1997, dropping to 0.24 in 2006 and then to 0.15 in 2017, indicating significant FDI liberalisation on the part of Australia. However, the degree of restrictiveness in Australia compared to selected EU Member States (and compared to the OECD average) is relatively high: of the country sample listed, only Austria has an index value exceeding 0.1 (the OECD average is 0.07). Two-thirds of Australia's index is related to screening procedures and most of the balance to foreign equity restrictions.

European business stakeholders have referred to the barriers to FDI flow into Australia (European Commission 2017a). These include equity caps on investment including in ‘telecom and national airlines’, FDI screening and some sectoral restrictions. Also listed are ‘postal and express delivery; distribution services (e.g. car sector); professional services (legal and accounting); financial services, gambling and betting, aviation, maritime transport, etc.’ (European Commission 2017a, p. 61). The European Commission (2017a, p. 7) notes that EU investors are in a less favourable position compared to investors from countries for which Australia has included investment protection in its free trade agreements (FTAs) or bilateral investment treaties (BITs).³ EU investors face stricter screening thresholds than investors from other countries such as the United States [US], the People's Republic of China (China), Japan and Korea that have already concluded FTAs with Australia.

Further, the BITs that EU Member States have with Australia include out-dated investor-state dispute settlement (ISDS) mechanisms, that no longer align with the EU’s new approach to investment (policies) as set out in the “Trade for All” Strategy (European Commission 2015).

The context of concern about screening is related to the Australian Government Foreign Acquisitions and Takeovers Act 1975 (FATA). The Foreign Investment Review Board (FIRB) was established in 1976 to administer this Act and to advise the Australian Treasurer on foreign investment-related policy matters.

Australia applies various different screening thresholds to different trading partners. Currently, screening is applied as follows. Foreign investors who seek to buy at least 20 per cent of an Australian business valued above A\$261 m must seek FIRB approval. This applies to EU investors. For FTA partners (Chile, China, Japan, Korea, NZ and the US), the threshold is A\$1.134 m. However, this remains at A\$261 m for sensitive businesses. These are media, telecommunications, transport, defence and military-related industries, along with the extraction of uranium or plutonium and the operation of nuclear facilities. Some real estate transactions must be approved. The limits in agribusiness are 10 per cent and A\$57 m; in media businesses, the limit is 5 per cent ownership at any value. Foreign investors must gain approval for a ‘proposed acquisition of an interest in agricultural land where the cumulative value of agricultural land owned by the foreign person (and any associates), including the proposed purchase, is more than \$15 million’ (FIRB 2018a). Under other legislation, foreign equity limits also apply to investment in airports, Qantas, Telstra, ships and banking (FIRB 2017).

3 Australia has BITs with the following EU Member States: the Czech Republic, Hungary, Lithuania, Poland and Romania (DFAT 2017d).

Foreign investment proposals subject to FIRB screening are rarely rejected, but often have conditions attached. In the financial year to June 2017, 15,190 applications were considered by the FIRB and (omitting those withdrawn or exempt) only three were rejected,⁴ 8,607 were approved and 5,750 were approved with conditions (FIRB 2018b). The number considered was far lower than the previous year, mainly as a result of a reduction in approvals related to real estate, and because the imposed application fees also lowered the number of applications (FIRB 2018b, p. 33). However, the value of projects approved was A\$192.9 billion (the value of rejected projects was A\$20 billion). The most important sectors in that year were services (28% of the value of approvals), commercial real estate (23%) and a category of ‘manufacturing, electricity and gas’ (21%). Important EU investors involved were the UK (A\$4.2 billion in value of approvals), the Netherlands (A\$4.1 billion) and Germany (A\$3.2 billion) (FIRB 2018b, p. 40).

While EU investors are subject to this process and these limits, different conditions apply to Australia’s FTA partners. A threshold of A\$1134 million applies to FTA investors from Chile, China, Japan, Korea, NZ and the US. However, a A\$261 million threshold applies to these investors if investing in sensitive businesses, which include agriculture, media, telecommunications and defence.

While there is no EU-wide investment-screening mechanism, many individual EU Member States—Austria, Denmark, Germany, Finland, France, Latvia, Lithuania, Italy, Poland, Portugal and Spain—have some type of inward investment-screening mechanism in place (European Commission 2017b). The screening mechanisms normally set out qualitative criteria or quantitative thresholds, or a combination of both. Qualitative criteria may require, for example, acquisition of direct or indirect control over a company or assets. Quantitative criteria may include thresholds referring to the percentage of shares or voting rights, within a 5 to 50 per cent range. In a similar vein to Australia, EU Member State investment-screening mechanisms limit investment in specific sectors deemed strategic—telecommunications, transport or energy—and in certain companies or activities considered of strategic importance to national security.

Another issue relates to the settlement of disputes (European Commission 2017a). The ‘Trade for All’ Strategy includes the goal that the Commission will:

in a first step, include modern provisions in bilateral agreements, putting stronger emphasis on the right of the state to regulate, something which was not sufficiently highlighted in the past. EU bilateral agreements will begin the transformation of the old investor-state dispute settlement into a public

⁴ FIRB 2018b (p. 22) reports that one of these was in the residential real estate sector and the other two related to the long-term lease of the New South Wales electricity grid.

Investment Court System composed of a Tribunal of first instance and an Appeal Tribunal operating like traditional courts. (European Commission 2015, p. 21)⁵

Australia takes a case-by-case approach to ISDS. For example, the agreements with Korea, China, Singapore, Chile, Thailand, Peru as well as the agreement with ASEAN and NZ, include provisions giving investors the right to initiate ISDS proceedings in accordance with international arbitration rules (DFAT n.d.[b]). The dispute would relate to a breach of commitments made in the trade agreement related to investment that induced a loss by the investor. However, this provision of third-party ISDS arbitration is excluded from Australia's FTAs with the US, NZ and with Japan.

INNOVATION AND INVESTMENT

This section illustrates areas of cooperation between Australia and the EU and comments on the value that can be added to that cooperation from investment flows.

Australia and the EU have a Science and Technology Agreement (1994).⁶ Originally signed in 1994, this was the first treaty-level science and technology agreement signed by the EU with an industrialised country. Australia is an active participant in the funding programs that support research in the EU, referred to as framework programs (FPs). The recent FP7 (2007-2013) contained 169 collaborative projects. Total spending in projects involving at least one Australian partner in FP7 was more than €1.6 billion (A\$2.4 billion), with over €1 billion (A\$1.5 billion) invested by the European Commission and €67 million (A\$100 million) coming from Australian sources. Australia ranked ninth among non-EU partners in this period.

The next cycle of these programs, called Horizon 2020, runs from 2014 to 2020 and is valued at €77 billion (A\$115 billion) (EU Delegation to Australia 2016). The EU is seeking to 'double' international collaboration in this cycle. Australia is not generally eligible for this funding, but this can be negotiated on the basis of 'outstanding competence/expertise, access to research infrastructure, access to particular geographical environments, access to data' (EU Delegation to Australia 2016, p. 11). Australians must also participate in collaboration with others from the EU (EU Delegation to Australia 2016, p. 12). The Australian Government also

5 This ambition is discussed in more detail in chapter 16 in this volume.

6 There was an amendment in 1999 which widened the coverage of the Agreement. See *Agreement amending the agreement relating to scientific and technical cooperation between the European Communities and Australia* (1999).

provides funds to support international collaboration in research. The Australian Global Innovation Strategy (Department of Industry, Innovation & Science 2016) focuses on collaboration between researchers and businesses, including small and medium-sized enterprises (SMEs), both in Australia and offshore.

The commitment to science and technology cooperation is referred to in the recent Framework Agreement between the EU and Australia (signed in August 2017) in several ways. According to DFAT, ‘(t)he Agreement will enhance cooperation between Australia and the EU to tackle challenges in foreign and security policy, sustainable development, climate change, and economic and trade matters’ (DFAT 2017c). Examples include mention of cooperation on technology in the section on climate change and that on the information society. Additionally, a dedicated section on science and technology is included, with agreement to enhance ‘cooperation in the areas of science, research and innovation in support of, or complementary to, the *Agreement relating to scientific and technical cooperation between the European Community and Australia* (DFAT 2017c). Areas of interest are ‘key shared societal challenges’.

The Agreement refers to a number of matters often considered in trade policy, including procurement, people movement, regulation and competition policy, and multilateralisation in the context of science and technology cooperation. For example:

- Efforts will be made to increase the scope for researchers in Australia and the EU to access the programs of both and to ‘include a range of public- and private sector innovation actors, including SMEs’; that is, to avoid discrimination against some domestic actors.
- There is agreement to work together to ‘initiate and participate in wider regional and international research and innovation collaboration’; that is, to extend cooperation beyond the bilateral.
- There is reference to access to critical infrastructure and to researcher mobility.

The scope for the negotiation to complement these ambitions is discussed further below.

Australian business is a significant investor in research. According to the Australian Trade Commission (Austrade 2018), business expenditure on research and development (R&D) accounts for 54 per cent of Australia’s total R&D expenditure. It expanded from A\$5 billion in 2000 to 2001 to about A\$17 billion in 2015 to 2016. This is a compound annual growth rate of 8 per cent since 2001. Austrade also notes that gross (public and private) R&D expenditure in Australia has increased on average by 8.5 per cent a year in real terms since 2000, which is

higher than the OECD average growth rate of 4.8 per cent. Willox (2014) however notes that relatively few Australian businesses (compared to OECD averages) are involved in research.

When the private sector is involved in research, the work is now often done with international partners,⁷ in the form of global innovation networks (GINs). Maskus and Saggi (2013) explain that these networks involve multinational corporations establishing research facilities at different locations globally. These facilities exchange information with each other and the parent firm, but also involve or connect to other local participants, such as universities, government agencies, start-ups and research service providers and institutions. Firms in the GINs are building global value chains (GVCs) in research and all the same motivations apply as for manufacturing or services. These include a reduction in the cost of innovation through allocating research services to locations with a competitive advantage. This relates to the endowments of key inputs into research, but also relates to the knowledge that has been accumulated (essentially a part of the capital stock) that reflects the current and past structure of an economy's output. An important element of this motivation is also access to relevant skills and talent. Through building a GVC for research, investors are also able to better design products and services for local markets and solve problems (thereby capturing business opportunities) which operate across borders.

Sachwald (n.d.) observes that the internationalisation of research has increased since the mid-1980s. He stresses the link between GVCs in production and those in research. He argues that internationalisation of research is driven by both the development of GVCs and by the dynamics of the processes of innovation. He refers to findings of other studies that identify drivers of offshore locations of research related to the potential size of the market for the final outputs, the quality of personnel to provide research services, the scope for collaboration with universities and the intellectual property (IP) regime. Sachwald identifies three types of international research centres. One type supports the tailoring of products to meet local demand. A second is driven by access to excellent academic research. A third relates to the efficient delivery of research services, and is linked to access to staff at a lower cost than in the investor's home economy.

A number of issues affect the operation of these research networks. In all their forms, they involve direct investment. Impediments in that respect will constrain their development. Other issues in the operation of these networks include the treatment of IP and the movement of people.

7 For examples involving Australia and the EU, see Davison (2016) and Pyne (2015).

IP can be already existing ('background' IP) or can also be created by new research. The Horizon 2020 documentation refers to the matter of IP rights in relation to research where IP rights arrangements are agreed to by all the partners before the project is signed. Normally, 'background' IP—the knowledge and information held by participants before (an agreement to cooperate) is struck—can be used by project participants with no charge and any IP created by the project is shared between the partners (European Commission 2018a, p. 13). More generally, IP Australia, which administers property rights and legislation related to IP, refers to the EU IP system as 'complex and expensive given the number of different national and EU-wide rights available. Fees to file applications for IP rights can be significantly more expensive than that incurred in Australia' (IP Australia 2016). However, it also refers to a pilot designed to fast-track patent applications in which 'a patent applicant who has received a ruling that at least one claim in an application is patentable/allowable will be able to fast-track examination of a corresponding application filed with the other partner IP Office' (IP Australia 2016).

Another issue is relates to the movement of people. Maskus and Saggi (2013) observe that face-to-face interaction is important for 'expanding research productivity within affiliated networks and creating spillovers across units' (Maskus & Saggi 2013, p. 2). That leads them to discuss the importance of people movement for the success of these networks, and the value of more freedom of movement for 'technical and entrepreneurial talent' (Maskus & Saggi 2013, p. 4), ideally among a group of like-minded countries in the form of an 'innovation zone'. This would involve cooperation on the issuance of visas and the recognition of qualifications. However, Maskus and Saggi (2013) derive this concept from their discussion of the nature of GINs, where they focus on arrangements which involve more than two economies. The negotiation of a bilateral agreement provides an opportunity to consider this concept and put in place relevant mechanisms, with those outcomes being more valuable when they can be extended to other parties. The openness to do so is an important principle in the design of the bilateral framework.

In summary, the development of the GINs and the participation of the private sector in research would be supported not only by commitments related to direct investment, but also to effective processes in the management of access to IP regimes and the movement of people. Further value would be created by making operational some of the ambitions in other current agreements related to science and technology, including access to funding, the treatment of data flows, access to infrastructure and the multilateralisation of bilateral cooperation. One way to form a structure that would facilitate the design of commitments in this area would be to adopt Maskus and Saggi's (2013) suggestion to specify a category of research-related services.

The value of work related to research cooperation has been heightened by recent events. An indication of the EU's approach to issues related to technology and its movement across borders lies in reports of cooperation between the Trade Ministers of the US, Japan and the EU meeting in Paris in May 2018. The Ministers issued a joint media statement (Office of the US Trade Representative 2018) confirming their 'shared view that no country should require or pressure technology transfer from foreign companies to domestic companies, including, for example, through the use of joint venture requirements, foreign equity limitations, administrative review and licensing processes, or other means'. The joint statement referred to using regulations to force foreign investors, who would in any case want to license technology to domestic businesses located in the host economy, to do so on terms more favourable than the market may determine. The Ministers agreed to share information on good practice to avoid this happening, and this included efforts to 'work together, including with other like-minded partners, to find effective means to stop harmful forced technology transfer policies and practices, including, where appropriate, dispute settlement proceedings at the WTO' (Office of the US Trade Representative 2018). The bilateral trade negotiations with Australia also offers an opportunity to work with a like-minded partner on these aspects of technology transfer and IP regime management.

CONCLUSION

The EU is Australia's biggest investment partner by far, in terms of inbound investment and similar to the US in terms of a destination for Australian investment. The investment flows between Australia and the EU are dominated by portfolio investment in both directions.

The main impediments to portfolio flows are those connected with the misalignment of regulation of cross-border transactions. There is considerable activity in progress in Australia and the EU Member States with respect to this issue. The negotiation of a bilateral agreement offers the potential opportunity to construct systems that will connect and coordinate those efforts, and to link them with the mutual interest in the flows of funds to and from third parties.

With respect to FDI flows into Australia, the main issues are related to investment-screening and limits on equity. Australia has been regarded as relatively highly restrictive in these dimensions. FTA partners are treated favourably and an agreement with the EU would be expected to apply treatment similar to that given to investors from other FTA partners. Some EU Member States also have screening mechanisms; and there is a conversation in progress regarding an EU-wide framework for screening FDI, which would also have to be considered in the design of an FTA with Australia.

FDI is a critical component of the systems of innovation that operate in Australia and the EU. These systems are now much more globally connected and they operate in the manner of, and are driven by, global value chains in production. They include private sector activity but are also open to collaborative participation by other private and public research providers; they are supported by public investment in research and cooperation and are enabled by academic cooperation. Their success hinges on a number of factors which can be explored in the process of a bilateral negotiation. These factors include:

- removing the barriers to investment flows associated with private sector participation in research—either investment in the enterprise that undertakes the research or investment into the research directly
- facilitating this cooperation by joint funding in public programs and by providing shared access to critical infrastructure
- promoting the movement of people, which would be facilitated by the creation of an ‘innovation zone’
- efficient management of IP.

These factors are worth attention alongside a bilateral discussion of impediments to investment flows. This may be facilitated by the consideration of a category of services related to research. Finally, an important principle is to keep the option to extend commitments to others, since the impact of networks for cooperation on innovation is greater when they are open to new members.

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PART 3

SERVICES IN THE DIGITAL AGE

12

E-COMMERCE AND DIGITAL TRADE

Hosuk Lee-Makiyama

ABSTRACT

This chapter explores the prospects for establishing e-commerce rules in the proposed Australia-European Union (EU) Free Trade Agreement (FTA), against the background of ongoing digitalisation of international trade. E-commerce (or digital trade) disciplines in trade agreements are necessary policy responses against governments' efforts at discriminatory interventions in the digital economy. It is imperative for Australia and the EU to establish a set of binding non-discriminatory rules on digital trade. Assuming Australia's textual proposals would be based on the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) however, the Australia-EU negotiations on e-commerce will pose a challenge to its conclusion. At a time when the EU and Australia share a common interest in the pursuit of constructive negotiations on these issues with third parties and in the WTO, there is also a danger that the EU negotiations for FTAs with Australia and with New Zealand could result in asymmetrical outcomes leading to further fragmentation of digital trade. This asymmetry may be even more pronounced if Australia fails to obtain an adequacy decision with respect to EU privacy rules, which do not allow onward transfer of personal information to third countries.

DIGITALISATION OF INTERNATIONAL TRADE

The context of negotiating e-commerce in the Australia-European Union FTA

As we are two decades into digitalisation, the use of e-commerce and cross-border data flows are relatively well-established concepts in international business. In response—and ever since the Uruguay Round and the popular dissemination of the internet as a platform for commerce—the question of how to govern digital trade has gradually evolved in a trade law context. Bilateral free trade agreements (FTAs), including those advocated by Australia and the European Union (EU), carry on that evolution, but are ultimately shaped by the policy priorities set by the ever-increasing digitalisation of economic activities within their societies, international trade with other economies and the tensions such developments may cause.

This article postulates that the direct bilateral trade and investment relationship between Australia and the EU is dominated by traditional services, rather than information and communications technology (ICT)-dependent services. Moreover, there are sensitivities and limitations on the side of the EU (*inter alia* due to the unilateral nature of its data privacy laws) that severely limit its policy space in any FTA negotiation. If Australia's textual proposal for an e-commerce chapter in the Australia-EU FTA were to be based on the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), it would be deemed too ambitious for many of the EU's trade policy-making institutions, especially in regard to provisions on data localisation and liberalisation of cross-border data flows.

Given these negotiation constraints, and given the relatively small economic incentive for Australia to address any bilateral trade issues relating to e-commerce, the Australia-EU negotiations are set to face a difficult challenge in establishing a common standard of disciplines that come close to alignment with the CPTPP provisions, or that could liberalise digital trade in a meaningful manner.

The impact of digitalisation on international trade

Trade rules curb governments' efforts at discriminatory and disproportionate regulatory intervention in open trade. Although rules for digital commerce in trade agreements (commonly collected under 'e-commerce chapters') are often referred to as 'rules for future trade', digitalisation has already had a major impact on how international trade is conducted in traditional goods and services.

First, the ability to aggregate global demand via the internet has significantly expanded the volume of international trade. Empirical research shows that internet

usage has had a measurable direct impact on economic growth, by expanding trade (Meijers 2014). Market assessments estimate the value of all online transactions conducted between business to consumers, business to business, and consumer to consumer amounted to US\$2 trillion per annum in 2016—with growth continuing at 20 per cent per year. If e-commerce was a sovereign economy, it would exceed the size of Australia, and grow three times faster than the Chinese economy (World Bank 2016).

Second, the use of e-commerce, online intermediaries and digital tools has increased the tradability of all types of goods by reducing the amount of capital needed to engage in exports. In goods trade, the ability to aggregate overseas demand via e-commerce platforms and other intermediaries has lowered the marginal cost of exporting to near-zero levels. Micro and small enterprises (that are often excluded from international trade) have evolved into multinational enterprises, or so-called ‘micro-multinationals’ (eBay Inc 2013).

Third, in the case of services trade, it has in many instances made the costly establishment of commercial presence overseas redundant and made business-process outsourcing possible. The use of the internet has allowed almost any service to become digitalised and tradable across borders. Thus, cross-border data flows have become the ‘carrier wave’ of international trade. Approximately half of the world’s services trade is enabled by ICT and connectivity (UNCTAD 2011), and the internet has become the dominant mode by which services are traded cross-border (‘mode 1’ and ‘mode 2’ in policy parlance) (Lee-Makiyama 2014). In the specific case of EU external trade, 56 per cent of EU services exports to the rest of the world are enabled by and dependent on ICT (and 52% of EU imports) (Nicholson 2017). These ICT-dependent services include *inter alia* financial services, research and development, professional services, information and communications services, and services using intellectual property.

Low ICT-dependency of Australia-EU trade

The idea of trading as a highly data-dependent business activity is consistent with the increasing use of software, telecommunications and data processing in industrial production across manufacturing and services sectors (Bauer, Lee-Makiyama, van der Marel & Verschelde 2014). However, bilateral Australia-EU trade is characterised by low ICT dependency—40.4 per cent of EU exports and 38.9 per cent of imports (Eurostat 2014). This is considerably lower than the average dependency rate of 56 per cent for EU external trade (Nicholson 2017).

The gravity model of international trade—and several empirical studies thereof—have established that physical distance is an impediment to trade.

Therefore, the long geographic distance that is characteristic of Australia-EU trade could explain the absence of high-quality services that depend on connectivity (Nicholson 2017; UNCTAD 2011). This is also the case for neighbouring New Zealand's (NZ) trade with the EU, although NZ has data privacy mechanisms in place. Moreover, Australia's merchandise exports to the EU are also concentrated on bulky items that are costly to transport (with 44% in raw materials and agriculture). Similarly, EU goods exports to Australia are mainly in machinery, vehicles and chemicals. As a result, more than half of the Australia-EU services trade costs relate to logistics (Eurostat 2014).

However, there is little digital trade between the two economies overall, as both the EU and Australia are able to source their demand domestically. For example, approximately 90 per cent of demand in computer and related services is supplied locally by the two economies, rather than through imports: EU exports account for 3.8 per cent of Australian demand for computer and related services, while EU demand for Australian computer and related services is a mere 0.1 per cent (OECD 2016).

Given the relatively low intensity of both digital trade and ICT-dependent services, the purely bilateral economic incentive for either party to establish new e-commerce disciplines through an Australia-EU FTA is lower than in the case of other FTAs the parties are involved in, such as the CPTPP or bilateral agreements with Japan.

THE IMPEDIMENTS TO DIGITAL TRADE

Privacy measures

In comparison to many emerging economies, relatively few domestic regulations impede on e-commerce in Australia and the EU.¹ The major impediment to e-commerce is the incompatibility of the data privacy rules in Australia and the EU, where both jurisdictions make any overseas processing of personal information conditional on compliance with local privacy laws. In other words, an Australian exporter, building a database of its customers based in Europe may be in violation of EU laws, but not vice versa.

Such policies result in a *de facto* data localisation requirement, forcing overseas businesses to establish a data centre from which they must service the local market (Bauer et al. 2014). The number of jurisdictions imposing data localisation requirements has quadrupled between 2000 and 2017, and these are imposed by at least 36 jurisdictions (Bauer et al. 2014).

1 For a cross-country comparison of digital trade barriers, see ECIPE (2017).

The applicability of EU privacy law—General Data Protection Regulation (GDPR)—is not territorially limited to within Europe. It explicitly prohibits, at the outset, international transfers of personal information to any country outside the EU (GDPR 2016). Exceptions are limited to jurisdictions that the EU has ruled as having ‘adequate protection’, which is not the case for Australia. Australian exporters must comply with EU rules by collecting explicit consent from each European citizen or use certain legal instruments (e.g. binding corporate rules or model contracts) (GDPR 2016). Ultimately, these are alternatives that are too time-consuming or too costly to implement for the majority of exporters (UNCTAD 2016).

Similarly, Australian privacy laws require that any transmission of data out of the country must take reasonable steps to ensure that the overseas recipient will not breach the Australian Privacy Principles (APPs) unless the overseas recipient is bound by laws similar to those principles that an Australian citizen could also legally enforce (Privacy Amendment 2012). Moreover, Australia requires storage of electronic health records within Australia, and no patient’s medical data can be held or processed outside Australia. This impedes trade in the healthcare sector (Personally Controlled Electronic Health Record Act 2012).

Australian and European privacy laws have bearings on international trade beyond just personal information. Both jurisdictions give the broadest possible scope to the term ‘personal information’. Since all services activities that take place cross border—communications, financial services, audio-visual services, remote operation of machinery, or e-commerce—require some form of identification in the form of a username, even the most trivial non-personal data fall within the scope of EU privacy legislation and could be subject to a legal challenge. However, Australia does not always equate all ‘metadata’ (sources of collection, payment data, employee or usernames, internet provider addresses, email, phone numbers) as personal information (OAIC 2015).

As a result, all cross-border trade in services is conditional on the data privacy authorities deeming the counterpart as having substantially similar or adequate legal protection. While Australia deemed EU privacy laws as substantially similar to the APPs (OAIC 2017), the EU had not reciprocated this recognition at the time Australia-EU FTA negotiations were opened.² The EU legal order designates privacy-related issues to its adequacy rulings and not its FTAs. Even a full, two-way recognition of privacy regimes will not address data localisation on non-privacy

2 There is a minor exception for transfer of air passenger name record (PNR) data under the 2008 and 2012 Agreement between the EU and Australia on the processing and transfer of PNR data by air carriers to the Australian Customs and Border Protection Service (Government of Australia and the European Commission 2008 and 2012).

grounds (e.g. performance requirements to invest in local data infrastructure, or conditions on public procurement of online services).

Moreover, unlike Australia, NZ had already received its adequacy decision prior to commencement of its EU negotiations (European Commission 2013), and will be the first 'adequate' country to negotiate a fully-fledged e-commerce chapter with the EU. Given the difference in standing of Australia and NZ in EU privacy law, it is feasible that each country's negotiations will result in different outcomes in their respective FTAs with the EU. This asymmetry may be even more pronounced if Australia fails to obtain its adequacy decision, as EU privacy rules do not allow onward transfer of personal information to third countries. Even if FTAs are signed between all three parties, an NZ exporter is not permitted to handle European customer data at its Australian subsidiary. Such triangular asymmetry in privacy or trade rules would obviously fragment the bilateral services trade between NZ and Australia.

Intermediary liability

Much trade in goods and services takes place with the internet acting as an intermediary between producers and users. This facilitation of trade occurs through several types of firms that may be involved in an online value chain. They range from infrastructural services and data hosting providers to various online services such as social media, search engines, advertising and e-commerce platforms, which all assist in connecting buyers and sellers on a global scale. Their functions are essential to online and to traditional trade across borders (Thelle & Jespersen 2012).

Under the laws of Australia (Copyright Amendment Act 2000; Copyright Legislation Amendment Act, 2004; United States Free Trade Agreement Implementation Act 2004) and of the EU (Directive 2000/31/EC), intermediaries have limited legal responsibility for illegal or harmful activities of their users. For example, an e-commerce website is not required to screen for counterfeit items sold by one of its users; a search engine is not required to screen every page on the internet for possible copyright or hate speech violations. Online intermediaries are not required to monitor their users, and the legislative model of 'safe harbours' grants immunity from unlawful third-party content. In return, intermediaries have a legal obligation to act against such illegal activities once they have been alerted by law enforcement agencies or rights-holders.

The alternative model to 'safe harbour' is present in authoritarian countries that impose strict liability for all online activities to the intermediaries, leaving commercial entities to monitor content, goods and services, threatening fines and

prosecution. The plurality of goods and services (as well as opinions) seems to hinge on the legal principles limiting intermediary liability.

Neither Australia nor the EU falls into the authoritarian category. The question remains as to whether provisions on intermediary liability can be included in the Australia-EU FTA for the normative effect it would have on third countries that do not yet implement liability limitations in their domestic laws.

THE DISCREPANCIES BETWEEN THE FTA MODELS

Cross-border data flows

As Australia deems EU privacy regimes to be ‘substantially similar’ and a safe destination for the personal information of Australian citizens, the question at hand is whether the EU can reciprocate the recognition within the FTA itself—clearly, the EU cannot. Under the EU Common Commercial Policy (CCP), adequacy decisions fall under a different competence than trade, while privacy falls under the EU Justice Policy.

Nonetheless, the adequacy rulings are implicitly linked to trade negotiations. A factor for consideration regarding whether proceedings for adequacy ruling (or *de facto* negotiations relating thereto) should be opened is partially dependent on ‘the extent of the EU’s (actual or potential) commercial relations with a given third country, including the existence of an FTA or ongoing negotiations’ (European Commission 2017a, p. 8). Prior to Australia, Japan (another non-adequate jurisdiction) had negotiated its Economic Partnership Agreement (EPA) with the EU in parallel (but not jointly) with its adequacy decision on privacy (European Commission 2017b).

However, whether an EU FTA counterpart starts their negotiation with or without an adequacy decision ought to have some relevance for the level of commitments achieved in the FTA. But there is no historical precedence to guide what the EU is able to agree on e-commerce with respect to a country with (or without) an adequacy ruling.

Historically, EU FTAs used to include a relatively simple rule for cross-border data flows limited to financial services, permitting them within the ‘ordinary course of business’. This provision is included in the EU-Republic of Korea (Korea) FTA (KOREU) (Article 7.43) and the EU’s Comprehensive Economic and Trade Agreement with Canada (CETA) (Article 13.15). However, these were drafted prior to the final enactment of EU privacy reforms and to e-commerce chapters becoming a standard feature in FTAs.

Since then, the EU has taken a restrictive course against commitments under e-commerce or digital trade chapters in FTAs. Up until the end of 2016, cross-border data flows were not an integral part of any publicised EU offers, such as negotiations on the Transatlantic Trade and Investment Partnership (TTIP) or the Trade in Services Agreement (TiSA).

At the time of the opening of Australia-EU negotiations, only two textual proposals on e-commerce by the EU have been released to the public. First, the EU proposal for its Mexico FTA contained an empty paragraph (Article 14—designated as a ‘Placeholder for provision of data flows/data localisation’). Second, the EU-Japan EPA negotiations have resulted merely in a rendez-vous clause, where the parties ‘shall reassess the need for inclusion of an article on the free flow of data within three years of the entry into force of this Agreement’ (EU-Japan EPA 2017, Article 8.81).

The cases of the Mexico and Japan talks (particularly the latter) have a bearing on the negotiations with Australia, as both are CPTPP signatories as well as non-adequate countries. It can be assumed that Japan, at least, had used CPTPP texts as a template for its own textual requests and offers in the negotiations. The CPTPP Article 14.11 contains a safeguard for ‘cross-border transfer of information, including personal information; arbitrary or unjustifiable discrimination or a disguised restriction on trade’ (CPTPP 2018). Moreover, the Article 14.13 CPTPP discipline on forced localisation of computing facilities bans ‘requirements to use or locate servers and storage devices for processing or storing information for commercial use as a condition for conducting business in the territory’ (CPTPP 2018).

In conclusion, at least one CPTPP signatory, Japan, has failed to negotiate the inclusion of CPTPP disciplines on cross-border data flows and data localisation requirements with the EU at the time of the opening of the Australia-EU negotiations.

Intermediary liability

FTA provisions that bind the signatories to implement or retain ‘safe harbour’ principles to protect intermediaries had been commonplace since their introduction in the United States (US)-Singapore FTA (signed in 2003). Provisions of similar effect were included in KOREU (signed in 2009) and the EU-Singapore FTA (signed in 2012), but they were removed from subsequent FTAs.³ Since the Australia-US FTA (signed in 2004), some but not all Australian FTAs have included intermediary

³ Provisions absent from CETA signed in 2016.

liability limitations (Australia-Chile FTA 2007; Australia-Malaysia FTA 2012; Australia-Korea FTA 2013; Australia-ASEAN-NZ FTA 2008; Australia-People's Republic of China (China) FTA 2014; Australia-Japan EPA 2014).

As both the EU and Australia maintain limitation statutes domestically, intermediary liability issues do not impede online trade between Australia and the EU (at the time of the opening of Australia-EU negotiations). However, the EU has pushed for platform regulations to rein in online platforms, stressing that 'Industry in Europe should take the lead and become a major contributor to the next generation of digital platforms that will replace today's web search engines, operating systems and social networks' (Oettinger 2015). EU industrial policy defines the online platforms as a competitiveness problem: as 'the EU currently represents only 4 per cent of the total market capitalisation of the largest online platforms: the vast majority of platforms originate in the US and Asia' (European Commission 2016, p. 3). A series of communications underline the 'need to adopt regulations that respond directly to those challenges' (European Commission 2016, p. 15).

These policy developments will take place concurrently with the negotiation of the Australia-EU FTA and other FTAs. The policy developments limited the negotiation mandate for the EU executive, and led to the deletion of the intermediary liability provisions in recent EU FTAs. Similar to the situation on cross-border data flows, other major trading partners—notably the US in the TTIP and TiSA—have been unable to reintroduce the liability limitation into EU FTAs, despite the fact that the mandate on intermediary liability is not legally limited by domestic privacy rules.

Disciplines without EU equivalence

If Australia is to negotiate from a CPTPP template, there are clearly several challenges involving EU sensitivities on data and intermediaries. In addition to these sensitivities, there are CPTPP provisions without equivalence in EU FTAs or textual proposals. The CPTPP contains in Article 14.4 an explicit principle of non-discrimination between like 'digital products', encompassing almost any types of online content, such as 'text, video, image, sound recording or other product that is digitally encoded' (CPTPP 2018). However, non-discrimination clauses in EU FTAs may require a different configuration of negotiation, involving EU Member States directly, as audio-visual products are exempt from EU competence under CCP.

CONCLUSION

Digital rules and ‘demandeurship’

E-commerce or digital trade disciplines in trade agreements are necessary policy responses against governments’ efforts at discriminatory interventions in the digital economy. While the barriers to digital trade between Australia and the EU themselves may not present a major economic interest on their own to either party, there is a political imperative for Australia and the EU to develop a set of binding non-discriminatory rules on digital trade. Whatever is agreed—rules and exceptions alike—with Australia and the EU can be used to justify the same treatment in future negotiations with more protectionist third countries. Any future multilateral rules will be derived from a least- common denominator of what is possible, even amongst a smaller set of like-minded countries, including Australia and the EU.

But even amongst a group of like-minded countries, each country pursues different templates or legal techniques. They also maintain a unique set of political sensitivities—as a function of their internal politics which are subject to change—to the degree that provisions from the EU’s own FTAs would be unacceptable today. All parties have their own standards and level of ambition which they advocate in their trade negotiations. Their respective sensitive issues are often presented as ‘hard’ and non-negotiable exceptions, justified by fundamental rights, competitiveness or national security. As it stands, from the outset of the Australia-EU negotiations, a full legal fragmentation within the trading system is in prospect.

Assuming Australia’s textual proposals are to be based on the CPTPP, Australia-EU negotiations on e-commerce would likely pose a challenge to conclusion of the FTA—in similar fashion to conclusion of the EU-Japan EPA, where e-commerce rules remain an outstanding issue. With the EU-Japan negotiations and the failure of TTIP in mind, Australia and the EU will only achieve more meaningful results if Australia negotiates more persuasively as a ‘demandeur’ than Japan or the US, or if the internal politics in Europe change their course during the process of Australia-EU negotiations.

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13

AUDIO-VISUAL SERVICES

Jimmyn Parc and Patrick Messerlin

ABSTRACT

This chapter covers audio-visual services in the Australia-EU Free Trade Agreement (FTA). It shows that the Australian film market has potential—demand size, cultural diversity, supply size—to attract the EU film industry, and hence to envisage negotiations favourably. An overview is presented of audio-visual provisions in the FTAs concluded to-date by Australia and the EU. The level of protection granted by existing Australian and EU regulatory barriers is assessed. The chapter argues that the Australia-EU FTA negotiators should seek to increase market access by improving the provisions on co-production that exist in the Australia-Korea and Korea-EU FTAs. These provisions have the merit not only of reducing the remaining regulatory barriers, but also of offering some opportunities to address the problems raised by large and increasing subsidies: subsidies are fast becoming the most important global problem facing the film industries.

INTRODUCTION

This chapter focuses on film and television (TV) works (hereafter ‘audio-visual services’), as they have attracted the highest visibility among the cultural industries in trade negotiations. At a first glance, opening negotiations on audio-visual services in the Australia-European Union (EU) context seems risky. The EU has excluded this sector as a pre-condition for negotiating bilateral (Transatlantic Trade and Investment Partnership [TTIP] with the United States [US]), plurilateral (OECD) (Multilateral Investment Agreement) and multilateral (WTO Doha Round) agreements. Negotiations for a free trade agreement (FTA) with the US and for the Comprehensive and Progressive

Agreement for Trans-Pacific Partnership (CPTPP) on audio-visual-related issues (including the free flow of data and copyright) involved sensitivities in Australia (Bernier 2004; Productivity Commission 2016).

However, this first impression ignores an important fact. Audio-visual issues are part of a notable number of existing FTAs—including those signed by the EU. If these issues are not dealt with by provisions in the main text (as is often the case in US-related FTAs) they take the form of provisions on co-production or cooperation and are relegated to annexes or are included in separate protocols (as in the case of the EU FTAs). Nevertheless, this humble appearance should not be misinterpreted. These provisions have the potential to play a key role in the global audio-visual market. This chapter argues that sound economic as well as cultural reasons exist to include such provisions in the Australia-EU FTA.

This chapter is organised as follows. Sections two and three present the main features of the EU and Australian film markets which reveal the attractiveness of the Australian market for EU audio-visual services producers. Section four provides a brief overview of the audio-visual provisions on international co-production in FTAs that involve Australia and the EU. In addition, it gives a sense of how restrictive the regulatory barriers are in key EU Member States, Australia, the US and Korea). Section five explores the benefits of the introduction of co-production provisions in the Australia-EU FTA. It argues that, if such provisions are well designed, they could pave the way for less distortive audio-visual policies, and serve as a promising platform for EU and Australian cultural relations with major East Asian countries.

THE EU AND AUSTRALIAN FILM MARKETS: RECIPROCAL ATTRACTION

At first glance, the sheer economic size of Australia compared to the EU requires a simple remark. Australia has an obvious interest in wider access to EU audio-visual markets (as shown below), whereas EU film suppliers might perceive the Australian market as too small to be attractive. This section provides evidence that, in fact, the Australian film market is attractive in two respects. First, it is much larger than it seems at first glance and it is very dynamic and diverse. Second, Australian film producers have limited capacity to penetrate EU film markets deeply. As a result, there are strong incentives for EU and Australian trade negotiators to seek inclusion of audio-visual provisions in the Australia-EU FTA.

The Australian film market: an attractive size for EU film producers

Table 13.1 presents the main features of nine selected countries' film markets: Australia, five large EU27 (EU minus the UK) Member States, the United

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	Revenues (mil euro)	Admissions		Screens		Avg ticket	Admission share (%)	
		Total no. (mil)	Per inhabitant	Total no.	Per million inhabitant	Price (euro)	Domestic films	US films
Australia	793	90.2	3.8	2,041	85.0	8.8	4.4	84.0
France	1,331	205.3	3.0	5,741	84.9	6.5	38.6	50.3
Germany	1,167	139.2	1.7	4,692	56.7	8.4	26.8	60.8
Italy	665	107.0	1.7	3,752	61.2	6.2	26.7	54.5
Poland	218	44.7	1.2	1,256	33.1	4.9	18.7	64.6
Spain	573	94.6	2.0	3,588	77.3	6.1	19.4	65.5
UK	1,708	171.9	2.6	4,085	62.6	9.9	30.9	63.2
Korea	1,371	217.3	4.2	2,492	48.4	6.3	54.1	41.1
US	10,009	1,340.0	4.1	40,547	124.8	7.5	95.0	95.0

Note: all figures are for 2015, except the admission shares which have been calculated on the years 2013-2015.

Table 13.1: Main features of the demand-side of selected film markets, 2015.

Sources: Centre National du Cinéma et de l'Image Animée (2015), Polish Film Institute (2015), Parc (2017a), Screen Australia (2017a).

Kingdom (UK) and two countries that have been key in the recent history of trade negotiations in the film industry: the US and the Republic of Korea (Korea). This shows that Australia has a surprisingly large market. With only 25 million Australians, the revenue from admissions to Australian cinemas (box office) is roughly the same size as the aggregated box office of Spain and Poland (with roughly 77 million people) and is 20 per cent larger than the Italian box office. This impressive feature is based on three components—the number of admissions, number of screens and ticket price. Australia has a very large number of admissions per capita, ranking it in the global top three after Korea and the US.

Australia also has a large number of screens per millions of inhabitants, placing it in the global top two after the US. This is similar in number to France—and the number of screens in France is often seen as a benchmark of success in Europe. The Australian market has two more remarkable characteristics. First, the market share of domestic films in terms of admissions is much lower than it is in the EU Member States. Second, the Australian ticket price is relatively expensive—second highest after British prices, and it is 36 per cent more expensive than in France. In these circumstances, the Australian cinema market would be reluctant to change this already high price. Hence, it can be reasonably conjectured that (everything else being constant) the attractive size of the Australian market should remain stable for a while.

The Australian film market: its increasing exposure to cultural diversity

Table 13.1 shows that US films have a large market share in the Australian market. However, Table 13.2 reveals the nuances in another aspect of the Australian film market—the country source of films imported to Australia has diversified significantly over the years. During the last 15 years, the total number of films exhibited annually in Australia has doubled. While the number of US films exhibited has remained roughly constant, the number of films from Asia has increased vastly. These represented only one per cent of the total number of films in 1999, but their share has increased to more than 30 per cent in 2016.

In such a dynamic context, European films have had a good performance. British films have recovered their market share of the early years in terms of the annual number of films released. French films have maintained their share and films from the rest of the EU have made substantial growth. The share of the number of all EU films increased notably after 2012.

In this context, it is worth noting that this increase in exhibited film diversity has occurred even though the main Australian film distributors are also agents for the most important American film companies. For instance, Roadshow (the largest distributor) operates for 20th Century Fox, Buena Vista, Miramax, Walt Disney Pictures and Warner Brothers. Amalgamated Movies (the second largest distributor) operates for Sony, Columbia Pictures or Tristar Pictures (Australian Film Societies Federation n.d.). These large Australian distributors also distribute Asian films. For instance, Madman is the biggest importer of Japanese anime, and has a close relationship with Amalgamated Movies.

Australian film production: a limited threat for EU film producers

The demand-side of the Australian film market has demonstrably attractive characteristics for EU film producers. However, examining the supply-side, some EU producers could be afraid of competition with Australian film-makers. However, Table 13.3 shows that Australian film production is small—only 13 per cent of French film production. Further, when faced with US films that are in competition with EU films in Europe, Australian films perform at a humbler level than EU films.

In other words, Australia does not represent a significant threat to EU film production and to the current situation in the EU markets in terms of production

Table 13.2 (right): Number and shares of films exhibited in Australia (by country of origin, 1999-2016).

Source: Screen Australia (2017b).

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	<i>Australia</i>	<i>NZ</i>	<i>Asia</i>	<i>France</i>	<i>UK</i>	<i>Rest-EU</i>	<i>Canada</i>	<i>US</i>	<i>Others</i>	<i>Total</i>
1999	24 (9.4)	3 (1.2)	3 (1.2)	5 (2.0)	28 (11.0)	11 (4.3)	5 (2.0)	174 (68.2)	2 (0.8)	255 (100.0)
2000	22 (8.8)	0 (0.0)	8 (3.2)	14 (5.6)	29 (11.6)	6 (2.4)	1 (0.4)	167 (66.8)	3 (1.2)	250 (100.0)
2001	27 (11.0)	0 (0.0)	13 (5.3)	11 (4.5)	15 (6.1)	9 (3.7)	0 (0.0)	163 (66.5)	7 (2.9)	245 (100.0)
2002	22 (8.5)	1 (0.4)	10 (3.9)	12 (4.7)	24 (9.3)	12 (4.7)	1 (0.4)	170 (65.9)	6 (2.3)	258 (100.0)
2003	23 (8.6)	4 (1.5)	5 (1.9)	11 (4.1)	24 (9.0)	17 (6.3)	1 (0.4)	178 (66.4)	5 (1.9)	268 (100.0)
2004	16 (5.0)	1 (0.3)	27 (8.5)	17 (5.3)	21 (6.6)	19 (6.0)	6 (1.9)	200 (62.9)	11 (3.5)	318 (100.0)
2005	27 (8.2)	1 (0.3)	47 (14.3)	17 (5.2)	29 (8.8)	20 (6.1)	4 (1.2)	175 (53.2)	9 (2.7)	329 (100.0)
2006	29 (8.7)	5 (1.5)	41 (12.3)	17 (5.1)	28 (8.4)	18 (5.4)	7 (2.1)	184 (55.3)	4 (1.2)	333 (100.0)
2007	26 (8.2)	2 (0.6)	40 (12.6)	22 (6.9)	32 (10.1)	13 (4.1)	5 (1.6)	172 (54.3)	5 (1.6)	317 (100.0)
2008	33 (11.0)	0 (0.0)	40 (13.3)	20 (6.6)	24 (8.0)	15 (5.0)	7 (2.3)	158 (52.5)	4 (1.3)	301 (100.0)
2009	44 (12.7)	3 (0.9)	59 (17.0)	18 (5.2)	27 (7.8)	18 (5.2)	3 (0.9)	173 (49.9)	2 (0.6)	347 (100.0)
2010	29 (8.9)	3 (0.9)	75 (23.0)	21 (6.4)	29 (8.9)	18 (5.5)	11 (3.4)	137 (42.0)	3 (0.9)	326 (100.0)
2011	36 (10.5)	1 (0.3)	71 (20.8)	18 (5.3)	28 (8.2)	21 (6.1)	8 (2.3)	153 (44.7)	6 (1.8)	342 (100.0)
2012	27 (6.4)	3 (0.7)	97 (23.1)	27 (6.4)	47 (11.2)	28 (6.7)	7 (1.7)	171 (40.7)	13 (3.1)	420 (100.0)
2013	26 (6.2)	3 (0.7)	99 (23.5)	23 (5.5)	44 (10.5)	27 (6.4)	5 (1.2)	183 (43.5)	11 (2.6)	421 (100.0)
2014	39 (7.7)	5 (1.0)	126 (25.0)	30 (5.9)	59 (11.7)	33 (6.5)	7 (1.4)	174 (34.5)	32 (6.3)	505 (100.0)
2015	33 (6.1)	4 (0.7)	153 (28.4)	30 (5.6)	74 (13.7)	30 (5.6)	3 (0.6)	192 (35.6)	20 (3.7)	539 (100.0)
2016	43 (7.1)	7 (1.1)	186 (30.5)	25 (4.1)	76 (12.5)	49 (8.0)	6 (1.0)	189 (31.0)	28 (4.6)	609 (100.0)

Note: Market shares are in parenthesis.

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	Total subsidies (million euros)	No. films produced (unit)	Subsidies per film (million euros)
Australia	85	33	2.6
France	610	276	2.2
Germany	325	226	1.4
Italy	126	184	0.7
Poland	36	35	1.0
Spain	145	234	0.6
UK	140	261	0.5
Korea	69	241	0.3
US	Na	745	na

Notes: The numbers of films include co-produced films, and the averages for the three years 2013-2015; Subsidy data for the EU countries are for the year 2009; data for Korea are for the year 2011; data for the UK do not include the amounts of tax deductions.

Table 13.3: Main features of the supply-side of selected film markets.

Sources: Centre National du Cinéma et de l'Image Animée (2015), Polish Film Institute (2015), Newman-Baudais (2011), Parc (2017a), Screen Australia (2017a) and UNESCO-UIS database.

quantity and quality. This is important from the perspective of negotiating behaviour dominated by mercantilist instincts. It means that defensive positions among the main EU Member States producing films, towards audio-visual provisions in the Australia-EU FTA, are unlikely to receive strong support in Europe.

Even more crucially, in a diversified market, the limited Australian film supply is unlikely to increase its production significantly, because Australia already subsidises its film production substantially. The level of Australian subsidies looks small in terms of absolute value compared to that of selected EU Member States with the largest market, such as France or Germany. However, the amount of subsidy per film in Australia is higher than it is in France, which has the most massive subsidy policy in Europe. This similarity deserves an additional remark. It means that disputes on subsidies among Australia and the EU are unlikely to emerge during FTA negotiations, as both partners follow the same questionable domestic policies. The FTA provisions are unlikely to directly touch on subsidies, all the more because subsidies in audio-visual services—as indeed in any other sector—can be handled only by a multilateral or plurilateral agreement, not a bilateral agreement. Rather, Australia and the EU share a common issue: how can they keep their subsidy policies sustainable? The next section argues that the Australia-EU FTA could contribute to this objective.

AUDIO-VISUAL TRADE NEGOTIATIONS: A BRIEF OVERVIEW

Under the pressure of the 1985 to 1988 Korea-US film agreements that opened direct access to the film distribution sector in Korea for Hollywood studios, Korean film producers established collaborations with these studios. This enabled the Korean film industry to enhance its competitiveness progressively and ultimately achieve remarkable success in both domestic and foreign markets (Parc & Messerlin 2018). Trade negotiations thus seem to be an interesting way to promote such collaborations. In this context, provisions on audio-visual co-production in the Australia-EU FTA could attract European film producers to Australia.

However, this positive perspective on trade negotiations seems at odds with the limited commitments on market access in audio-visual services as described by the current literature on the trade deals concluded since 1995 (Bernier 2004; Chase 2015; Roy 2008). Very few meaningful commitments have been achieved in the WTO, and most have been extracted from new WTO members during negotiations for their accession to the WTO. In the bilateral FTA context, new commitments on market access in non-digital audio-visual goods and services are rare and involve mostly small countries (e.g. Central America and Morocco). By contrast, reservations are many and wide, even in FTAs concluded by the US, such as the Australia-US FTA. In particular, there is no commitment on restricting the use of subsidies for supporting the domestic film industry, as in any other service.

However, this literature suffers from limitations. It has paid very little attention to provisions on ‘cooperation and co-production’. Although relegated to annexes, these provisions can deliver interesting outcomes, at least in terms of national treatment, as argued below. Table 13. 4 focuses on this specific set of provisions. As already mentioned, somewhat surprisingly and interestingly, the EU has the largest number of FTAs with such provisions among WTO members; 13 out of a total 24 in the world as of 2015 (Hofmann, Osnago & Ruta 2017). It is fair to add that ten of these agreements involve countries with long-lasting ‘special’ trade relations with the EU; namely African, Caribbean, Pacific, Mediterranean and Eastern European countries. The remaining three EU FTAs involve Chile, Korea and Mexico.

Interestingly, Korea is the top two WTO member after the EU for having FTAs that include provisions on audio-visual cooperation and co-production. Australia is part of this limited club of WTO members, with its FTA with Korea. The joint presence of these three countries or entities—Australia, the EU and Korea—deserves attention. This ‘trio’ can play a particularly critical role in East Asia, as suggested below. Clearly, it suggests that the Australia-EU FTA provisions

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<i>Signatory</i>	<i>No. of FTAs</i>	<i>Partners or pairs of FTAs</i>
Australia	1	<i>Korea</i>
EU	13	<i>Korea, Chile, Mexico; South Africa, Central America, Israel, Egypt; Albania, Macedonia, Georgia, Moldova, Ukraine</i>
Korea	5	<i>Singapore, India, Peru, Australia, Canada</i>
Other FTAs	4	<i>Chile-El Salvador; China-Costa-Rica; India-Singapore; Peru-Mexico</i>
Total	23	

Table 13.4: FTAs with provisions on audio-visual cooperation and international co-production.

Source: Hofmann et al. (2017).

on audio-visual issues could, and indeed should, be drafted to complement and strengthen their equivalents in the Korea-EU FTA (KOREU) and the Australia-Korea FTA (KAFTA).

How effective is the EU quota protection?

A detailed analysis of the KOREU and KAFTA main texts leads to the conclusion that neither FTA provides a desirable trade environment in the usual sense of trade negotiations; that is, national treatment with domestic film producers and non-discrimination with trading partner film-makers. In particular, they do not reduce or eliminate blatant instruments of protection, such as broadcast or screen quotas. For instance, KOREU does not state that Korean films would become beneficiaries of the EU broadcast quotas granted to EU films, nor that EU films would benefit from the 73 days of Korean screen quota. The two FTAs do not even bind the existing level of these quotas. As a result, from a traditional legal trade policy perspective, these FTAs could be seen as having very limited impact (if any) on the audio-visual markets of the two signatories.

However, an economic analysis suggests a very different assessment. The first question to raise is whether current quotas for TV broadcasts or movie screenings (and similar instruments of protection) are biting or not. If they are not, devoting the limited available negotiating capital for an FTA on such a sensitive issue as audio-visuals would seem counterproductive. Indeed, evidence suggests that today these quotas have a limited capacity to protect, because audio-visual markets have been opened substantially during the two last decades by technological progress and related domestic regulatory reforms.

For instance, EU regulatory reforms in the telecom sector in the 1990s and internet technology since the 2000s, combined with the ‘Television without Borders Directive’ (based on the principle of the ‘country of origin’) have led to a massive increase in the supply of TV channels in EU Member States—from 400 in 1989 to 7,000 today—with many of these TV channels broadcasting over several Member States. As a result, the current EU broadcast quotas inflict a de facto limited harm to most EU watchers, who have ample alternative channels at their disposal (either from their own country or from foreign investors having invested in EU Member State channels). Even if one ignores the huge supply from internet service providers, quotas (somewhat ironically) harm the domestic TV channels of the EU Member States that enforce them. This is because they impose constraints on the number of films that may be produced and on the conditions for distributing and exhibiting these films. This situation results in reduced efficiency (Benghozi 2017; PC 2000). Such ‘ineffective’ protection is not rare, as illustrated by the Korean screen quota imposed on movie theatres (Parc 2017a). From an economic perspective, it is important—before embarking on delicate negotiations about regulatory barriers in audio-visual matters—to review whether barriers have a notable impact, and hence whether their elimination will bring substantial economic benefits.

A broader view on protection of audio-visual services: STRI-based information

The above assessment is confirmed by the broader and more systematic picture provided by the OECD Services Trade Restrictiveness Index (STRI). Table 13.5 provides STRIs for film and broadcasting services and for the same nine selected countries as those in Tables 13.1 and 13.3. Focusing on sectors, STRIs for films are smaller than the average STRIs for all services sectors, except for France, Italy and the UK, where they are modestly higher. By contrast, broadcasting appears more protected compared to other sectors. The STRIs for broadcasting are higher than the average STRIs for all services sectors and for most of the selected countries.

Focusing on the nine countries, their STRIs are close to the average, or lower than the average, of the STRIs for all OECD countries, with a few exceptions: France and Italy for films; Italy, Poland and Korea for broadcasting. Last but not least, note that Australia has a notably lower level of restrictions than the EU27 (EU without the UK) Member States. This is a good reason for Australia to support negotiations over audio-visuals in the Australia-EU FTA.

Table 13.6 provides more detailed information on the sources of protection reflected in the overall STRI indicators by distinguishing six different STRI

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	<i>Films</i>	<i>Broadcasting</i>	<i>All services sectors</i>		
			<i>Maximum</i>	<i>Average</i>	<i>Minimum</i>
Australia	0.154	0.203	0.394	0.199	0.123
France	0.245	0.248	0.593	0.229	0.144
Germany	0.173	0.191	0.385	0.176	0.106
Italy	0.248	0.279	0.386	0.226	0.159
Poland	0.196	0.347	1.000	0.265	0.147
Spain	0.206	0.234	0.420	0.241	0.145
UK	0.200	0.181	0.382	0.192	0.129
Korea	0.154	0.268	1.000	0.263	0.089
US	0.170	0.256	0.541	0.233	0.124
All OECD countries					
maximum	0.422	0.616	--	--	--
average	0.202	0.253	--	--	--
minimum	0.090	0.140	--	--	--

Note: An index close to one means that the market is completely closed, whereas an index close to zero means that the market is entirely open.

Table 13.5: Barriers to audio-visual services.

Source: OECD STRI (2016).

components (Nordas et al. 2014). The core of the restrictions in both audio-visual industries remains limited to foreign market entry and the movement of people: they amount to 66 to 90 per cent of the overall indicator. Initially, this feature seems inconsistent with what has been said above regarding the limited interest in negotiating to improve market access.

However, the above-mentioned situation is not apparent. STRIs reflect barriers that exist in the ‘rule book’, whether or not they have a true effect. They suggest that negotiations aimed at getting the ‘best’ market access—meaning they eliminate regulatory barriers, even those with little effective impact—have a rationale in an ideal world where negotiating on such a politically toxic topic as audio-visuals will have no political price. By contrast, in the real world, where obtaining concessions in audio-visuals may be very costly politically, eliminating de facto ineffective regulatory barriers may generate more costs than benefits. This suggests the need to refrain from entering such negotiations for the time being.

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	Limitations on		Other discriminatory measures	Barriers to competition	Regulatory transparency	Overall indicator
	Foreign market entry	Movement of people				
Films						
Australia	0.05	0.04	0.00	0.00	0.00	0.10
France	0.07	0.07	0.05	0.02	0.00	0.22
Germany	0.04	0.03	0.01	0.01	0.01	0.10
Italy	0.04	0.06	0.03	0.01	0.02	0.15
Poland	0.04	0.03	0.00	0.00	0.02	0.09
Spain	0.04	0.03	0.00	0.00	0.02	0.09
UK	0.04	0.07	0.03	0.01	0.00	0.14
Korea	0.07	0.04	0.00	0.01	0.01	0.14
US	0.02	0.03	0.01	0.00	0.00	0.06
Broadcasting						
Australia	0.13	0.02	0.01	0.02	0.00	0.18
France	0.15	0.04	0.05	0.02	0.00	0.27
Germany	0.10	0.02	0.01	0.02	0.01	0.16
Italy	0.10	0.03	0.04	0.03	0.02	0.23
Poland	0.25	0.02	0.00	0.03	0.02	0.32
Spain	0.08	0.02	0.00	0.02	0.02	0.13
UK	0.05	0.04	0.02	0.02	0.00	0.13
Korea	0.28	0.02	0.00	0.03	0.01	0.34
US	0.25	0.02	0.02	0.00	0.01	0.30

Table 13.6: Barriers to audio-visual services: decomposition of the overall STRIs.

Source: Nordas et al. (2014).

WHAT CAN BE DONE? CO-PRODUCTION PROVISIONS

Countries protect their domestic film industries through a wide array of measures. They first protect their films by imposing barriers on the exhibition of foreign films in domestic theatres or TV channels; these measures include screen quotas, TV quotas and subsidies. They also protect the production factors necessary for producing films domestically by imposing (for instance) barriers on importing

special equipment or more importantly, barriers on the free movement of film crews. It should be stressed that the barriers on production factors are not necessarily specific to the film industry. They are often defined on an economy-wide basis (such as restrictions on labour movement) but they may be particularly costly in the film industry.

Granting better market access in such a context is a more complicated task than it is for goods, where the two negotiating parties can open their markets reciprocally by exchanging concessions in terms of tariff cuts. Dismantling barriers one by one is not an option for negotiating market access in services. In audio-visuals, as in most other services sectors, too many barriers exist. Above all, they differ between the negotiating countries, making a fact-based comparison of the concessions impossible. For instance, to what extent would the elimination of a screen quota by one partner represent the same improvement in market access as eliminating a dubbing constraint by the other partner? This section argues that co-production provisions in FTAs offer an attractive solution to this thorny issue.

Co-production provisions in current FTAs

Co-production provisions in the existing KOREU and KAFTA address both the barriers on exhibiting foreign films and those on the movement of production factors. Regarding film imports, these preferential trade areas (PTAs) address the many barriers in an indirect, but potentially efficient way. This situation relies on the fact that, to be implemented, these barriers require knowing the 'nationality' of the film. A film classified as 'national' is not subjected to these barriers, whereas a film classified as 'foreign' is. In this context, the best way to eliminate trade barriers is to ensure easier access of the films produced to the 'nationality' of both partners by adopting a 'co-production' approach. The set of barriers in each country remains untouched, but the co-productions of the two partners are effectively exempted from their application. Australia, the EU Member States and Korea each have their own list of criteria for defining nationality, for example called the 'significant Australian content' test in Australia or 'cultural test' in France. These lists contain a certain number of criteria (e.g. nationality of the actors, directors and studios' headquarters, localisation of the shooting, language), with each bringing a certain number of points when the film under scrutiny fulfils the criterion. A film with more than a fixed minimum number of points is classified as 'national' and is not subjected to the barriers. In other words, these lists define the 'rules of origin' for films.

The Protocol on cultural cooperation in KOREU and Annex 7B on audio-visual co-production of KAFTA define a co-production as follows: i) each potential co-producer should satisfy the conditions for being eligible as producing

a national work in its own country; ii) there should not be permanent relations (in terms of management, ownership and control) between the two co-producers; iii) each co-producer should bring a contribution to the film production which should be above a given threshold and below a given ceiling. If all these conditions are met, the two potential co-producers are granted, by the competent authorities of the two countries, the status of co-production. This opens the door to 'national treatment' in both countries, meaning that each co-producer is eligible for the 'benefits' provided by each negotiating partner.

It is beyond the scope of this short chapter to discuss these benefits in detail. They are stated in slightly different terms in the KOREU Protocol and in the KAFTA Annex. Article 5.4 (5.5) of the KOREU Protocol expresses these benefits in general terms: 'Co-produced audio-visual works shall be entitled to benefit from EU (Korea) Party scheme for the promotion of local/regional cultural content'. Article 5.2 adds: 'The Parties reaffirm that the Member States of the European Union and Korea may grant financial benefits to co-produced audio-visual works [...]'. Likewise, Article 5.1 of the KAFTA Annex refers to the 'full enjoyment of all the benefits which are accorded to national audio-visual works of either Party'. Article 5.2 adds an explicit stance on subsidies with a clearer legally binding commitment: 'Any subsidies, tax incentives or other financial incentives which may be granted by either Party [...] shall accrue to the co-producer who is permitted to claim those benefits in accordance with the existence measures of that Party'.

It is essential to stress that the economic value of these provisions depends largely on the business strategy of each co-producer. For instance, a Korean co-producer who has already made successful films may not be particularly interested in gaining financial benefits from an EU Member State where the EU co-producer is located. Rather, the Korean producer could find more value in obtaining a wider and longer visibility for the film by gaining unrestricted access to EU works on EU TV screens. The EU co-producer could find it more valuable to access Korean funds that help achieved more effective film distribution in Korea.

Both the KOREU Protocol and the KAFTA Annex also deal with barriers to the movement of factors among signatories. The KOREU Protocol covers only temporary importation of material and equipment, although with no commitment other than facilitating these importations in the traditional perspective of promoting a territory as a location for shooting films (Article 7). It also aims at facilitating the entry and temporary stay in their territories of artists and other cultural professionals (Article 4). The KAFTA Annex has similar provisions on the importation of equipment and immigration facilitations, but these are written in more legally binding terms and with a wider coverage in terms of professions.

Co-production provisions in an Australia-EU FTA

The Australia-EU FTA should build on the experience of KOREU and KAFTA. First, it should avoid some provisions that exist in these texts. The best illustration of this is the ‘balance’ provision included in KAFTA (2013). Article 15 of this agreement reads:

An overriding aim of the Annex, as monitored by the competent authorities, shall be to ensure that an overall balance is achieved between the Parties with respect to (a) the contribution to the production costs of all audio-visual co-productions and (b) the use of studios and laboratories, (c) the employment of all performing, craft and technical personnel, measured on a straight head control basis, and the participation in each of the major performing, craft and technical categories and in particular, that of the writer, director and lead cast, over each period of three years commencing on the date that this Annex enters into force.

Enforced in a strict manner, such a provision could easily introduce a regime of ‘barter’ trade, which is incompatible with the degree of freedom that international cultural works require in order to be more successful.

Second, the Australia-EU FTA should adopt the provisions mentioned in the previous section by using the best drafting of the available text of the KOREU Protocol and the KAFTA Annex. It is beyond this short chapter to present in detail the choice that should be made. It suffices to present some guidelines to follow when making these choices. First, preference could be given (for any similar provision) to the text with the most legally binding commitments. Second, preference could be given to text offering the largest scope for international cooperation. For instance, the KAFTA Annex on labour movement covers ‘any individual that falls within the relevant scope of the audio-visual agreement or arrangement of less-than-treaty status referred to in that Article [...]’, whereas the KOREU Protocol adopts a narrower approach of listing categories (though arguably in broad terms) of professionals.

Third, the Australia-EU FTA should use the opportunity to harmonise existing provisions. In particular, an effort should be made concerning the proportion of financial contributions from each side (for instance, what percentage of the production costs each participant should bring), and the proportion of technical and artistic contributions (the number of ‘points’ of the culture test each participant should contribute to). In KOREU and KAFTA, these proportions and related provisions are different in many respects, including the amounts and procedures. These differences tend to freeze existing, not necessarily efficient, situations because the provisions written in the FTA reflect recent or ongoing

deals among film-makers of the two signatories. They also induce film-makers to develop a strategy of ‘FTA-shopping’. Indeed, tax- and subsidy-shopping has a long history in the film industry (Parc 2017b).

Finally, welfare-improving provisions appearing in one text could be taken on board in the Australia-EU text. For instance, KAFTA contains more detail about third-country co-production than the short recital in the KOREU Protocol. This provision may open the door to co-productions that correspond to a demand in the current more globalised audio-visual world. In addition, this provision could play an important role if the EU wants to design a multicountry-consistent strategy in East Asia, as suggested by Patrick Messerlin and Jimmyn Parc in chapter 3 of this volume. Such efforts may look modest. However, if successful, they would be a decisive contribution to lowering (in the least discriminatory way) the highly complicated array of barriers in the film industry.

Subsidies and international co-production

As argued above, the provisions of KOREU and KAFTA—and of a future Australia-EU FTA—cover a much wider range of barriers than subsidies. However, the increased magnitude and geographical scope of the subsidies during the last decade stress the necessity of an international effort to keep subsidies under some control (Parc & Messerlin 2018). This is a delicate task because subsidies in cultural industries are ambiguous. When used strategically, they can play a positive role in promoting cultural creativity and diversity. However, most of the time they operate as a purely protective instrument (Messerlin & Parc 2017; Parc 2014, 2017a). Moreover, as explained above, settling this issue is clearly beyond the reach of an Australia-EU FTA (as for any FTA).

However, exploration should be given to how FTAs could contribute to keeping subsidies under more control through provisions on international co-production. International co-production regimes currently tend to be seen as a means of accessing subsidies, rather than initiated by the needs (or necessity) of business. These provisions could be designed with a view to minimise the unintended negative effects of subsidies in the two signatories. In a nutshell, they should aim to strike a balance between two opposite risks. On the one hand, generous domestic subsidies, with no possibility of co-production with foreign film producers, are likely to protect domestic producers excessively, to the detriment of cultural diversity and creativity in the subsidising country. On the other hand, abundant subsidies opened too widely to foreign film producers risk forcing, sooner or later, the subsidising country to increase its subsidies so it cannot be accused of discriminating against its domestic producers. Hence, the race for subsidies may become even more exacerbated. FTA provisions on subsidy-related

co-production should therefore strike a balance between these two forces when defining appropriate conditions for granting ‘national treatment’ to foreign film producers. Alternatively, they should—instead of offering subsidies—focus on removing red tape and other business-unfriendly regulations.

In light of the above, it is essential to keep in mind that international co-production is a complex instrument. In this context, it is crucial to distinguish between ‘international co-production’ and ‘strategic co-production’ (Parc 2017b). A country can use international co-production to promote what it perceives as the characteristics of its national identity; that is, in a way that echoes the criteria listed in the ‘culture test’ that grants nationality to a film. For instance, once a film is recognised as a co-production, it can be eligible for the subsidies a country grants in accordance with its domestic regulations. The international partners for co-production can exploit this possibility with some of their films that require international shooting locations, such as scenery or scarce technical skills not available domestically. That said, it is worth noting that the initial motive of a co-production agreement remains to share the financial burden of shooting films (Parc 2017b). This initial purpose can be adroitly distorted by the use of subsidy schemes.

In contrast, ‘strategic co-production’ is strictly based on business decisions to synergise the advantages or reduce the disadvantages of joining partners. Consider this scenario: Country A offers a fabulous landscape or other factors that can be difficult to find in Country B, while the studio from Country B transfers film shooting technology or other factors that are more advanced (Parc 2017b). As an example, *The Lord of the Rings* is a British film shot in New Zealand (NZ) thanks to the rules of origin regarding staff and actors’ entry and temporary stay. Its success has clearly brought more film business and improved NZ’s locational reputation (resulting in increased international tourism). In contrast, *The Ghost in the Shell* tells quite a different story: this film shows a city supposedly located in Japan, although the film was shot in Wellington, NZ. In other words, the main benefit for NZ—roughly €53 million (NZ Herald 2017)—was largely derived from the availability of high-quality computer graphics technicians in NZ.

It is vital to stress that all these concerns about the possible role of FTAs in subsidies echo emerging thinking in the audio-visual business community. This perceives the hunt for subsidies not only as a loss of time and money, but also as a cost to the quality of film and TV works, as recently stressed by Ted Sarandos, Netflix’s Chief Content Officer (Donnelly & Waxman 2017). The Australia-EU FTA should thus seek an opportunity to develop these common concerns among governments eager to make the most effective use of their

country's taxes, and film companies eager for the least distorted access to resources (locations, equipment or labour skills), or to outlets exhibiting films (theatres, TV channels or internet-based devices).

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14

PROFESSIONAL SERVICES

Pascal Kerneis

ABSTRACT

This chapter provides a tour d'horizon across the content that professional services providers expect to be covered in the Australia-EU FTA. This includes market access limitations such as residency requirements and restrictions to legal corporate forms for services providers. It also includes an array of issues affecting the temporary movement of natural persons. The chapter proposes how to handle these in the FTA context, drawing on both Australian and EU experience in other FTAs, as well as in APEC. These issues include visa facilitation for business visitors, intra-corporate transferees, contract services suppliers and independent professionals. The chapter also explores the potential for innovation in negotiating mutual recognition agreements for professional qualifications, based on the EU's recent FTA outcome with Canada in the Comprehensive Economic Trade Agreement (CETA).

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INTRODUCTION

Professional services are part of the larger category of business services. Professional services are also services that in most countries are regulated in one way or another. For example, the services providers must obtain licences or specific authorisations often

linked to diplomas or qualification procedures. Regulation ensures the ability to supply the service and meet conditions such as training, ethics and consumer protection rules. These services include, but are not restricted to, those provided by lawyers, architects, urban planners, accountants, auditors, engineers, nurses and the medical professions.¹

The increasing tradability of services has created the need for multilateral disciplines, resulting in the General Agreement on Trade in Services (GATS)—achieved during the Uruguay Round of trade negotiations in the WTO—which entered into force in January 1995. The GATS distinguishes between four modes of supplying services: cross-border trade, consumption abroad, commercial presence and the presence of natural persons:

- Mode 1—Cross-border trade—services provided through, for instance, digital services from the home-based headquarters to the subsidiary, affiliate, partner or client including to support operation in the host country.
- Mode 2—Consumption abroad—a service may be delivered outside the territory of a Member to a service consumer in the territory of another Member, for instance tourism services.
- Mode 3—Commercial presence—market access must be allowed for the corporate entity providing the service, for instance through a locally incorporated subsidiary i.e. foreign direct investment.
- Mode 4—Presence of natural persons—the supply of services is often only possible through the physical presence of the services provider, requiring the temporary movement of ‘natural persons’ to a country in which the services provider is non-resident, for instance, an information technology (IT) engineer serving a maintenance contract, or an accountant writing an audit report.

Of equal importance is the following preliminary condition to be fulfilled:

- The professional qualification of the provider must be recognised in the host country via a mutual recognition agreement (MRA).

Building on Kerneis & Prentice 2011, this chapter focuses on areas of most significance to a prospective Australia-European Union (EU) free trade agreement (FTA), giving particular emphasis to the importance of mutual recognition of qualifications.

1 Professional services are listed in Section 1.A of the WTO document MTN.GNS/W/120, which is a guide for trade in services negotiators as a summary of the Central Product Classifications (CPC) issued by the UN Statistical Commission (UNSC).

MARKET ACCESS NEGOTIATIONS

With the digital economy, it is currently technically possible to provide some professional services across borders without having direct client contact. But given the sensitivity of some of these services, regulatory authorities of regulated professions such as lawyers, accountants and auditors, usually allow cross-border services (GATS Mode 1) only in matters for which the foreign supplier is qualified; for instance, home country law, or public international law for lawyers.

Furthermore, to provide services to local clients in the host country (GATS Mode 3), a foreign professional services provider must have the right of establishment in that country. This authorisation is provided by that country's regulatory body. In many countries, in addition to conditions that must also be fulfilled by domestic providers, special conditions or restrictions are imposed on foreign providers. In some countries, access to the market is allowed, but preferential conditions apply to domestic suppliers, depriving foreign competitors of so-called 'national treatment'.

In order to remove or reduce these conditions, trade negotiations are often appropriate. In this context, some commitments have been undertaken by the EU and Australia in the framework of the WTO, where the GATS determines the disciplines, and the countries' specific Schedule of Commitments lists the undertakings (WTO 1995). The WTO services negotiations use the so-called 'positive list', where committing countries list the sectors committed (column 1 of the Schedule of Commitments) and the remaining limitations to market access (column 2) and to national treatment (column 3). These commitments are taken under the rule of the most-favoured nation (MFN), which means that they apply to all WTO members, whether the other WTO trading partners have reciprocated this access or not. It is essential, however, to look at the MFN exemptions that each country can table. The possibility also exists to table 'additional commitments' (column 4), but this has generally not applied to professional services.

Other commitments on market access for professional services can also be taken within the frameworks of regional or bilateral trade negotiations. These additional commitments must be more liberal than those taken under the WTO framework, in accordance with GATS Article V. These bilateral or regional agreements can use the positive list approach. Here, as in the WTO, only the listed sectors are committed, taking into consideration the limitations listed. Alternatively, they can take the 'negative list' approach, where *a contrario*, all sectors are open to foreign services suppliers, except for the restrictions listed in the schedule of commitments.

Traditionally, the EU has used the WTO-style 'positive list' approach, on the basis that trading partners are probably more at ease making commitments within a system that they fully comprehend, as there is likely to be less fear of

making ‘mistakes’ in a negative list by inadvertently opening some services sectors. This is particularly true with developing countries. There has also been another aspect to the EU’s preference for the “positive list”, namely that some members of the European Parliament prefer to keep control of their newly acquired exclusive competence² by listing only what is opened on a case-by-case basis.

However, the EU accepted using the ‘negative list’ approach for the first time during negotiations for the Comprehensive Economic and Trade Agreement (CETA) with Canada (CETA 2016). The parties signed this Agreement in October 2016, it was ratified by the European Parliament in February 2017, and it entered into force on a provisional basis in September 2017. The ‘negative list’ approach was subsequently also used for negotiations with Japan.

In contrast, Australia’s preferred way of scheduling services commitments in bilateral trade agreements is the ‘negative list’ approach. This approach was used in the Australia-US FTA in 2004. It was then used with Japan and the Republic of Korea (Korea), as well as more recently with the People’s Republic of China (China) in 2015, although China did table its own commitments on a ‘positive list’ basis (ChAFTA 2015). The ‘negative list’ approach was used in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand (NZ), Peru, Singapore and Vietnam (CPTPP 2018). Given that the EU has now accepted use of the ‘negative list’ approach with most developed country members of the OECD, this will also likely be the one used in the Australia-EU FTA negotiations.

One of the important differences between the positive and the negative listing, is the presence of a standstill clause and of a ratchet clause in the latter approach (European Commission 2016). The standstill clause is a means of freezing any possibility of introducing new discriminatory barriers towards the trading partner in sectors which are currently open. The ratchet clause is a provision that specifies that the trading partner will benefit automatically from any further liberalisation that results from unilateral reforms by the hosting country, without any need to go through a phase of revision of the agreement or commitment.

The main market access barriers encountered in professional services—and that the FTA negotiations will have to deal with—are restrictions to the legal corporate form that a services provider can use, along with some residency requirements (such as imposing obligations that members of the senior management team must live in the host country).

2 Before the Lisbon Treaty on the Functioning on the European Union [TFEU], trade in services had been a shared competence with the EU Member States).

In addition, being allowed to establish a professional services company in a host country does not necessarily mean that an individual professional service provider will be entitled to supply services in that country. Other conditions may apply: in particular, being allowed to travel physically in the host country to do business locally (see below: movement of natural persons—GATS Mode 4).

MOVEMENT OF NATURAL PERSONS

It needs to be clearly understood that negotiations are only aimed at easing the movement of natural persons for a temporary period and only for those persons whose activity is related to business and trade (GATS Mode 4). This is completely separate from, and has nothing to do with, permanent migration. The aim, therefore, is to make sure that restrictions that apply to migration do not impinge upon or hamper business activity.

Visa facilitation

It will be important for the Australia-EU deal to make an attempt to negotiate more rapid delivery procedures for business visas and work permits. In the EU, visa policies fall under Member States competence, and therefore are not part of trade policy per se. However, with a view to facilitating trade, it might be of interest for the two parties to discuss how to facilitate business visa delivery. Australia negotiated such a parallel deal on this with the United States (US) in the Australia-US FTA. Simultaneous with the trade talks, the negotiators at that time convinced the US Congress to create a new category of visas through legislation separate to the FTA. This so-called ‘E-3’ visa is not a migration visa and serves purely to facilitate temporary work (DFAT 2005).

A similar approach could be useful in the Australia-EU FTA negotiations. But clearly, this is a sensitive issue for both negotiating partners. The recent abolition and replacement by the Australian Government of the 457 visa is clear evidence of the tensions in Australia around this issue.³ The movement of natural persons is often a contentious political issue: witness the heated debate in Europe around the intake of refugees from war-affected countries and economic migrants from poor African countries, alongside similar debates on the exit of the United Kingdom (UK) from the EU (Brexit) and the movement of people within the EU single market. Should such a discussion take place between Australia and the EU, it will

3 On 18 April 2017, the Temporary Work (Skilled) visa (subclass 457 visa) was abolished and replaced with the completely new Temporary Skill Shortage (TSS) visa, which will support businesses in addressing genuine skills shortages. It entered into force on 1 July 2017; see <https://www.homeaffairs.gov.au/trav/visa-1/457->.

be exclusively related to trade. Thus, the parties could aim at negotiating specific visa arrangements which:

- i. allow for a separate annual numerical limit for EU and Australian citizens for business purposes
- ii. incur costs no higher than reasonable standard visa application fees
- iii. enable stays to be granted for up to a sufficiently long period and offer the possibility of renewal
- iv. provide eligibility for spouses and unmarried children under 21-years of age.

But in addition to possible separate visa-related issues, the FTA will have to negotiate better market access for all categories of natural persons covered under Mode 4.

These categories of natural persons are:

- i. intra-corporate transferees (for example managers, specialists and graduate trainees);
- ii. contract service suppliers (for example employees of juridical persons)
- iii. independent professionals
- iv. business visitors.

Intra- corporate transferees

In relation to the category of intra-corporate transferees, it should be recalled that in May 2014, the EU adopted a Directive 'on the conditions of entry and residence of third-country nationals in the framework of an intra-corporate transfer' (L 157 2014). This was to be implemented into the national legislation of EU Member States, effective from 29 November 2016. However, only a few Member States have implemented this and the UK, Denmark and Ireland are opting out of it altogether.

The aim of the Intra-Corporate Transfer Directive (2014/66/EU) is to improve the temporary assignment of highly skilled non-EU nationals into the EU, facilitate the mobility of intra-corporate transferees within the EU and establish a common set of rights for intra-corporate transferees when working in the EU, to avoid exploitation and distortion of competition.

The Intra- Corporate Transfer Directive is part of an initiative to improve the relocation, on a temporary basis, of highly skilled non-EU nationals into and within the EU by international companies, so that they can benefit effectively from the so-called 'Single EU Market'. The Directive applies if:

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

- the assignee is not a national of an EU Member State
- the assignee is transferred within an international group of companies (no annual turnover minimum applies, so both small and large sized organisations fall under the Directive)
- the assignee has an employment contract with an entity outside the EU which belongs to the group
- the intra-corporate transfer is for a duration of longer than 90 days.

It is also important to note is that the Directive does not permit Member States to maintain their own national intra-company transfer 'work permit scheme'. The criteria for admission are laid down in the Directive and can be summarised as follows:

- the individual holds a position as a manager, specialist or trainee
- managers and specialists must have worked for the international organisation/company for between three and 12 months uninterrupted immediately preceding their transfer; for trainees, this mandatory period is for three to six months
- evidence of professional qualifications and experience as required by the host entity must be provided; trainees must have a Masters-level degree
- the salary is set at the local market level.

Once the Intra-Corporate Transfer Directive is implemented, third country nationals with an Intra-Corporate Transfer Permit issued in any Member State of first residence can enter, stay and work in one or more additional Member States with little or no interruption to their assignment. In this way, the administrative burden associated with work assignments in several Member States may be reduced significantly.

The maximum duration of the intra-corporate transfer period is three years for managers and specialists, and one year for graduate trainees, after which the transferee must return to a third country. Member States may require a period of up to six months to elapse between the end of the maximum duration of a transfer and another application concerning the same third country national for the purposes of this Directive in the same Member State. But intra-corporate transferees should not be submitted to any economic needs tests, limits or quotas.

Australia would benefit automatically from the implementation of this Directive. It is clear therefore that the EU negotiators will attempt to negotiate something similar for intra- corporate transfers coming from EU companies to those companies' Australian subsidiaries and affiliates.

Contract service suppliers

The second category to be negotiated covers the movement of a services supplier to a client in the host country under the terms of a contractual arrangement (contract service supplier—CSS). The conditions allowing contract service suppliers into the EU are that the person is employed by a company (juridical person) with no commercial presence in the EU, that the company has obtained a service contract for a maximum period of 12 months from a final consumer, that the person has worked for the company for at least one year prior to the contract, and that the person possesses a university degree or the required technical and professional qualifications and has at least three years of professional experience in the sector. Where the degree or qualification has been obtained in a third country, an EU Member State may evaluate whether this is equivalent to a university degree required in that Member State.

Replicating its GATS offer made in the Doha Development Agenda, the EU has allowed professional service suppliers from several partner countries to be contracted for transactions on a preferential bilateral basis. These contract service suppliers are restricted to a certain number of services sectors; but the list has been enlarged progressively from around 20 to 37 sectors in the recent CETA agreement (CETA Annex 10-E 2016). This includes a large number of professional services such as legal services, accounting and bookkeeping, taxation advisory services, architectural services, urban planning and engineering services. Of course, commitments in these sectors are the result of bilateral negotiations, and might either be extended or restricted, depending on the extent of reciprocal commitments granted by the partner country to EU service providers.

Independent professionals

The third category is the independent professionals. These are individual professionals who have signed a contract with a company in the host country to come and provide a service for a specific period of time, and then return to their home country. This category is very similar to the second one, with the difference being that the professional does not work for a company in the home country. Since there is no control by a home company, a risk exists that this professional might wish to stay in the host country at the end of the contract, and eventually migrate permanently. To try to reduce this risk, the EU offers Mode 4 commitments with conditions that are tighter than for the contract service suppliers (CSS); notably the natural persons entering the territory of the other party must have obtained a service contract for a period not exceeding 12 months and must possess, at the date of submission of an application for entry into the other party, at least six years'

professional experience in the sector of activity which is the subject of the contract (in contrast to three years for contract services suppliers).

Business visitors

The fourth category of business travellers, a category of significant interest for professional services providers, is the one that covers business visitors. It principally covers services sellers. These are persons who:

- do not reside in an EU Member State
- represent a service supplier
- are seeking temporary entry to negotiate the sale of a service
- are not engaged in making direct sales
- are not receiving remuneration.

This typically includes lawyers or auditors who ‘fly in’ and ‘fly out’. They meet the client or the local team. They do not make any direct business transactions, but contribute to advising a client as part of a broader package. This category also covers persons analysing opportunities for establishing a commercial presence. For this category also, the EU does not require any economic needs test and does not fix any limit or any quota. The period of stay can be up to 90 days in any 12 months.

It is interesting to mention here the APEC Business Travel Card (ABTC), which is a voluntary program to facilitate travel for APEC member economy passport-holders that are engaged in verified business in the APEC region. The ABTC⁴ removes the time-consuming need to apply individually for visas or entry permits. It allows multiple entries into participating economies during the three years for which the card is valid. Card-holders also benefit from faster immigration processing on arrival via access to fast-track entry and exit procedures through special APEC lanes at major airports in participating economies.

This could be a potential model for professional services providers travelling between the EU and Australia; it would be interesting to see whether a similar system could be established either through the FTA negotiations or another parallel process.

⁴ APEC member economies fully participating in the scheme include Australia, Brunei Darussalam, Chile, People's Republic of China, Hong Kong SAR, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, NZ, Papua New Guinea, Peru, the Philippines, Russia, Singapore, Chinese Taipei, Thailand and Vietnam. Canada and the US are transitional members of the scheme. See <https://www.apec.org/About-Us/About-APEC/Business-Resources/APEC-Business-Travel-Card.aspx>.

MRAS IN PROFESSIONAL QUALIFICATIONS

Even full market access and national treatment commitments in a trade agreement across all areas of professional services—including allowing temporary movement of professionals in regulated professions in the different categories described above—will not result in substantial increases in bilateral trade if professional service providers are forced to re-qualify before they can provide services across borders.

The Australia-EU FTA, through regulatory cooperation provisions, could establish a mechanism that encourages and enables regulators of these sectors to achieve Mutual Recognition Agreements (MRAs) in professional qualifications when there is mutual demand for this from the professional bodies. In this respect, they could follow, for instance, the example set in CETA. While the EU Treaty gives full competence to EU institutions on all external aspects of the internal market—including on professional qualifications—the EU still needs to find a way to reconcile its authorities in the areas of professional services and of international trade. For many years, the private sector in the EU was expected to work on the details of mutual recognition in professional services via ‘profession-to-profession’ agreements. These would then be examined by the relevant regulatory institutions of two trading partners before becoming an annex to a binding international treaty. This was not an easy process; some MRAs finalised by private sector organisations in the areas of architectural services were never implemented due to lack of coordination across all the parties involved.

With the Framework Agreement that is part of CETA, the European Commission and Canada have found a new way forward. This agreement describes the modalities for how MRAs on sector-specific professional qualifications—once concluded by the private sector between the ‘licensing bodies’—will finally be transformed into a binding international treaty (see Sosnow, Kirby & Stephenson 2014, p. 255). It is important to highlight here that all competent authorities in the Member States and provinces have been involved in reaching this solution.

The Framework Agreement (enshrined in Chapter Eleven of CETA) is an enabling tool containing guidelines for the services sectors that ensure legal security for the agreement. Even before the CETA signature,⁵ the associations of architects of the EU and of Canada had already begun work on an MRA. EU professional services stakeholders can be expected to have an interest in seeking to replicate this model in the Australia-EU negotiations. It is, however, important to emphasise that such a model can only be relevant if all administrative levels of the signatories—

⁵ CETA was bound to provisionally enter into force on 21 September 2017.

that is to say, the EU Member States, and where relevant the Australian States and Territories—are involved.

The points below summarise a method for how an MRA is to be negotiated, as suggested in Article 11.3 of CETA:

1. Each Party encourages its relevant authorities or professional bodies to develop and provide joint recommendations on proposed MRAs to a Joint MRA Committee.
2. A recommendation provides an assessment of the potential value of an MRA on the basis of criteria such as the existing level of market openness, industry needs and business opportunities; it may include an approach for negotiation.
3. The MRA Committee reviews the recommendation and if requirements are met, it establishes the necessary steps to negotiate.
4. The negotiating entities (i.e. the licensing bodies) pursue the negotiation and submit a draft MRA text to the MRA Committee.
5. The MRA Committee reviews the draft MRA to ensure its consistency with the CETA Agreement. If, in the view of the MRA Committee, the MRA is consistent with the Agreement, it adopts the MRA by means of a decision.
6. The decision becomes binding on the Parties.

The ‘Guidelines for MRAs’ are found in CETA: Annex 11-A (2016). They provide a four-step process for the recognition of qualifications:

Step One: Verification of Equivalency—activities and qualifications required.

Step Two: Evaluation of substantial qualification process differences—knowledge, duration, practice and training.

Step Three: Compensatory Measures (that would be needed by the professional before being allowed to practice)—adaptation period and aptitude test.

Step Four: Identification of the Conditions for Recognition—a detailed description of what is necessary after the three first steps.

It remains to be seen how Australian services providers will react to this new EU approach as set out in CETA. What is clear, however, is that the business community in both Europe and in Australia has been dissatisfied with progress made to date on liberalisation of professional services, and will no doubt welcome innovations and attempts at new solutions on the part of their negotiators.

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15

FINANCIAL SERVICES

John Cooke

ABSTRACT

This chapter studies the prospects for financial services within the Australia-European Union (EU) Free Trade Agreement (FTA). Reviewing Australia-EU trade in financial services, the chapter examines variations in flows and the resultant balance. It then considers the scope for enhancing financial services trade, with reference to variations in services openness in Australia and in EU Member States, (as shown in the OECD Services Trade Restrictiveness Index) and other factors, including current Australian regulatory obstacles to inward investment flows). Based on the financial services objectives in the European Commission negotiating mandate, it considers the current state of competition in the Australian banking and insurance services markets, and how the FTA might contribute to bringing even greater market competition. Consideration is also given to how the FTA, as an advanced agreement, might offer scope for greater regulatory coherence in financial services. Attention then turns to Brexit (exit of the United Kingdom [UK] from the EU), underlining the UK's high current share of Australia-EU trade in financial services, and Brexit's effect on the EU's financial services profile towards Australia. The chapter concludes that the FTA negotiations will begin at a challenging moment for the global rules-based system and for the EU's Common Commercial Policy, with Brexit bringing an added dimension.

ACKNOWLEDGEMENT

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POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	2010	2011	2012	2013	2014	Average
All services	14.64	16.15	18.80	19.12	18.62	-
All services growth (%)	-	10.17%	16.62%	1.65%	-2.6%	6.46%
Financial services	2.60	2.34	2.98	2.24	2.02	-
Financial services share of all services (%)	17.75%	14.48%	15.85%	11.71%	10.85%	14.13%
Financial services growth (%)	-	-9.74%	27.26%	-24.81%	-9.99%	-4.32%

Table 15.1: EU services and financial services exports to Australia (€ billion).

Source: Eurostat (2016).

	2010	2011	2012	2013	2014	Average
All services	7.40	7.89	8.62	8.17	7.81	-
All services growth (%)	-	6.65%	9.13%	-5.16%	-4.44%	1.55%
Financial services	0.35	0.39	0.48	0.37	0.55	-
Financial services share of all services (%)	4.70%	4.94%	5.57%	4.53%	7.04%	5.36%
Financial services growth (%)	-	11.36%	23.47%	-23.14%	47.04%	14.68%

Table 15.2: EU services and financial services imports from Australia (€ billion).

Source: Eurostat (2016).

	2010	2011	2012	2013	2014	Average
All EU services exports	14.64	16.15	18.80	19.12	18.62	-
All EU services imports	7.40	7.89	8.62	8.17	7.81	-
Balance	7.24	8.26	10.18	10.95	10.81	-
Change in balance (%)	-	13.76%	23.81%	7.42%	1.21%	10.95%
Financial services exports	-	2.60	2.34	2.98	2.24	-
Financial services imports	-	0.35	0.39	0.48	0.37	-
Financial services balance	-2.25	-1.95	-2.5	-1.87	-1.47	-
Change in financial services balance (%)	-	-13.05%	28.02%	-25.13%	-21.33%	-7.87%

Table 15.3: EU services and financial services balance of trade with Australia (€ billion).

Source: TheCityUK calculations using data from Eurostat (2016).

INTRODUCTION

In recent years, financial services have accounted for roughly one-fifth to one-sixth of total European Union (EU) services exports to Australia, and a much smaller share—varying between one-fifteenth and one-twentieth—of EU services imports from Australia. Tables 15.1, 15.2 and 15.3 provide greater detail (LSE Enterprise & European Commission 2017).

The broad trend over the period 2010-2014 is an increase averaging 6.46 per cent a year in total EU services exports to Australia, and 10.95 per cent

average annual growth in the EU's services trade surplus with Australia. This trend is not equally true of financial services: here, EU financial services exports to Australia have averaged negative growth (-4.32%), with financial services experiencing a falling share in EU services exports to Australia and a generally static share of Australian services exports to the EU. The causes for these trends are not altogether clear; however, some reasons are explored later in this chapter.

SCOPE FOR INCREASING TRADE IN FINANCIAL SERVICES

There ought to be scope for two-way trade in financial services between the EU and Australia to increase further. Regarding barriers to financial services, both sides compare reasonably in terms of the performance of different markets against the OECD Services Trade Restrictiveness Index (STRI). Figures 15.1 & 15.2 illustrate the OECD STRI variations in services openness in commercial banking and in insurance across 22 EU Member States, together with Australia and New Zealand (NZ). The variations relate to policy measures that are implemented on a most-favoured nation (MFN) basis; preferential treatment entailed in regional

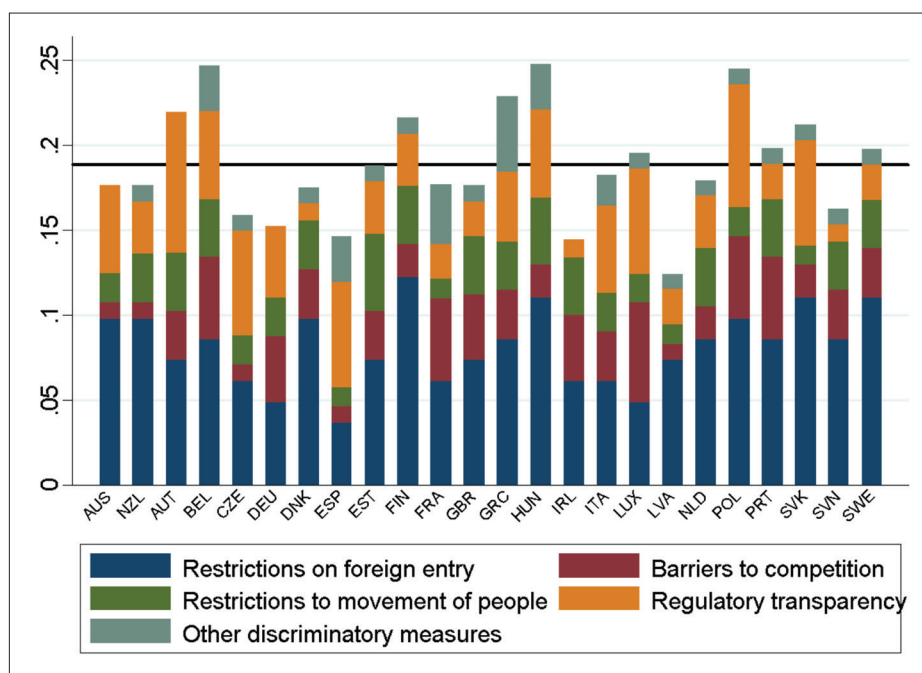


Figure 15.1: STRI for commercial banking services.

Source: OECD STRI database (2017a).

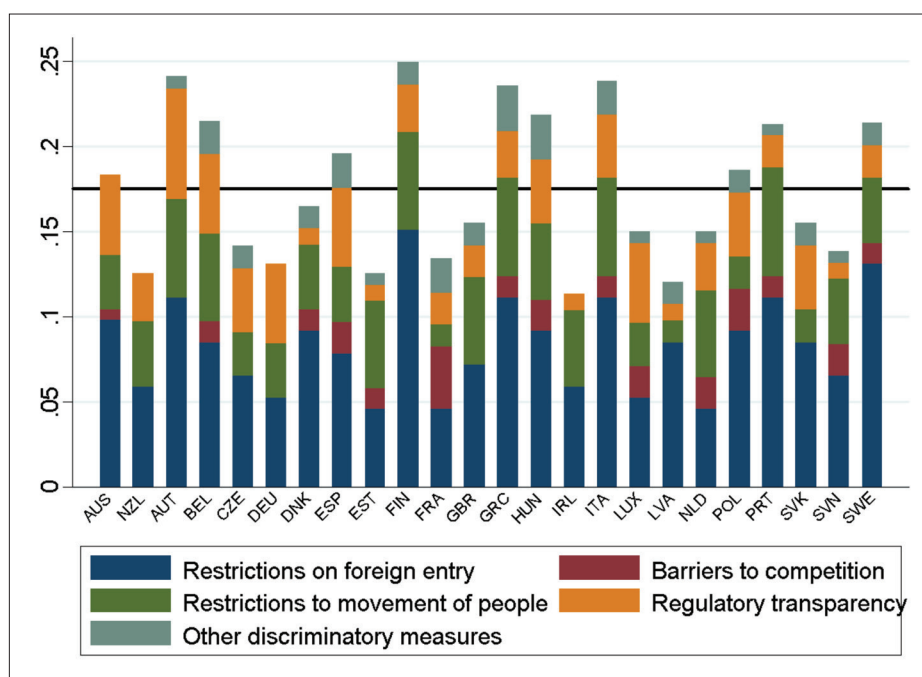


Figure 15.2: STRI for insurance services.

Source: OECD STRI database (2017a).

trade agreements is left out of account (Rouzet et al. 2014; OECD 2017a). The index uses a basic binary evaluation (0 = totally open; 1 = totally closed).

It is noteworthy that, across all STRI indices, Australia is fifth of the top ten countries with the most open markets for services trade in 2017 (OECD 2018). As can be readily seen from Figures 15.1 and 15.2, all the countries shown are relatively open, with STRI scores averaging under 0.2. The average, however, disguises some significant variations. For both insurance and banking, Australia scores relatively highly in restrictions on foreign entry, although not as highly as certain EU Member States (for example Finland).

The EU's own analyses of the scope for increasing Australia-EU trade in financial services are generally not highly detailed. The ex-ante study of the EU-Australia and EU-NZ FTAs (LSE Enterprise & European Commission 2017) provides little or no analysis of the scope for expanding trade in financial services, except in the area of removing restrictions arising from the Australian system of regulatory obstacles to investment and their impact on inward investment flows. The Annex to the European Commission's proposed negotiating mandate goes somewhat further, offering the following commentary;

Trade in Services, Foreign Direct Investment and Digital Trade

In line with Article V GATS [General Agreement on Trades in Services], the Agreement should have substantial sectorial coverage and should cover all modes of supply. The Agreement should have no a priori exclusion from its scope other than the exclusion of audio-visual services and services supplied and activities performed in the exercise of governmental authority. The negotiations should aim at the progressive and reciprocal liberalisation of trade in services and foreign direct investment by eliminating restrictions to market access and national treatment, beyond the Parties' WTO commitments and offers submitted in the context of the negotiations of the Trade in Services Agreement [TiSA]. The Agreement should include rules concerning performance requirements related to foreign direct investment.

Furthermore, the Agreement should contain regulatory disciplines. To that end, the negotiations should cover matters such as:

- Regulatory provisions on transparency and mutual recognition;
- Horizontal provisions on domestic regulation, such as those ensuring impartiality and due process with regard to licensing and qualification requirements and procedures; and
- Regulatory provisions for specific sectors including telecommunication services, financial services, delivery services and international maritime transport services.

In the context of the increasing digitalisation of trade, the negotiations should result in rules covering digital trade and cross-border data flows, electronic trust and authentication services, unsolicited direct marketing communications, and addressing unjustified data localisation requirements, while neither negotiating nor affecting the EU's personal data protection rules.

The Agreement may include procedural commitments for the entry and stay of natural persons for business purposes pursuant to the Parties' commitments in Mode 4. However, nothing in the Agreement should prevent the Parties from applying their national laws, regulations and requirements regarding entry and stay, provided that, in doing so, they do not nullify or impair the benefits accruing from the Agreement.

[...]

Capital Movement and Payments

The Agreement should aim for the removal of restrictions to current payments and capital movements related to transactions liberalised under this Agreement, and include a standstill clause. It should include safeguard and carve-out provisions (e.g. concerning the Union's economic and monetary union and balance of payments), which should be in accordance with the provisions of the

TFEU [Lisbon Treaty on the Functioning on the European Union] on the free movement of capital. (European Commission 2017 pp. 6-7)

As with most such mandates, the extracts quoted above are fairly broad in scope and some—for instance, those concerned with the removal of restrictions on current account payments and capital movements, related to transactions liberalised under the proposed FTA—are fairly standard, rather than specific to Australia. Others cover important points and presage negotiations which could prove challenging. An example is the paragraph on the need for rules covering digital trade and cross-border data flows. The most advanced language developed so far on this subject is that established in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). But the continuing exclusion of financial services from the CPTPP version of these rules—as stipulated by the United States (US) Treasury when the US intended to become a party to the original TPP—could well be unacceptable to Australia. The EU itself faces internal arguments over the treatment of personal data protection rules in trade agreements. This has led to some controversy over the right to regulate in relation to the provisional application of the rules set out in the EU-Canada Comprehensive Economic and Trade Agreement (CETA) and the publication in July 2018 of the European Commission’s Explanatory Note on provisions on cross-border data flows and protection of personal data in EU trade agreements (European Commission 2018).

The third bullet point in the mandate extract above contains the only reference to financial services, specifying the need for regulatory provisions. But regulation is not the only area in which there could be scope for liberalisation. As a WTO Trade Policy Review of Australia noted:

While the financial services sector has performed well over the review period, a recently-released Financial Sector Inquiry has made various recommendations to strengthen and develop the sector, including eliminating distortions to the efficient market allocation of financial resources as well as impediments to competition. Approval is still required for all investments (both domestic and foreign) of over 15 per cent in financial institutions. Banking reforms undertaken since 2011 have included: implementation of new capital and liquidity requirements; strengthened supervision; and winding down of measures introduced to mitigate the impact of the global financial crisis. Recent developments in the insurance sector have included the sale of a major state-owned private health insurer and the closure of the Private Health Insurance Administration Council. The provision of life insurance by foreign companies through branch operations is prohibited, but exceptions to this rule are increasingly being granted through RTAs [regional trade agreements]. (WTO 2015 p. 133)

The removal of such restrictions is important in international trade terms, given that financial services represent a significant part of the Australian services sector, contributing 8.7 per cent of Australian gross domestic product (GDP) in 2015. In prudential terms, the sector appears in good health, although concerns are reported, particularly relating to the degree of concentration in banking (OECD 2017b). Indeed, the global financial crisis strengthened the already-dominant position of the four main banks, as two of them took over smaller banks during this period.

Nonetheless, competition in the Australian banking sector apparently remains generally robust. The Financial System Inquiry Report, released in December 2014, recommended eliminating distortions to the efficient market allocation of financial resources (such as taxation, information imbalances and unnecessary regulation), as well as removing impediments to competition. Other recommendations fell under five specific themes: (1) strengthening the economy by making the financial system more resilient; (2) increasing the superannuation system's capacity and raising retirement incomes; (3) driving economic growth and productivity through settings that promote innovation; (4) enhancing confidence and trust by creating an environment in which financial firms treat customers fairly; and (5) enhancing regulator independence and accountability, and minimising the need for future regulation. It would be logical—consistent with the steps required under these five headings—for Australian authorities to use the Australia-EU FTA as an added means of securing their objectives through introducing further competition.

Australia's insurance market was the eleventh largest in the world in 2016 (Swiss Re Institute 2017). In the same year, Australian insurance penetration—total insurance premiums as a percentage of GDP—stood at 6.52 per cent. Insurance density—direct gross premiums per capita—stood at US\$3397.1, above the OECD average. However, the market share of foreign providers in the Australian domestic insurance market was below the OECD average, at 20.8 per cent for life insurance, with a slightly larger percentage for non-life insurance. The Figure for foreign providers' share of the Australian life insurance market, although steadily rising, is lower than in some EU markets, for example Austria at 39.3%; the Czech Republic 96.8%; Germany 25.3%; Italy 33.1%; Luxembourg 77.2% and Poland 54.3% (OECD 2016). However, of the 20 EU markets covered by OECD data, others show markedly lower percentages. The crude average for the 18 EU Member States for which OECD provides figures might be expressed as about 55 per cent; but this Figure takes no account of market size, insurance density or insurance penetration and is best disregarded. The range of data is presented in Table 15.4.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

EU Member State	Market share in 2015 or 2016	EU Member State	Market share in 2015 or 2016
Austria	39.3	Italy	33.1
Belgium	N/A	Latvia	90.3
Czech Republic	96.8	Luxembourg	77.2
Denmark	18.8	Netherlands	18.5 (2015)
Estonia	100	Poland	54.3
Finland	38.5 (2015)	Portugal	77.5
France	N/A	Slovak Republic	89.0 (2015)
Germany	25.3	Slovenia	17.1
Greece	76.9	Spain	12.3
Hungary	96.9	Sweden	11.2
Ireland	4.7 (2015)	United Kingdom	16.9 (2015)

Table 15.4: Market shares of foreign companies in EU domestic markets (life assurance).

Source: OECD (2016b).

It seems reasonable to conclude that there should be scope for the foreign providers' share of the Australian life insurance market to increase further. But it is difficult to hazard a figure.

One factor in the relatively low market share held by foreign insurers may be the growing concentration of the Australian domestic insurance industry. Following a decline in the number of insurance providers over the past 10 to 15 years, Australia's domestic general insurance business has become more concentrated, with the largest five direct insurance groups accounting for over 70 per cent of direct insurance premiums in 2013. Over the same period, the top five life insurers held some 82 per cent of the industry's assets. The Australian Government used to own 100 per cent of Australia's largest private health insurer, Medibank Private Limited, but this was sold through an initial public offering in November 2014. Overall, general insurer profitability has strengthened since 2012, due in part to a benign claims environment—in sharp contrast to the years 2010 and 2011—and increases in premiums. Both the general and life insurance sectors are well capitalised at levels equivalent to 1.7 times and 1.9 times (respectively) the amount prescribed by the Australian Prudential Regulatory Authority (APRA). The likely inference appears to be the growing dominance of a concentrated group of well-capitalised domestic providers in the Australian insurance sector, discouraging market entry by new or smaller foreign businesses.

Against this background, and given Australia's existing OECD STRI scores for banking and insurance, there should be scope for further expansion of Australia-EU trade in financial services. How could the Australia-EU FTA contribute to this most effectively? On this and other aspects, the European Services

Forum (ESF) has provided its views to the European Commission, including some recommendations on financial services. These are worth examining in detail.

The ESF starts by observing that Australian commitments under the CPTPP mostly reflect commitments made under the GATS and the GATS Understanding on Commitments in Financial Services, and that many restrictions which existed under the GATS have been removed. The ESF further remarks that Australia nevertheless still maintains some non-conforming measures whatever the type of financial services. First, all existing non-conforming measures at the regional level are maintained (CPTPP Annex I: Schedule of Australia 2018). Second, the ESF requests the removal in particular (or at least some clarifications on its terms and conditions) of the following restriction: ‘The acquisition of a stake in an existing financial sector company by a foreign investor, or entry into an arrangement by a foreign investor, that would lead to an unacceptable shareholding situation or to practical control of an existing financial sector company, may be refused, or be subject to certain conditions’ (CPTPP Annex I: Schedule of Australia 2018).

The ESF also notes that proposed foreign investments in Australian financial institutions—as with foreign investments in other sectors—are subject to a screening process. Some of Australia’s trading partners are exempt from this under bilateral FTAs (for example Chile, Republic of Korea [Korea], New Zealand [NZ] and the United States [US]) (WTO 2015). The ESF favours the same exemption for the EU.

Regarding insurance and insurance-related services, the ESF notes that Australia has largely opened insurance services in its CPTPP Schedule of Commitments. Only one non-conforming measure (albeit a major one) is maintained: the provision of life insurance by foreign companies through branch operations remains prohibited, with the national ‘Life Insurance Act 1995’ restricting the approval of non-resident life insurers to subsidiaries incorporated under Australian law (CPTPP Annex III: Schedule of Australia 2018). However, Australia has granted exceptions to this rule through RTAs with the US, NZ and Korea; and Japan will also benefit from this exception once the EU-Japan Economic Partnership Agreement enters into force (WTO 2015). The ESF accordingly favours the same exception for European life insurers.

On banking and other financial services (excluding insurance services), the ESF notes that the Australian banking sector remains closed for many sub-sectors under Mode 1; further, cross-border trade is only open for ‘the provision and transfer of financial information, and financial data processing and related software’ and ‘advisory and other auxiliary services, excluding intermediation’, relating to banking and other financial services (CPTPP Annex 11-A: Cross-border Trade

2018). In particular, the ESF states that retail banking remains restricted, as a branch of a foreign bank authorised as a deposit-taking institution is not permitted to accept initial deposits (and other funds) of less than A\$250,000 from individuals and non-corporate institutions (CPTPP Annex III: Schedule of Australia 2018). The ESF concludes by stating the need for improvements in all these aspects within the framework of the Australia-EU FTA.

In addition to the above analysis of the scope for increasing trade in financial services, it is worth adding that the Australia-EU FTA will be an advanced FTA. It will be able to draw on not only the language of other existing FTAs, but also on the wordings established in the CPTPP and provisionally established in the TiSA negotiations. The latter offers various clarifications of the GATS Understanding on Commitments in Financial Services. There should, therefore, be a diverse range of potential opportunities for fresh approaches to further liberalisation in financial services.

SCOPE FOR GREATER REGULATORY COHERENCE IN FINANCIAL SERVICES

It is to be hoped that the Australia-EU FTA will also offer opportunities for fresh approaches to greater regulatory coherence in financial services. The Australian Financial Services Council (FSC) evidently favours this (FSC 2015). On the EU side, there has been a steady, if limited, expansion in approaches to regulatory cooperation in (or alongside) FTAs. The EU's most ambitious approach was that taken in the context of the recent Transatlantic Trade and Investment Partnership (TTIP) negotiations before they were placed in abeyance. In 2014 the European Commission drew attention (European Commission 2014) to the need for deeper EU-US regulatory cooperation, stating:

The need to address regulatory barriers is particularly evident in the financial services sector. The financial crisis showed in stark clarity that financial markets are global and deeply interconnected. The global nature of financial services allows systemic risks to be transmitted across national borders. Financial stability is not served by a fragmented regulatory approach, inconsistent rules and a low level of co-operation among supervisors. (European Commission 2014, p. 1)

The European Commission went on to propose a system of regulatory cooperation based on a number of principles:

- joint work to ensure timely and consistent implementation of internationally agreed standards for regulation and supervision
- mutual consultations in advance of any new financial measures that may significantly affect the provision of financial services between the

EU and the US and to avoid introducing rules unduly affecting the jurisdiction of the other party

- joint examination of the existing rules to examine whether they create unnecessary barriers to trade
- a commitment to assessing whether the other jurisdiction's rules are equivalent in outcomes.

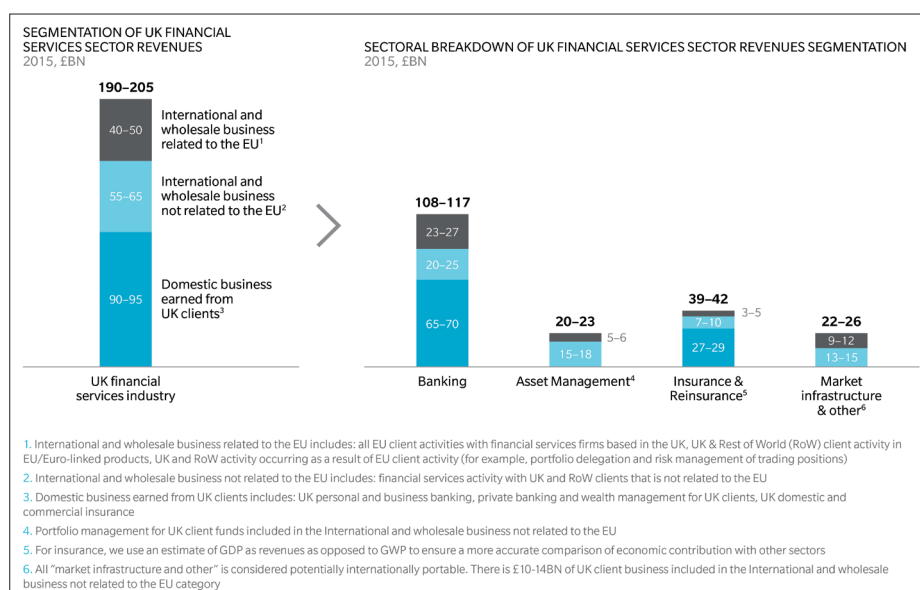
Other proposals have been developed. Some of these amplify the Commission's thinking (see Bowles, Murphy & Brummer 2013; Cummings 2016). Australia is par excellence a valued trading partner with a long history of regulatory cooperation and mutual recognition of regulatory regimes with its close partner, NZ, enshrined in the Australia-NZ Closer Economic Relations Trade Agreement—an accord which contains important 'living agreement' features. It is to be hoped that the Australian experience can be used to guide and inform approaches to regulatory cooperation in financial services in the Australia-EU FTA.

The prospect of the UK leaving the EU has also led to a fresh examination of the provisions in EU financial services legislation on equivalence decisions. These are decisions that the Commission may take in relation to other countries' financial services regulatory regimes. These decision-making powers are variable and non-comprehensive. This has prompted studies of alternatives to EU equivalence decisions, such as mutual recognition of financial regulatory regimes, with purpose-built approaches to the treatment of alignment and divergence. The International Regulatory Strategy Group (IRSG), which is jointly run by TheCityUK and the City of London Corporation, has recently produced three reports (IRSG 2017a, 2017b, 2017c) that develop detailed proposals in this regard. The most recent of these offers a model for mutual recognition within the FTA framework. Although the UK Government has preferred an alternative approach for the future UK-EU relationship (UK Government 2018b; TheCityUK 2018), the IRSG's model contains concepts that would certainly bear study in other contexts such as the Australia-EU FTA. Central to these is the IRSG's proposal for mutual recognition of financial services regulatory regimes as a basis for market access, along with highly developed consultation and dispute settlement procedures to manage instances where the prospect of regulatory divergence exists.

BREXIT AND ITS EFFECTS

The UK's departure from the EU is bound to have effects on the EU's stance and profile in the Australia-EU negotiations. There will be a pronounced effect in the financial services area. The UK has long held a large share across the internal EU28 (EU with the UK) financial services markets, historically reaching 50 per cent

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT



Note: market shares relate to revenues (whole sector), bank lending (banking), value of assets under management (asset management) and insurance premiums (insurance and reinsurance).

Figure 15.3: Segmentation of the UK financial services industry.

Source: EGOV based on figures provided by TheCityUK (2016); LSE (2016); New Financial (2016); Oliver Wyman (2016).

or more in areas such as hedge fund assets, interest rate over-the-counter (OTC) derivatives trading, foreign exchange trading, marine insurance premiums and funds management. For example, as of April 2016, the UK's share of EU28 interest rate OTC derivatives trading was 82 per cent and its share of EU28 foreign exchange trading was 78 per cent (TheCityUK 2016).

The UK's deep interconnections with the EU27 financial services market are shown in Figure 15.3.

This is not the place to discuss all the effects of Brexit, which are more fully covered in chapter 4 in this volume. However, as the author of that chapter, L. Alan Winters notes, in the years 2014 to 2016, the UK accounted for some two-fifths of all EU services trade with Australia, and for the great bulk of trade in banking and other financial services trade between the EU and Australia as highlighted in Table 15.5).

As L. Alan Winters writes in chapter 4 of this volume:

Australia-EU services trade relies heavily on trade with the UK, which accounts for 47 per cent of Australia's exports and 38 per cent of its imports. Financial

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	Exports from Australia			Imports into Australia		
	Average annual 2014–16	Share of total	UK share	Annual average 2014–16	Share of total	UK share
All services	10,249	-	46.8%	18,678	-	37.5%
Insurance & pension services	19	0.2%	67.9%	511	2.7%	92%
Banking and financial services	895	8.7%	78.6%	693	3.7%	81.5%

Table 15.5: Australia-EU trade in services, 2014-2016 (A\$ millions). (With acknowledgements to L. Alan Winters).

Source: DFAT (2016).

and insurance services have two-thirds or more of their trade with the UK, so the outcome of Brexit is likely to result in major effects on trade and the incentive to pursue liberalisation. The two-way nature of financial services trade suggests that it stems at least partly from a financial-centres effect. This reflects the partners' global and regional roles, rather than merely the intermediation of savings between Australia and the EU (or the UK).

L. Alan Winters adds in chapter 4 of this volume that there is great uncertainty as to how these effects may play out. At the time of writing, there is no need to rehearse his tentative analysis of the range of possible outcomes as amply set out in his chapter. Suffice it to endorse the three main possibilities he identifies: (1) that to an as yet unknown extent, financial services may drain out of London into one or more EU centres; (2) that financial services could drain abroad, possibly to New York or Singapore, again to an unknown extent; and (3) that the economies of agglomeration in the financial services sector may be strong enough for the UK and London to maintain their leading market positions, despite the added costs and uncertainties. The outcome has yet to be known. As has been said, there will be effects on the EU's financial services profile and offering in international trade negotiations. Depending on trends during the Australia-EU negotiations, there could therefore be developments in the attitudes of both sides as to how best to approach financial services in the negotiations.

Whatever the precise effects of Brexit (Van Geffan 2016; Wright et al. 2016), however, it remains a fact that a preponderant share of UK international financial services business will continue. In a careful analysis, which merits reading in full, Oliver Wyman (2016) summarises the range of possibilities as follows:

Our analysis suggests that, at one end of the spectrum, an exit from the EU that puts the UK outside the European Economic Area (EEA), but otherwise delivers passporting and equivalence and allows access to the Single Market on terms similar to those that UK-based firms currently have, will cause some

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

	Exports	Imports	Trade surplus	Share of total
US	16,762	3,471	13,291	19.5%
France	6,449	868	5,581	8.2%
Germany	5,552	744	4,808	7.0%
Netherlands	4,436	666	3,770	5.5%
Italy	1,827	229	1,598	2.3%
Spain	1,791	212	1,579	2.3%
Luxembourg	1,309	197	1,112	1.6%
Ireland	1,575	576	999	1.5%
Other EU	5,783	630	5,153	7.6%
Japan	4,733	959	3,774	5.5%
Switzerland	1,924	357	1,567	2.3%
Russia	1,291	111	1,180	1.7%
Canada	723	86	637	0.9%
Australia	762	168	594	0.9%
Other non-EU	24,096	1,523	22,573	33.1%
EU total	28,722	4,122	24,600	36.1%

Table 15.6: UK trade surplus in financial services with selected countries/regions (£million) 2016.

Source: UK Office for National Statistics (2016).

disruption to the current delivery model, but only a modest reduction in UK-based activity. We estimate that revenues from EU-related activity would decline by -£2BN (-2 per cent of total international and wholesale business), that 3-4000 jobs could be at risk, and that tax revenues would fall by less than £0.5BN per annum.

At the other end of the spectrum, in a scenario that sees the UK move to a third country status with the EU without any regulatory equivalence, the impact could be more significant. Severe restrictions could be placed on the EU-related business that can be transacted by UK-based firms. In this lowest access scenario, where the UK's relationship with the EU rests largely on WTO obligations, 40-50 per cent of EU-related activity (approximately £18-20BN in revenue) and up to an estimated 31-35 000 jobs could be at risk, along with approximately £3-5BN of tax revenues per annum. (p. 2)

The scale of UK financial services trade with global markets is shown in Tables 15.6 and 15.7. These illustrate that after the US, the EU, Japan, Canada and Switzerland, Australia is the fifth-largest single country export market for UK financial and insurance services:

The same position is roughly confirmed in the insurance and reinsurance sector by figures for the London Market premium growth-by-location of those insured (London Market Group & Boston Consulting Group, 2017). Here however, the figures show significant falls in relation to Australasia as a whole.

POTENTIAL BENEFITS OF AN AUSTRALIA-EU FREE TRADE AGREEMENT

Insured location	Lloyd's			Company market ²			London market			
	2013	2015	Growth p.a.	2013	2015	Growth p.a.	2013	2015	Growth p.a.	
UK & Ireland	6.8	7.6	5.4%	15.2	15.3	0.1%	22.1	22.9	1.8%	86% of total
US & Canada	17.6	19.2	4.5%	3.3	3.3	-0.3%	20.9	22.5	3.7%	
Europe ¹	6.1	5.5	-5.3%	4.3	4.1	-2.9%	10.4	9.6	-4.3%	
Australasia	2.7	2.2	-10.3%	0.5	0.3	-17.2%	3.2	2.5	-11.3%	
Asia	3.1	2.8	-5.1%	2.1	1.5	-15.6%	5.2	4.3	-9.3%	14% of total
Other Americas	3.2	3.0	-2.0%	1.1	1.0	-3.1%	4.2	4.0	-2.3%	
Africa	0.6	0.6	-4.9%	0.5	0.4	-5.4%	1.1	1.0	-5.1%	
Total	40.0	40.8	0.9%	27.0	25.9	-2.1%	67.1	66.7	-0.3%	

¹ Excluding UK and Ireland ² Including Protection and Indemnity Clubs.

Table 15.7: London Market premium growth-by-location of insured, 2013-2015.

Source: London Market Group and Boston Consulting Group (2017).

Anecdotal evidence suggests that while London Market Australian premium levels in 2013-2015 remained fairly steady in A\$ terms, they would have fallen in US\$ terms due to foreign exchange fluctuations. For Australasia as a whole, some of these falls may have been caused by insurance changes affecting NZ rather than Australia. The significant NZ earthquake activity and related insurance losses in 2010-2011 resulted in increased premium rates which then fell away again after 2013 (for example Lloyd's NZ\$ premiums are thought to have increased significantly in 2011-2013, subsequently dropping slightly before rising again from 2016 to surpass 2013 premium levels). Foreign exchange fluctuations over the period have had a far greater impact on Australian premiums than NZ premiums.

Post-Brexit, the UK will doubtless seek to retain financial services markets of this kind and consolidate its position in them. Depending on the Brexit terms as finally agreed, the UK will pursue its own trade and investment policy. Pending Brexit, this policy is still at a preparatory stage, with the government seeking a partnership with UK businesses. UK business groups, for their part, have offered suggestions on the form the policy should take (TheCityUK 2017). At present, the UK Government is seeking to ensure that existing EU trade agreements with third countries continue as the UK leaves the EU so that their benefits are not lost. On 9 February 2018 the UK Government issued a proposal (UK Government 2018a) for achieving this through an agreed continuity mechanism consistent with Article 31 of the Vienna Convention on the Law of Treaties (Vienna Convention). The proposal was made in the form of a Technical Note, 'International Agreements during the Implementation Period', published on the UK Government website. In addition, Australia and the UK established a Joint Trade Working Group in September 2016 to scope the parameters of a future, comprehensive UK-Australia

FTA and exchange views on global trade policy issues and developments. Both governments have committed to ensuring an expeditious transition to FTA negotiations post-Brexit when the time is right (Austrade 2018). On 20 July 2018, the UK Government announced a public consultation on UK-Australia trade negotiations, which will run until 26 October 2018 (UK Department of International Trade 2018).

CONCLUSION

As noted in other chapters in this book, the Australia-EU FTA negotiations have got underway at a challenging moment in the evolution of the global rules-based system for trade and of the EU's Common Commercial Policy. Brexit will mean a change of scale and trading profile for the EU in international trade. Nowhere is this likely to be more marked than in financial services. Here, the UK's departure from the EU, depending on how its effects play out, has the potential to bring about major changes that will affect the UK, the EU and the interaction of global financial markets. The Australia-EU FTA negotiations will take place against the background of these developments.

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PART 4

WHERE TO ON INVESTOR-STATE DISPUTE SETTLEMENT?

INVESTOR-STATE DISPUTE SETTLEMENT

Julien Chaisse and Yves Renouf

ABSTRACT

This chapter explores the pros and cons of the European Union (EU) proposal for an investment court system (ICS) in comparison with the arbitration-based investor-state dispute settlement (ISDS) system currently prevailing in international investment agreements, and in connection with the negotiation of a new generation Australia-EU Free Trade Agreement (FTA) including foreign direct investment. It argues, based on the WTO experience with a quasi-judicial dispute settlement mechanism, that an ICS could contribute to a more transparent, predictable, objective and uniform resolution of investor-state disputes in general and, more particularly, in an FTA between the EU and Australia. The chapter nonetheless questions the feasibility of such a system in an Australia-EU FTA, having regard to the differences in the political and practical experiences of the EU and Australia with ISDS.

INTRODUCTION: INVESTOR-STATE DISPUTE SETTLEMENT (ISDS) IN AN AUSTRALIA-EU FTA? DRIVERS, ISSUES AND DIRECTIONS

Even the best-drafted treaty is not immune to issues of interpretation or application. Although some can be resolved by the parties themselves through negotiation—which is often a prerequisite to any other form of dispute settlement under international agreements—others might require external means of resolution.

Investor-state dispute settlement (ISDS) is a treaty-based dispute resolution mechanism found in many international investment agreements (IIA). It is now

included in the investment chapters of the most ambitious bilateral free trade agreements (FTAs), such as the Comprehensive and Economic Trade Agreement (CETA), the People's Republic of China (China)-Australia FTA (ChAFTA), or plurilateral regional economic agreements, for instance the Energy Charter or the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

ISDS usually takes the form of an arbitration mechanism. International investment arbitration—also known as investment treaty arbitration or investor-state arbitration—is a procedure through which foreign investors may obtain a binding adjudication of claims against host States which they believe have either violated their treaty-based investment protection or, in some circumstances, breached their contractual commitments or their national foreign investment law.¹

Investment arbitration provisions can be critical in some contexts because they allow an investor to enforce its treaty rights directly against its host state in a forum that the state does not control. In other words, it can be said that investment treaty arbitration is what 'gives teeth' to IIAs (Chaisse 2012).

In practice though, ISDS elevates private entities to the status of subjects of international law for the purpose of protecting the rights conferred upon them by international agreements concluded between states. Even though, under some arbitration rules, such as the United Nations Commission on International Trade Law (UNCITRAL), ISDS may be used to restore the balance of rights and obligations set by an IIA, it is more often used—or perceived—as a mechanism intended to provide financial compensation to private investors for a breach of its rights under the IIA by the host state.

Many bilateral treaties contain clauses on the settlement of disputes between investors and host states. In older treaties, such provisions specifically mentioned the types of conflict to which the clauses applied (Chaisse 2015b, p. 563). Thus, only those that met the criteria in this definition could be submitted to arbitration by investors.

For some time though, the most frequently used approach in bilateral investment treaties (BITs) has been to require only that the dispute be *related to an investment*. Under this approach, most treaties use different formulations, among which there is very little difference, but the effect of this broader language on the freedom of states to determine their policies can be significant.

1 BITs may also involve disputes between private investors or between states that may be parties to such treaties. Conflicts between private parties are normally resolved by recourse to the courts of the state jurisdiction under the rules of private international law or commercial arbitration. Therefore, they are not the object of this article. Whereas conflicts between a state and investors of the other state party to a BIT could normally also be submitted to courts or competent national authorities, treaty-based arbitration is currently the standard practice for BITs.

ISDS has been subject, over recent years, to increasing criticisms of a political and legal nature (Sornarajah 2015). Some argue that the origin of these criticisms results from developing countries no longer being the only ones facing potential claims for damages under ISDS. Indeed, developed countries' policies are also being challenged.

ISDS essentially provides relief to the aggrieved investor in the form of (often hefty) financial compensations. Such compensations are often presented as a way for investors to recoup their original investment when they want to pull out of the host country. The amounts can appear scandalously high in light of the actual resources of the host states. In developed countries, ISDS is increasingly perceived as unnecessarily giving rights to foreign investors that neither domestic investors nor citizens have. It is also seen as a 'neo-liberal' instrument allowing private companies to challenge the environmental or health policies of host states, or unravel social protection standards.

Public opinion in the EU has become increasingly opposed to ISDS and more generally to investment treaties or the new generation of FTAs, including investment chapters, such as in the Comprehensive and Economic Trade Agreement (CETA) with Canada or the proposed Transatlantic Trade and Investment Partnership (TTIP) with the United States (US).

In September 2015, the European Commission, either as part of a damage-control operation in the context of the TTIP negotiations, or in a genuine attempt to have subjects of international law regain control over ISDS, proposed an ISDS mechanism substantially inspired by the WTO dispute settlement mechanism. Indeed, the proposal shares many features with its WTO model. These are essentially:

- an integrated, treaty-based dispute settlement mechanism
- a system rooted in public international law
- independence of adjudicators
- the possibility to appeal issues of law before an Appellate Body
- transparency.

The EU has succeeded in having the ISDS chapter in its CETA with Canada amended to reflect the above.² This proposal had previously been incorporated

2 CETA Article 8.29 reads as follows: 'The Parties shall pursue with other trading partners the establishment of a multilateral investment tribunal and appellate mechanism for the resolution of investment disputes. Upon establishment of such a multilateral mechanism, the CETA Joint Committee shall adopt a decision providing that investment disputes under this Section will be decided pursuant to the multilateral mechanism and make appropriate transitional arrangements'. See <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1468>

in the EU-Vietnam FTA (2016) and is part of the European Commission's mandate in the framework of the negotiation of future FTAs, including a potential Australia-EU FTA.

International support for the EU approach remains, for the time being, embryonic. The same doubts that were levelled at the EU proposal to professionalise dispute settlement panels in the WTO dispute resolution mechanism are now expressed vis-à-vis the EU proposal for (an) investment court(s). EU trading partners have questioned the composition of these courts if each FTA includes an investment court system (ICS) as well as the cost of retaining permanent judges without knowing if they will be kept busy.

There are indications that, beside these composition and budgetary issues, the Australian Government is not averse to the EU proposal as a matter of principle. However, two points should be made regarding the Australian position on ISDS, which may influence its position during the negotiation of ISDS provisions as part of an Australia-EU FTA. These are:

- First, the 'relationship' between the Australian Government and ISDS has been a particularly complex one, aggravated by the Philip Morris case (Philip Morris Asia Limited (Hong Kong) v. The Commonwealth of Australia 2012). This complex interaction is reflected in the FTAs concluded by Australia over the past decade or so. The current position apparently remains: that the inclusion of ISDS in a treaty is to be considered on a case-by-case basis. One basis for excluding it—as in the FTAs with Japan and the US—is the existence of an independent and reliable judiciary. This approach seems confirmed *a contrario* by the recent ChAFTA, where Australia accepted ISDS, but in a very circumscribed form, to the point that one wonders if ISDS can be used at all, even though the bilateral investment treaty between China and Australia continues to apply.³
- Second, where Australia agreed to an ISDS, it has been an arbitration-type ISDS, but with an appeals clause, which was also accepted in the ISDS chapter of the CPTPP.

The Australian position leaves the door open to several ISDS options in the Australia-EU FTA negotiations:

- an EU court-style ISDS

³ E.g. Japan, Malaysia, New Zealand (NZ), United States (US). In ChAFTA, ISDS claims can only be made on the basis of a breach of either party's obligation to provide non-discriminatory 'national treatment to established investments of the other party.

- an arbitration system, most probably with an appeal mechanism (as in ChAFTA)
- no ISDS at all.

In the latter case, investors would challenge breaches of the investment chapter of the treaty before domestic courts.

The Australian Government has also demonstrated some concern regarding the risk that private companies will draw any violation of the treaty under ISDS, and not only expropriation *stricto sensu*. This worry seems to be one that is shared by EU public opinion.

This said, in proportion to its gross domestic product, Australia invests more in the EU than the EU invests in Australia.⁴ Applying its ‘case-by-case doctrine’, Australia may conclude that what is not necessary with Japan or the US would be useful with the EU.

This is the context in which the issues identified below will be addressed. Will the EU still aim for an ISDS if Australia refuses the court system it advocates? Will it be a make or break issue? Will the EU accept no ISDS at all as a means to avoid the arbitration-based ISDS to which it is officially opposed?

This contribution is by no means intended to be exhaustive. Rather, it is intended to open a discussion by focusing on some issues which the authors—in a subjective and arbitrary manner—deemed particularly relevant in the context of a future Australia-EU FTA.

A FACTUAL ACCOUNT: EU AND AUSTRALIA ISDS PRACTICES

A ‘not-so-clear-cut’ situation

It is now fashionable in some political circles to argue that an ISDS is a ‘Trojan horse’, allowing foreign private investors to control or at least significantly influence states’ policy choices. Yet the studies suggest a more nuanced situation.

For instance, private investors are not as successful in ISDSs as some have argued. In a 2016 study, Rachel Wellhausen (Wellhausen 2016) indicated that:

States are winning arbitrations more than one-third of the time, and arbitrations are settled before a judgment about one-third of the time. Fourth, based on publicly available data, there remains great diversity in the size of claims that investors make. Based on conservative codings, investors are winning only 30-40% of their initial demands. (p. 120)

⁴ In 2014, Australian foreign direct investment (FDI) in the EU was valued at \$83.5 billion (almost half of the value of EU FDI in Australia!). EU Member States’ investment in Australia represented in 2015 31.1 per cent of total FDI in the country.

This analysis is confirmed by other sources (UNCTAD 2016):

By the end of 2015, a total of 444 ISDS proceedings have been concluded, with 36 per cent of cases decided in favour of the State, 26 per cent in favour of the investor and 26 per cent of cases settled. (p. 1)

However, it remains difficult to obtain a clear overall idea of who gains the most from ISDS (Schneiderman, Tienhaara & van Harten 2015):

[Empirical studies on ISDS outcomes] are based on a massaged presentation of the numbers on 'wins' and 'losses' in ISDS because it (1) conflates the results at the jurisdictional and substantive stage of ISDS cases as outlined here; (2) puts aside the large number of settlements in which foreign investors are also fairly described as 'winners' and states as 'losers' based on the expectation that ISDS helped the investors to get a public pay-out or a regulatory change that was not otherwise available; and (3) downplays the inability of states to be 'winners' in ISDS, in the manner of a foreign investor, because the treaties do not allow states to sue and recover a damages award from a foreign investor. Put differently, ISDS is like a football game in which foreign investors take a series of penalty kicks and states have to stop them all in order to avoid losing. (p. 5)

In other words, whether a future Australia-EU FTA could or should include ISDS provisions and the form this should take, is more likely to be based on philosophical and political considerations than IIA statistics.

AUSTRALIA

An existing network of BITs

It is instructive to analyse Australia's approach towards the negotiation of the investment chapter of a comprehensive Australia-EU FTA, in the context of the 23 BITs it has already concluded.

One important element is that Australia already has BITs with five EU Member States.⁵ Each of these treaties includes ISDS provisions, which is not the case for a number of newer BITs concluded by Australia with non-EU countries. However, the treaties concluded by Australia which do not include ISDS are generally more recent than the BITs concluded with the five EU Member States.

Australia's (very positive) record with ISDS

One factor which may make the Australian Government reluctant to set up any elaborate ISDS provisions (or for that matter, any ISDS provisions at all) is the fact that Australia has hardly ever been sued in the context of an investment treaty and

5 Poland (1991); Hungary (1991); Romania (1993); the Czech Republic (1993); Lithuania (1998).

that, when it has been, it has prevailed. In other words, Australia may see ISDS as unnecessary and the EU investment court as a luxury.

Australia was sued once by a foreign investor—Philip Morris. In comparison, Australian investors have successfully sued host states on five occasions.⁶ This positive record should normally enhance the Australian negotiators' confidence in ISDS.

To date, Australia has accepted ISDS provisions in five FTAs—Chile, Singapore, Thailand, Korea and NZ-ASEAN. Australia also has ISDS provisions in 21 BITS, including with 5 EU Member States. In light of what precedes, it is difficult to conceive that ISDS would not be included in an Australia-EU FTA. Of course, there has been a turbulent period between 2010 and 2014 but it is in no way a proper representation of Australia's investment treaty practice—including with regard to ISDS—over the last three decades.

The EU

EU investors are, not surprisingly, larger users of ISDS than Australian investors in absolute terms. Recorded cases brought by investors from the EU total 327. However, these data must also be nuanced because they include intra-EU cases and, in some instances, ISDS provisions in a BIT concluded by one EU Member State which may be used by foreign-owned companies. This is the case of the Netherlands' BITs used as a vehicle for ISDS by US companies.

It should not come as a surprise either that EU Member States are also prime ISDS targets. Between 1994 and 2017, the cumulative number of known ISDS cases involving an EU Member State as the defendant increased from one to 81. That is, there have been about three to six new cases per year since 2003, with peaks of nine cases per year in 2005, 2006 and 2016 (OUP 2016; UNCTAD 2016).

⁶ These cases are:

Churchill Mining PLC and Planet Mining Pty Ltd v Indonesia, Procedural Order No 14, ICSID Case No ARB/12/14, 12/40, IIC 663 (2014), 22nd Dec 2014, International Centre for Settlement of Investment Disputes 9ICSID0.

Planet Mining Pty Ltd v Indonesia, Decision on jurisdiction, ICSID Case No ARB/ 12/40, IIC 635 (2014), 24th February 2014, World Bank; ICSID0.

Tethyan Copper Company Pty Limited v Pakistan, Decision on Claimant's request for provisional measures, ICSID Case No ARB/12/1, IIC 571 (2012), despatched 13t Dec 2012, ICSID0.

Tullow Uganda Operations Proprietary Company Limited and Tullow Uganda Limited v Uganda, Order taking note of the discontinuance of proceedings, ICSID Case No ARB/13/25, IIC 702 (2015), despatched 15 July 2015, World Bank, ICSID).

White Industries Australia Ltd v India, Final award, IIC 529 (2011), 30 Nov 2011, Arbitration.

This, of course, begs the question whether the existence of ISDS clauses in BITs concluded by individual EU Member States is the reason for so many cases being initiated against EU Member States, or whether these disputes would have occurred anyway, but in a different form.

IS THERE AN ECONOMIC OR LEGAL NEED FOR ISDS BETWEEN AUSTRALIA AND THE EU?

A change in investment patterns

It is generally admitted that investment patterns have changed since investments treaties were first concluded—with more small and medium-sized enterprise (SMEs) involved, more investment in services, lower sunken costs, and so on. In this evolving context, is ISDS, including in the form proposed by the EU, capable of providing effective dispute resolution for the new generation of investors who may be looking more for the vindication of their rights under a treaty as a means to continue doing business in the host state than as a way to recover all or part of their investment and leave the country? If not, how can ISDSs be adapted to these new investment forms, or is ISDS only necessary when domestic judicial systems cannot effectively afford protection to foreign investors rights?

This new pattern is undeniably at work in the way EU economic operators invest in Australia. For instance, high tariffs on certain processed agricultural goods, strict sanitary and phyto-sanitary (SPS) measures, and issues around the protection of certain intellectual property rights with respect to processed agricultural products could justify direct investments by EU SMEs in the Australian economy.

Is ISDS adapted to these new investment patterns?

One of the main issue which needs to be examined in order to answer this question is whether ISDS can play an effective role in the new investment paradigm where smaller companies will invest smaller amounts and generally need legal protection to keep doing business, not compensation for the loss of current value of large investments made several years before in the host country.

Inefficiency in domestic legal systems cannot be an argument in the case of Australia and the EU. In both jurisdictions, foreign companies once established enjoy national treatment. Australia did not see the need to include ISDS in its FTAs with Japan and the US primarily for this reason.

The ICS proposed by the EU: some salient features

In September 2015, the European Commissioner for Trade, Cecilia Malmström, proposed a ‘major change in trade and investment policy’ (Malmström 2015). She

claimed that many entities, including non-governmental organisations (NGOs), had raised concerns about the traditional system of ISDS. She hoped to increase public trust in ISDS objectivity and fairness, which she claimed was lacking in the current system, by establishing an ICS.

To this end, she suggested that the ICS be modelled on domestic courts, and that ICS judges should possess qualifications comparable to those found in national domestic courts or highly esteemed international courts. Further, she considered it was essential that judges be publicly appointed and that an appeal system be available. Such an appeal system could draw from the one currently found in the WTO dispute settlement mechanism (European Commission 2015b). She insisted that ISDS was often regarded as private justice, whereas the proposed new court would be a system of public justice to which people could relate.

Further, it is a stated objective that over time, the Commission will work with other countries to create a permanent international investment court (IIC), to replace all investment dispute resolution mechanisms ‘provided in EU agreements, EU Member States agreements with third countries and in trade and investment treaties concluded between third countries’ (European Commission 2015a). This is designed to ensure that ISDS will become increasingly consistent, efficient and legitimate (European Commission 2015a).

A concept paper also issued by the EU on the subject describes the appellate mechanism as a standard feature in all future EU trade and investment agreements (European Commission 2015a). Furthermore, it explicitly states that the EU wishes to pursue the creation of a permanent court ‘applying to multiple agreements and between different partners’ (European Commission 2015a, p. 1).

Third countries have expressed an interest in a new legal order for ISDSs and the creation of a permanent court system. NZ’s former Trade Minister Alex Young stated that he was open minded to replacing the traditional ISDS model, pointing out that this model may now be outdated (Young 2015). The EU Commissioner for Trade, Cecilia Malström, has stated that the EU is committed to leading the way globally, that it upholds a high standard in promoting and protecting investment in its territory, and that it wishes to obtain similarly credible and enforceable guarantees for EU investments and investors abroad. (Malmstrom 2015, p. 4).

From arbitration to the investment court system

On 12 November 2015, the EU published a Proposal for Investment Protection and Resolution of Investment Disputes (the EU proposal)—Under Chapter II, Section 3 thereof—The Resolution of Investment Disputes and Investment Court System—the EU proposed that an ICS modelled on the WTO be created for investment disputes (European Commission 2017).

The EU proposal builds on existing ISDS norms and practices. For instance, most ISDS tribunals have agreed that expropriation can be direct or indirect (for example in the TTIP 2015), and this has been reiterated in the proposed EU text. Further, multiple references are made to United Nations Commission on International Trade Law Transparency Rules (UNCITRAL 2014),⁷ as well as the International Centre for Settlement of Investment Disputes (ICSID) between States and Nationals of Other States (ICSID 2006).⁸ Amicable resolutions should at all times be favoured and settlement can be agreed upon at any time, including after court proceedings have commenced (ICSID 2006). Mediation between the two parties involved in the dispute is also explicitly encouraged under Article 3, which is a provision not commonly found in other BITs, but is available under the WTO Dispute Settlement Understanding (WTO 1995). However, where a dispute cannot be resolved amicably, the claimant alleging the breach may submit a request for consultations to the other party, with such consultations to be held within 60 days of the request's submission, unless otherwise agreed (WTO 1995, Article 4/2).⁹ If, after a period of 90 days of the request being submitted for consultation the dispute has not been settled, if the dispute is the result of an alleged breach by the EU or one of its Member States, a notice must be delivered to the EU requesting a determination of the respondent (WTO 1995, Article 5/1). The notice shall, among other things, identify the treatment in respect of which the claimant intends to initiate proceedings (WTO 1995, Article 5/2). In this situation, the respondent could be either the EU collectively or an individual Member State of the EU (WTO 1995, Article 5/3).

If consultations do not take place or if they fail, the claimant may submit a claim for adjudication (WTO 1995, Article 6/1). Significantly, the claim may be submitted under multiple ISDS forms, including:

- (a) the ICSID Convention of 18 March 1965
- (b) the ICSID Convention in accordance with the Rules on the Additional Facility for the Administration of Proceedings by the Secretariat of the ICSID
- (c) the arbitration rules of UNCITRAL or
- (d) other rules agreed by the disputing parties at the request of the claimant.

Claimants will therefore not have to suddenly familiarise themselves with an entirely new set of arbitration rules for dispute settlement (WTO 1995, Article 6/2).

⁷ For a commentary, see Kelly-Slatten (2016).

⁸ ICSID (2006) *ICSID Convention, Regulations and Rules*, ICSID, Washington DC retrieved from <https://icsid.worldbank.org/en/Documents/icsiddocs/ICSID%20Convention%20English.pdf>.

⁹ Article 4(2) is directly based on its WTO equivalent.

Class actions, where a number of unidentified claimants are involved, are not admissible (WTO 1995, Article 6/5), even though this could present some interest for SMEs by spreading the cost of litigation. However, consolidated hearings can take place where there is a question of fact or law common to several complaints (WTO, 1995, Article 27), provided the respondent agrees (WTO 1995 Article 7/1). Many of these provisions are inspired from the WTO dispute settlement mechanism.

The ICS would consist of two degrees of jurisdiction: the Tribunal of First Instance (TFI) and the Appeals Tribunal (AT). The TFI would replace the ad hoc arbitration tribunals currently relied upon in ISDS. Further, 15 judges would be appointed to the Tribunal on a permanent basis, with five being EU nationals, five being nationals of the other party to the regional agreement and a further five being nationals of third countries (WTO 1995, Article 9/2). A much higher qualifications threshold than the one currently imposed under most BITs and FTAs would apply to these judges, who would be required to possess the qualifications for appointment to judicial office in their respective countries, or at the very least be jurists of recognised competence. Furthermore, while it is not a requirement, it is desirable that they have particular expertise in areas such as international investment law, international trade law and the resolution of disputes arising under these areas (WTO 1995, Article 9/4). These judges would be appointed for six-year terms, renewable only once (WTO 1995, Article 9/5).

Three judges would hear each individual dispute, with one judge from the EU, one from the other party to the agreement and one from a third country (WTO 1995, Article 9/6). This remains largely similar to how current ad hoc international investment arbitrators are composed and is a departure from the WTO system where the nationality of those contributing to adjudication is either a cause for exclusion for panellists, or is totally disregarded, as in the case of the appellate body members. However, as in the WTO appellate body and many domestic judiciaries, judges will be randomly assigned to cases. Moreover, the president and vice-president of the TFI may only be selected from third country judges. This should further the impartiality of the system (WTO 1995, Article 9/7).¹⁰

The EU proposal could also have a positive effect on SMEs, whose interests are generally overlooked under international investment law, as they may not have

10 Dispute settlement practice under General Agreement on Tariffs and Trade (GATT) 1947 and the WTO has, however, demonstrated that the nationality of adjudicators actually has the opposite effect to what these provisions suggest. Panellists have generally proven to be particularly strict vis-à-vis the policies of their own countries and appellate body members have gone against the expectations of those who appointed them, by establishing the appellate body from its inception as a model of independence.

the money to finance expensive ad hoc investment tribunals and costly litigators. Under Article 9(9), the disputing parties may agree that the case be heard by a sole judge—who, in such a circumstance, will be a third country national—in order to reduce costs, but also when the damages sought are relatively low. This could favour greater access to justice for smaller investors.

The EU suggested that the retainer fee for TFI judges could be in the range of one-third of the retainer fee for the WTO appellate body members (WTO 1995, Article 9/12). The possibility of judges being employed on a full-time basis is also considered (WTO 1995, Article 9/15).

The ability to appeal decisions to an Appeals Tribunal (AT) was one of the key issues raised in the EU public consultations on the ICS (Hughes 2017). It also received broad support from both EU businesses and NGOs (European Commission 2015a). The current ISDS system has been systematically criticised as it does not include any corrective mechanism in the event that arbitrators ‘get their decisions wrong’. The impossibility to appeal awards also results in far less legal certainty, making the system as a whole less predictable for both host state governments and investors (European Commission 2015a).

The AT (WTO 1995, Article 10/1) would consist of six members, with two members each from the EU, the other party and third countries (WTO 1995 Article 10/2). The EU and the other party would propose three candidates each. Two of these would be their own nationals and the remaining candidate would be a third country national. The AT judges would not be allowed to hold office for more than 12 years (WTO 1995, Article 10/5). Legal expertise is seen as crucial. Members must have the same professional qualifications as TFI members but, in addition, they must have demonstrated expertise in public international law. This qualification is also required in the case of the WTO appellate body (WTO 1995, Article 10/7). Each appeals division would also be chaired by the AT member who is a national of a third country. By comparison, in the WTO appellate body, nationality is not an issue.

Ethics

Ethics has also been highlighted as a significant concern for the EU, with Article 11 of the EU proposal focusing on the need for TFI and AT judges to be independent. This means that government affiliation is not permitted and they are precluded from participating in the consideration of any disputes that would create conflicts of interest (WTO 1995, Article 11/1). Disputing parties are permitted to challenge the appointment of judges in the same way it can be done in the WTO (WTO 1995, Article 11/2 & 11/5). Likewise, as in the WTO, judges are under

disclosure obligations prior to their appointments, where they must disclose any potential conflict of interest (WTO 1995, Annex II Article 3).

Domestic law as a fact

The domestic law of the parties shall not be part of the applicable law, only the treaty; although the TFI and the AT should rely on customary norms of interpretation of public international law, as codified under the Vienna Convention on the Law of Treaties (1969) in applying and interpreting it. Parallel claims under the Tribunal and domestic courts or other international courts are not permitted (WTO, 1995, Article 14/1). This is intended to prevent double compensation or conflicting decisions and to avoid ‘forum shopping’.

Deterring frivolous complaints

Moreover, jurisdiction would be declined where the dispute was foreseeable with a high degree of probability at the time the claimant acquired ownership of the investment, and where the main purpose of acquiring control of the investment was to initiate a dispute. This includes situations of investment or a business’s reorganisation of an investment for the purpose of bringing a case, a situation found by the arbitrator to have happened in *Philip Morris Asia Limited (Hong Kong, SAR) vs The Commonwealth of Australia* (Permanent Court of Arbitration 2015).¹¹ ‘Mailbox’ companies will not be able to bring cases to arbitration, as only real business operations in the territory of one of the Parties will be covered under the investment protection provisions (European Commission 2015a).

Under Article 23(1), intervention by third parties will be permitted where a natural or legal person can establish a direct and present interest in the result of the dispute. This leaves open the possibility for this interest to be economic or legal.

Remedies

The TFI and AT will have the authority to order indemnification and other compensation (WTO 1995, Article 25). The ability of the claimant to offset its losses through insurance or indemnification is not an adequate reason to object

11 Award on admissibility of 17 Dec 2015, in which the arbitrator concluded as follows regarding the third objection to the admissibility of the case made by Australia: ‘the initiation of this arbitration constitutes an abuse of rights, as the corporate restructuring by which the Claimant acquired the Australian subsidiaries occurred at a time when there was a reasonable prospect that the dispute would materialise and as it was carried out for the principal, if not sole, purpose of gaining Treaty protection. Accordingly, the claims raised in this arbitration are inadmissible and the Tribunal is precluded from exercising jurisdiction over this dispute.’

to compensations. Further, damages awards cannot be punitive (WTO 1995, Article 28/3).

Interim measures in the form of ‘provisional awards’ may be granted, subject to appeal, with payment following the principle that such compensation should represent the fair market value of the property at the time immediately before expropriation (WTO 1995, Article 28/1b). Provisional awards become final awards after 90 days if no appeal has been launched. The WTO dispute settlement system not only does not foresee any possibility to award interim measures, but it also provides for an implementing period, during which legislative or regulatory steps are being adopted to repeal the illegal measures. This creates a frequently criticised ‘grace period’, during which the responding member may continue, with no legal consequences, to nullify or impair the trade interests of the complaining member.

Unlike in the WTO, where this is the primary purpose of dispute settlement, it would not fall under the remit of the FTA or the AT to order ‘the repeal, cessation or modification of the treatment concerned’ (WTO 1995 Article 28).

An award of the TFI may be appealed if the Tribunal erred in the interpretation or application of the applicable law, or manifestly erred in the appreciation of the facts. These grounds for appeal essentially mimic those applicable under the WTO dispute settlement mechanism, the failure to make an objective assessment of facts being a frequent ground for appeal before the WTO appellate body. An appeal may also be based on Article 52 of the ICSID Convention (WTO 1995 Article 29/1).

Appeal proceedings shall not exceed 270 days (WTO 1995, Article 29/3). WTO practice has demonstrated the importance of rapid dispute resolution for the credibility of a dispute settlement system; this was not lost to the drafters of the EU proposal.¹² Final awards are binding between the disputing parties and may not be subject to further appeal, annulment or any other remedy.¹³ Once a judgement is final, each party must recognise the award rendered as binding and enforce the pecuniary obligations in its own territory in the same manner it would enforce the final judgement of a domestic court.

Preserving host States’ regulatory freedom

In the fact sheet ‘Why the new EU proposal for an Investment Court System in the TTIP is beneficial to both States and Investors’ (European Commission 2015c), the Commission attempts to put to rest some concerns regarding the creation

¹² See also Section 3.6.

¹³ Article 30.

of an ICS and how this court could impinge upon the regulatory freedom of participating states (European Commission 2015d).

This is to be ensured primarily through the appointment of independent judges who shall also subscribe to the highest ethical standards, and the possibility to have legal errors, or manifest errors of fact, corrected through an appeals process. The impartiality of judges applying clear legal rules is said to afford both investors and host states greater legal certainty than what is currently possible under ISDSs. In other words, the new ICS is expected to be a neutral venue for the settlement of international investment disputes. The calibre of members of the TFI and AT will be on par with the members of other permanent courts, such as the International Court of Justice (ICJ) and the WTO (European Commission 2015c).

Strict procedural deadlines would ensure that disputes are settled in a timely manner and at minimal cost. Actually, the main costs incurred by the disputing parties would be through legal counsel fees. The current aim is for the duration of proceedings under the ICS, including appeals, to be limited to a period of two years, as the TFI would have reached its decision within 18 months and the AT within 6 months (European Commission, 2015b, p. 1). In comparison, proceedings under current investment treaties tend to last between three and four years, with the further risk that the award may be set aside by a domestic court, increasing the total length of proceedings to six or more years (European Commission 2015b, p. 1). This can result in such delayed justice that some companies under the current ISDSelect to cut their losses by not challenging illegal or unfair measures.

In addition, the EU has proposed that the grounds for appeal be clearly defined, to ensure that the appellate system is not abused by the losing party. Apart from the advantages afforded to SMEs already mentioned above, including the ability to request that a dispute be heard by a sole judge, an adjustment to the loser pays principle has also been proposed to limit the costs that SMEs would be required to cover (European Commission 2015b, p. 1).

Towards an international investment court?

The ICS has already been incorporated in the CETA with Canada and the EU-Singapore FTA. These agreements include standards of investment protection covering five main guarantees; no expropriation without compensation; the possibility to transfer or repatriate funds relating to an investment; the general guarantee of fair and equitable treatment and physical security; a commitment that the governments respect their own written contractual obligations towards investors and to compensate for losses in certain circumstances linked to war or armed conflict (European Commission 2015c, p. 2).

A basic requirement to be met in order to raise a dispute under the ICS is that at least one of these five guarantees have been breached. Definitions of these guarantees and key concepts are provided, and in order to discourage any potential judicial activism, the definition of 'fair and equitable treatment', at the origin of many perceived abuses, includes a closed list. The FTAs between the EU and Canada and the EU and Singapore, while not including the creation of a permanent court, have already introduced some major changes to dispute settlement procedures. These include the need for full transparency, a ban on forum shopping, government control of interpretation (with the respective governments being able to issue binding interpretations on how provisions are to be interpreted under CETA) (European Commission 2015a),¹⁴ strict codes of conduct for arbitrators, early dismissal of unfounded claims and the introduction of the 'loser pays' principle (European Commission 2015d).

In the reading guide issued by the Commission in 2015, it is stated that ICS in the TTIP project, CETA and the EU-Singapore FTA 'represent a new era on the settlement of investment disputes' and that this new system will be negotiated in subsequent EU trade and investment agreements (European Commission 2015d p. 2).

For the purpose of arbitrating disputes between the EU and Australia, it seems that establishing a permanent court could be of great benefit to both, provided that governments remain free to adopt public policies in issues such as health, labour standards and the environment. However, it remains to be seen how often it would be used. Moreover, an entirely new composition of judges under the ICS would then have to be devised if the court is to become multilateral and consensus on this could be difficult to obtain. After all, one reason for the persistence of a very large number of BITs and FTAs in the first place is because a multilateral investment treaty could not be agreed upon at the OECD.

The EU concept paper acknowledges that an IIC would be most effective in applying 'multilateral agreements with multiple partners', but it also admits that this 'will require a level of international consensus to be built' (European Commission 2015a). Further, it is stated that the current changes are 'intended to be the stepping stones towards a permanent multilateral system for investment disputes' (European Commission 2015a). The danger is that a multiplicity of investment courts will be established, which may not make international investment much clearer than what it currently is under the ad hoc arbitral tribunals system (Chaisse & Vaccaro-Incisa 2018, p. 3). This issue was even raised under the public

14 This mechanism is similar to the power of the *erga omnes* interpretation given to the Ministerial Conference and the General Council under Article XI:2 of the Agreement Establishing the WTO.

consultation process with the suggestion that for this very reason, a multilateral instead of bilateral approach should be adopted (European Commission 2015a).

OTHER ISSUES TO CONSIDER IN THE DESIGN OF ISDS FOR AN AUSTRALIA-EU FTA

A broad or a narrow ISDS jurisdiction in the FTA?

The Australian approach under its most recent FTA with ISDS provisions—for instance ChAFTA, Chapter 8—has been to narrow the scope of the ISDS ‘jurisdiction’. This may be a mere reaction to the Philip Morris case—which Australia eventually won on admissibility—to avoid frivolous claims or ‘judicial harassment’. It is not clear if this is a way to fix its internal debate about ISDS. One may also wonder if the EU will share the Australian approach based on arbitration flaws when it wants to set up a different adjudication mechanism.

ISDS or jurisdiction of domestic courts over foreign direct investment (FDI)?

An advantage of ISDS arbitration for investors is that it allows them to control the presentation of the claims made before the arbitral tribunal. Investors do not need to persuade their home countries to submit their claims.

From the perspective of the country of which the investor is a national and the host country, another advantage could be that ISDS moves investment-related disputes outside the political arena. The conflict thus becomes an issue to be solved between the investor and the host country in the framework of an international legal forum, rather than being the subject of controversy between two countries.

However, is it necessary to put in place an international mechanism when domestic courts, both in Australia and the EU, already deal with domestic investment disputes almost on a daily basis. Is there something so fundamentally special about FDI in the EU and Australia to justify the inclusion of ISDS in an Australia-EU FTA? Indeed, the EU and Australia share the same legal culture and both have efficient and independent judiciaries. In such a context, does it make any sense at all to have an ISDS?

Canada has an efficient and independent judicial system. Despite this, CETA provided for ISDS in the form of investor-state arbitration and so did the proposed TTIP. The fact is that the EU promotes a new form of ISDS, intended to address interests as diverse as those of investors, civil society and policymakers. Politically, if not from a practical or financial perspective, this may appeal to Australia and its doctrine of ‘case-by-case’ insertion of ISDS in FTAs. Australia opted out of ISDS in its FTAs with the US and Japan, claiming that domestic courts were an efficient

avenue for investors to seek redress—still, it did not do the same with the Republic of Korea (Korea) and Singapore. This suggests that the existence of an effective domestic judicial system in the other FTA partners will not systematically lead Australia to renounce ISDS.

However, in such a case, a clear allocation of claims between domestic courts and ISDS would most probably contribute to a more efficient dispute resolution, *inter alia* by excluding forum shopping.

ISDS giving more rights to foreign investors than to domestic companies and citizens

The negotiators will also have to take a position on the recurrent claim that ISDS gives more rights to foreign investors than to domestic investors or citizens. In an Australia-EU FTA incorporating ISDS and prior exhaustion of domestic remedies, an EU investor could use the Australian judicial system (like Australian investors) but only EU foreign investors could have access to ISDS. Whether this is objectively an advantage may be discussed, but it is a second avenue which domestic investors will not have access to, and it can be perceived as discriminatory.

Taking this hypothesis as our starting point, the main question may be whether ISDS in an Australia-EU FTA should require prior exhaustion of domestic remedies.

Under the principle of exhaustion of domestic remedies—as applied for instance in the WTO agreements on anti-dumping or subsidies an exporter confronted with an illegal measure on the part of the government of the importing country, will first seek to have this measure cancelled before domestic courts before pursuing action from its own government under the WTO dispute settlement mechanism. Foreign direct investors may do the same. This is consistent with the economic assumption that the investor wishes to continue doing business in the country where it has invested. However, on some occasions the only remedy is financial compensation. A domestic judge may be entitled to review an administrative decision, but awarding damages under an investment treaty is a totally different game.

Even in developed countries, domestic justice may be slow and lack expertise in interpreting international agreements. By the time a final judgement is issued, it may be far from satisfactory for the investor. For instance, in some countries, a judge may be reluctant to award large monetary compensations out of consideration for taxpayers and to avoid a multiplication of appeals by foreign investors and an inflation of monetary damages.

It seems that, in the economic context outlined at the beginning of this chapter, prior exhaustion of domestic remedies should be required by the investment chapter of an Australia-EU FTA.

First, the prior exhaustion of domestic remedies requirement offers the possibility of having the government measure at issue being cancelled, which is more in line with the assumption that the investment is intended as a long-term project.

Second, the prior exhaustion of domestic remedies seeks to ensure the avoidance of discrimination between domestic investors owned by nationals of the host country and foreign or domestic investors owned by foreign nationals.

Third, the question of the efficiency of domestic courts can to some extent be disregarded. This is because courts can order provisional measures to preserve the value or productive capacity of the investment, pending a judgement. They may even suspend the execution of an administrative decision, something an ISDS arbitrator could not achieve without some form of consent from the host state. If necessary, an Australia-EU FTA could allow an investor to make the claim that domestic courts are, in spite of their efforts, ineffective. It could also include a test to be applied by the ISDS tribunal or arbitrator to determine whether courts proceedings have been delayed, through no fault of the party, in order to determine if there is a denial of due process—a concept generally loosely defined in investment treaties—justifying a direct recourse to ISDS.

Some treaties which mandate the use of domestic remedies in the host country allow the investor to submit a dispute to an ISDS after having attempted to have the matter addressed by domestic courts over a certain period, even if they have not concluded their efforts. This period can vary from three months to two years. In some cases, treaties state that arbitration is available only if the result obtained by having recourse to domestic courts is unfair. Proceedings before the domestic court will usually be suspended while the dispute is submitted to international arbitration. Another approach is to state explicitly that the requirement of exhaustion of internal remedies may be waived by consent of the host country, the latter being favourable to immediate arbitration. Alternatively, some treaties simply mention that by initiating proceedings before the local courts, an investor will forego their right to arbitration. The exhaustion of domestic remedies is not required, but this type of provision can effectively deter the investor from pursuing local solutions.

Another group of treaties fit between these two approaches, seeking neither to require nor deter the exhaustion of local remedies. These treaties simply indicate that the referral of the conflict to local remedies would be one choice available to

the investor. Sometimes these treaties do not prevent an investor who has appealed to local remedies from later having recourse to international arbitration if it considers the result obtained locally unsatisfactory.

The case for an appellate procedure in ISDS

Interest in an appellate mechanism arose out of the lack of consistency in awards produced by an increasing number of arbitral tribunals, and from the need to avoid 'wrong' decisions by some 'rogue tribunal' (Gantz 2006). Both views point, however, at the same issue: a need for harmonisation in 'jurisprudence'. Proponents of the appellate stage argue that an appeals mechanism would avoid contradictory awards and might result in a more coherent investment legal system.

A lack of coherence is something the GATT experienced after the Tokyo Round, where all the agreements had their individual dispute settlement system. The response was to provide for a single, integrated dispute settlement mechanism in the results of the Uruguay Round. This was relatively simple since the WTO incorporated all the agreements resulting from the Uruguay Round. However, it is currently difficult in the field of investment, with more than 3,000 IIAs in force. The ever-increasing number of actors in the investment field may make it particularly difficult (although increasingly necessary) to establish a single, unified appellate body.

Negotiators in the Uruguay Round had originally introduced an interim review phase, following a principle resembling judgement revision as it exists in some jurisdictions. Under the interim review phase, the same dispute settlement panel would be requested to reassess its findings on the basis of comments by parties to the dispute. Short of a court of appeal, this was an effective solution to address the potential factual and legal errors that a panel could make during the drafting of its report. This was rendered necessary by the 'negative consensus' approach taken in the dispute settlement understanding (DSU), whereby a panel report would be adopted unless consensus prevailed against such adoption.

The idea of an appellate body came very late in the negotiations. Officially, this was to control the risk of inconsistency between panel reports regarding the interpretation of WTO provisions and to correct a panel's assumed tendency to be influenced by political considerations. As a result, the appellate body could only address issues of law.

The selection of the first appellate body members, however, suggests a different story. When both the European Commission and the US claimed the right to have two appellate body members each out of seven, suspicions arose

that these two important WTO members were aiming to control Appellate Body through their nationals.

Events turned out to be totally different. The first appellate body members were both superior skilled lawyers and used to political environments. They also had a common vision of their role as the supreme court of the world trading system—a vision that WTO members probably did not expect them to have—and they developed their role based on that assumption. After a series of patronising and hurtful comments in appellate body reports, the panels turned increasingly legalistic. Assuming the role of a supreme court, the appellate body engaged in legal policy, all the more so as negotiations were stalling and members were consequently losing their power to ‘legislate’ (Rajesh Babu 2016). Whereas GATT panels had tried to make their rulings compelling on parties by building all sorts of presumptions and ‘litmus tests’, as the appellate body described them, the appellate body established a ‘jurisprudence’ approach, as supreme courts have, which would allow it to evolve as the situation required. ‘On a case-by-case basis’ seemed to become its motto.

It seems clear that the introduction of appeals procedures in the ISDS chapters of recent IIAs (CPTPP, ChAFTA, etc.) has drawn on the WTO experience, and that the same expectations that presided over the establishment of the WTO appellate body are at work in ISDS. But can an appeals system operate in an essentially arbitral system where members of the appeals tribunal would change in each case? Why would appeals arbitrators feel compelled to follow the precedents of other arbitrators? What builds a jurisprudence is continuity and this can be primarily achieved by giving appellate tribunals members a tenure; in other words, turn them into judges. By introducing appeals, states have—willingly or not—paved the way for a judicial ISDS.

Some authors argue that a discussion on the establishment of an appellate body does not even need to be considered. Some, like Barry Appleton, consider that it is, on the contrary, time to focus on the ‘pernicious underlying symptoms’ (Appleton 2013). It is, however, because of the existence of current loopholes in the arbitration system that the idea of establishing an appellate body developed over recent years and that the right of appeal was embodied, with some restrictions, in recent ISDS clauses in bilateral and regional agreements.¹⁵

That an appellate review can achieve greater consistency in the investment adjudication system is evidenced by the role played by the appellate body at the WTO. Over 20 years, the WTO appellate body has developed its role of ‘supreme

15 In 2004, the ICSID had pointed out that it could absorb an appellate facility into its framework, but this idea did not receive a positive response from its members.

trade court' and built an extensive jurisprudence, assisted in this regard by the paralysis of the multilateral trade negotiations and the mechanism of interpretation of *erga omnes*, built in the Marrakesh Agreement, to allow WTO members to control the dispute settlement system (Ehlermann 2016).

In practice, most international investment arbitral awards have for now been final. The only form of arbitral awards review available for a long time has been the annulment procedure. In most instances where the parties to an arbitration are not satisfied with an award, annulment is an inconvenient option. Annulment means basically 'a return to square one'. This may account for why, so far, the review of international investment arbitrators' awards through annulment procedures has remained quite limited.

Currently, the ICSID arbitration awards have the nature of exclusiveness and finality. In other words, the arbitral decision and award of ICSID cannot be challenged before any other entity outside of the ICSID framework, including the national courts in host states. The only way to review an ICSID's arbitral decision is the annulment mechanism. The parties can submit an application for an *ad hoc* annulment committee. Based on the abuse of this process, the ICSID established five limited grounds for setting up an *ad hoc* annulment committee:

1. improper constitution of the arbitral tribunal
2. manifest abuse of power by the tribunal
3. corruption on the part of a member of the tribunal
4. serious departure from a fundamental procedural rule
5. failure to state the reasons in the award.

Moreover, there are only two possible outcomes before an annulment committee. Either the challenged award stands or it is annulled in whole or in part. The annulment procedure cannot deal with the substantive issues of the challenged arbitral decision.

In addition to the ICSID, many other international arbitration institutions often treat arbitral decisions and awards as final. However, unlike the exclusiveness of the ICSID process, the arbitration decision or award issued by other investment arbitration institutions and their enforcement would be challenged before other jurisdictions, under domestic law or various international agreements. Moreover, different countries have distinctive national laws for the enforcement and review of arbitration decisions or awards. Generally, the awards can be challenged on some limited grounds in most national laws; otherwise, the review of arbitration decisions will be subject to the UNCITRAL rules. The following limited grounds are provided by the 1958 New York Convention on the Recognition and

Enforcement of Foreign Arbitral Awards (New York Convention) for the review procedure of arbitration awards. There must exist:

1. an incapacity of the parties to enter into the arbitration agreement or invalidity of the arbitration agreement
2. a lack of proper notice to a party or incapacity to present its case
3. inclusion in the award of matters outside the arbitrator's mandate
4. irregularities in the composition of the tribunal or in the arbitral procedure
5. non-arbitrability of the subject matter, or
6. a violation of domestic public policy.

Comparatively, an appeals mechanism offers more flexibility. Parties can select the findings and rulings which they want to contest, and the rest of the award remains untouched and binding. An appeals tribunal can affirm, reverse in total or in part the original award, or affirm a conclusion or ruling while substituting its own reasoning for that of the first-degree arbitrator. Moreover, the appeal can be subject to specific treaty-based deadline as with appeals before the WTO appellate body. This is something quite impossible to impose on a municipal court. Finally, it remains in the international sphere, whereas annulment is—with the exceptions of ICSID awards—pronounced by domestic courts.

The *quid pro quo* for the efficiency of an appeals mechanism in ISDS and its acceptability by states is that arbitrators will have to limit their findings to issues of international law, and not enter into interpretations of domestic law. This has often been a temptation to arbitrators in the past and, as illustrated by the EU ICS proposal, a source of criticism.

There has been, to the authors' knowledge, no use made yet of the appeals provisions recently introduced in the ISDS chapters of FTAs recently concluded by Australia, such as ChAFTA. Traditionally, the principle of finality of arbitral awards has been one of the most attractive features of international investment arbitration, because it saved time and money. Moreover, what often mattered was to have an award that would create an incentive for parties to negotiate a settlement. Whether it was consistent with other awards in similar circumstances or whether it was legally sound was not always a core concern of the parties. The same applied to trade disputes in the pre-WTO days.¹⁶

16 The authors recall a former US GATT delegate once telling them in substance that the greatest thing about winning a panel procedure was that one could start negotiating an amicable solution. It should be recalled that, at the time, panel reports had to be accepted by the parties in dispute and there was no effective mechanism available to enforce adopted reports.

Judges versus arbitrators

The EU wants professional judges to replace private individuals who currently act as arbitrators in ISDS. The pros of this proposal are well known. Private arbitrators are accused of lacking objectivity because their detractors believe that their decisions are influenced by a position they may have defended as counsels to a party in a similar case, or by the prospect of a future case, or of not antagonising potential 'clients'; as a result, they 'stay in business'. They are, for similar reasons, accused of lacking independence due to their links with the companies they defend in other circumstances. Some will argue that arbitration is a 'cosy business' monopolised by an oligarchy of largely Anglo-Saxon academics and law firms which partners serve alternatively as arbitrators or representatives of parties. Others finally accuse arbitrators of charging indecent fees in comparison with their responsibilities.

These arguments largely reflect political opinions and perhaps also prejudice, but one argument seems worth exploring further from a legal point of view: that of the law applied by arbitrators. For the outside observer, the law of foreign investment is more related to the law of contracts of common law countries than to public international law. One reason for this may be that foreign investment is, as mentioned above, a domain where private entities deal with states on an equal footing. It is also one where investors and states are often led to conclude contracts. If one also keeps in mind that foreign investment, for a long time, was conducted primarily by Anglo-Saxon or common law countries,¹⁷ one can fully understand the common law influence in the law of foreign investment, particularly through its reliance on such catch-all general principles as 'fair and equitable treatment' (Kenneth & Vandevelde 2010).

But what about the cons? The first argument usually raised against the EU ICS proposal is the cost of placing professional judges on retainers. This is a particularly sensitive issue for Australia, which has had only one case brought against its government since it entered into IIAs. Paying retainers to several judges to ensure they will be immediately available if a case is filed may eventually prove as expensive as private arbitration, for which one pays only when needed. The same issue would apply to the TFI and the AT.

If insufficient retainers are paid, the EU and Australia will have to accept that the judges take up other responsibilities during their tenures, pending occurrence of a case. This would nullify the purpose of a taxpayer-funded judicial system,

17 For instance, foreign investments in the oil industry, particularly in the Middle-East after the discovery of oil in Iraq in 1908, were primarily carried out by British and American oil companies, such as the Anglo-Persian (1935) or Aramco.

the objective of which is precisely to isolate the ICS judges from investor or government influence.

A more serious, yet probably underestimated, obstacle is the number of qualified FDI specialists available to act as judges in the ICS as designed by the EU.

If one goes by the WTO experience, it should not be too problematic to find 'first instance' judges for an ICS in an Australia-EU FTA. The WTO to date still selects ad hoc panellists to serve on its dispute settlement panels, as used to be the case in the GATT 1947 days. Whereas serving on panels was originally reserved for government officials and Geneva-based trade diplomats, by the mid-1980s, practice and reforms had opened panellist functions to academics and private sector specialists. Some of the most ground-breaking panel reports of the GATT-WTO history are owing to panellists who originated from outside the inner circle of trade bureaucrats.

Since the inception of the appellate body, being a panellist is no longer as prestigious as it may have been before 1995. Having served on a panel remains, however, a valuable experience and good publicity. It is valuable experience because it allows academics and private sector professionals to break into a world usually reserved for government officials and Geneva-based diplomats. Therefore, world-renowned academics and successful private lawyers do not hesitate to dedicate up to six months over several years to a poorly paid and largely ungratifying task. There is also the constant risk, once it is over, of being the direct target of belittling comments from the appellate body and generally unfair or uninformed criticisms from the parties to the dispute, other WTO members or NGOs.

To a large extent, international trade and FDI law are both niche markets. As there is no real shortage of panellists to serve in the WTO dispute settlement system, it should not be difficult to find a sufficient roster of qualified judges for an EU-Australia ICS, especially as one-third of them should originate in countries other than the parties. This also means that one-third should be from Australia, and another third from the EU. Once again, if one goes by the WTO practice, and the large number of Australians who served and are serving on trade dispute panels, it should not be too difficult to find FDI specialists in Australia. Indeed, given the attractiveness of Australia for foreign investors, there should be a sufficient pool.

The fact is, however, whereas international trade law has been from its origin the turf of bureaucrats, FDI has been the hunting ground of private lawyers. FDI arbitration is a private business and attracts large arbitration fees. By comparison, the WTO judicial system is funded by the WTO budget (that is, taxpayers' money). The WTO cannot afford to pay private sector fees to its panellists. The situation is similar to that of commercial arbitration, where arbitrators can charge

significant amounts in fees, depending on the monetary value of the matter in dispute, whereas domestic courts are staffed by professional judges whose salaries are neither affected by the number of cases they decide nor by the amounts at issue.

If an ICS is established in a future Australia-EU FTA, the efficiency and credibility of the system will depend on the quality of those working in it. This is evidenced by the establishment of the WTO appellate body. WTO members appointed as first appellate body members were highly qualified and respected individuals who had served in the highest public positions. Will investment specialists in the EU and Australia be prepared to serve as judges, when defending parties is likely to remain a more lucrative business? Or will the EU and Australia have to resort, like the WTO, to recently retired lawmakers, senior government officials or renowned academics?

Another precedent suggests that replacing ad hoc or voluntary adjudicators with professional judges can, at least in the beginning, seriously work against the expectations of those who initiated the change. When the UN sought to professionalise its internal justice system dealing with internal labour disputes in the UN, it replaced the previous peer-based network of joint appeals boards by a number of 'dispute tribunals' (Gulati 2010). Although the number of new judges which had to be recruited was not much larger than an ICS would require, UN administrative law is as much a niche market as investment law. It proved quite difficult to fill all the positions with the right people, despite the remuneration and other benefits attached to them.

Enforcement of awards or judgements

The Australia-EU FTA will need to incorporate a genuine enforcement mechanism for ISDS decisions. Although this may seem simple at first sight, enforcement of international decisions offers a great diversity of models. Implementation of ISDS awards is governed by the New York Convention and is generally a relatively straightforward matter, since awards are enforced through domestic judgements.

By comparison, the enforcement of international judgements between states has always been a delicate matter. The ultimate means of enforcement available to a state in cases of responsibility for internationally wrongful acts is retaliation.¹⁸ This is undeniably unsatisfactory because of the difficulties arising from the recourse to retaliation, one of them being proportionality. The GATT 1947 had an enforcement system which was used only once—with the agreement of the

18 Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission's report covering the work of that session (A/56/10). The report, which also contains commentaries on the draft articles, appears in the Yearbook of the International Law Commission, 2001, vol. II, Part Two.

respondent, the US, since the GATT 1947 dispute settlement system was based on some sort of implicit agreement to comply. Panel reports could only be adopted with the agreement of the losing party. As a contracting party could easily dispense with its obligations by not joining a consensus on the adoption of the panel report, agreeing to the adoption of a panel report meant some implicit agreement to cooperate, often in the interest of the system, and sometimes because compliance with a panel ruling also dealt with a political issue domestically.¹⁹

Beside unilateralist trends in the 1970s and 1980s, a relatively low compliance record in very controversial domains—such as subsidies and anti-dumping or on politically loaded issues—is probably at the origin of the Uruguay Round negotiators' opting for exactly the opposite system in the adoption of panel and appellate body reports under the WTO. In contrast to the GATT rules, the WTO provides for the adoption of reports unless there is consensus against their adoption.

Another difference is that ISDS has traditionally been primarily about financial compensation, whereas WTO dispute settlement is first and foremost about WTO members bringing their policies into compliance with their international obligations.

If however, ISDS moves to increasingly address requests for compliance by host states, the same issues as those occurring under state responsibility for wrongful acts may occur.

Under the WTO DSU Article 23, WTO members automatically accept the jurisdiction of the WTO dispute settlement mechanism over their trade disputes when they relate to the violation of a WTO Agreement. In contrast with arbitration mechanisms, such as that of the ICSID (which have open jurisdiction), the WTO dispute settlement mechanism is a contained system.

Comparatively, IIA and BITs do not establish arbitral courts. They rely on existing arbitration centres and, often existing procedural rules. One consequence of this is that the jurisdiction of a given arbitration centre and the application of a given arbitration rules requires that both parties to an investment dispute accept them either in the IIA or subsequently on an ad hoc basis.

As the Australia-EU FTA investment dispute settlement mechanism will aim at protecting foreign investors, it may be important to link the future ICS with the existing ICSID Convention to ensure that decisions made under Australia-EU FTA will be enforced by the most effective mechanism, which is currently ICSID. This, however, raises the question of whether ICS judgements could be enforced under the 1958 New York Convention which formally applies only to arbitral awards.

19 A government may use a panel report ruling on the legality of a given domestic policy to initiate reforms it would have had political difficulties to carry out otherwise.

Confidentiality of awards versus public judgements

One of the core elements of the EU ICS proposal designed to re-establish civil society's confidence in foreign investment agreements and in their dispute resolution mechanisms is the public transparency of ICS judgements. In the WTO, panel and appellate body reports are published upon their adoption by the dispute settlement body (DSB). Leaking a panel report before its issuance is also a way for parties to a dispute to influence public opinion against or in favour of the findings made by the panel.

Moreover, as a result of a jurisprudential move, panel hearings are now largely public. By comparison, ISDS proceedings still take place behind closed doors and awards are, despite real efforts by arbitration centres, often kept confidential at the request of the parties. This is basically intended to protect the privacy of the parties, along with the relevant commercial or investment secrets.

The ICSID, the only arbitration institution that exclusively administers investment disputes, maintains a website that provides basic information about all pending and concluded cases (Ten Cate 2012). The Permanent Court of Arbitration in The Hague does the same. It is commonly agreed that the ICSID approach of disseminating and updating its information on dispute resolution has made a major contribution in promoting international investment and ISDS. Although the ICSID cannot make arbitration awards public without the permission of the parties, its publication may include the legal reasoning of arbitration tribunals (ICSID, 2006). This allows other ISDS arbitrators, investors and states to be informed of the legal reasoning applied in given circumstances, thus implicitly promoting consistency in awards and predictability for parties to IIA.

This argument was, for a long time, also made in the field of dispute settlement in international trade, until it entered into conflict, supported by a number of members, with the public demands for transparency. The problematic consequences of this became particularly acute when dispute settlement panels had to review complaints against domestic subsidies for the aircraft industry, where extensive cooperation was required—from engine manufacturers to avionics companies. Until those cases, it had been argued that government officials would keep information they were given access to by the other party in the course of a dispute confidential. This position was questioned on the occasion of those cases which involved billions of dollars of research and development, trade secrets and know-how. This led to the adoption of ways to protect 'business confidential information' (BCI), a sophisticated system of information sharing, allowing parties to argue their case and panels and the appellate body to base their rulings on real data instead of inferences. The treatment of BCI in the WTO dispute settlement

mechanism is evidence that confidentiality, including in the most sensitive domains, is not an obstacle to transparency, that there are ways to make sure that justice is not only done, but is also seen to be done.

Choice of procedures

A core feature of ISDS is the large number of entities which can host arbitration and the number of rules of procedure that parties may choose from. These include such well-respected institutions as the London Court of International Arbitration and the International Chamber of Commerce (ICC), set up in 1923, which is similar to another venerable institution, the Permanent Court of Arbitration. The last two institutions usually provide technical assistance and a list of arbitrators, but do not render awards (Dolzer & Schreuer 2012).

Among the rules for ISDS, the UNCITRAL rules are increasingly popular. This is because they offer flexibility and are regularly modernised. One advantage of the UNCITRAL rules is that they do not require the use of any institution. Parties may create an ad hoc tribunal anywhere in the world, and adopt their own framework of arbitration and still use UNCITRAL rules (Dolzer & Schreuer 2012, p. 8). However, an existing institution such as ICSID, can also apply the UNCITRAL rules to a dispute (Dolzer & Schreuer 2012, p. 9).

The main problem with multiple rules and multiple institutions is the risk of ‘forum shopping’, a practice whereby a complainant will select the agreement and/or the procedures under which it will initiate a dispute because it considers it more likely to produce the expected result.

If the EU ICS proposal is not accepted by Australia, an arbitration-based ISDS could lead to a status quo, reflecting the vested interest of major stakeholders in maintaining the possibility of treaty shopping (Chaisse 2015a). This said, the Australian Government is likely to be very sensitive to the issue of ‘forum shopping’. Indeed, one recent example of this practice directly affected it, when Philip Morris initiated a complaint against Australia under the ISDS provisions of the Australia-Hong Kong BIT, in relation to Australia’s plain packaging legislation (Chaisse 2013, p. 332).

CONCLUSION: THERE WILL BE ISDS IN A FUTURE AUSTRALIA-EU FTA. BUT WHICH TYPE?

The UK has been, historically, the main EU investor in Australia and Australian investments in the EU are primarily made in the UK. However, Brexit is unlikely to decrease the relevance of an investment chapter in a future Australia-EU FTA and the EU interest in an ICS.

Indeed, with the loss of the UK as its traditional gateway to the EU, Australia probably has a now-increased interest in an Australia-EU FTA covering investment. If anything, it would save time and resources by dispensing Australia with negotiating BITs with EU Member States with which it does not already have one, and where Australian investors might potentially have an interest in investing.

Likewise, the current stalemate in multilateral trade negotiations can only be an incentive for the EU to use FTAs to access Asian markets. Australia, with its primarily Western culture and legal system, remains a convenient bridgehead to Asia; but it is also a growing market where EU investors directly compete with other investors, primarily Chinese. Whether this will make investment a priority in the negotiations is not clear in light of the other issues, such as SPS measures. One thing seems clear however. If there is an investment chapter, the European Commission will push for the establishment of an ICS, since this is part of its overall mandate. It is possible that in an Australia-EU FTA, the EU may temporarily accept an arbitration system—as it did in CETA—with the expectation that this will be subsequently replaced by its proposed investment tribunal. This concession, if made in return for the prompt conclusion of an FTA, could be judicious if it were to result in placing EU exporters and investors on an equal, or even preferential footing, with their competitors.

From a systemic point of view and in order to set an additional precedent after CETA and its other recent FTAs, the EU will most probably push for an ICS. The UK's exit from the EU (Brexit) is likely to reinforce this trend. Indeed, the UK has historically been home to a number of ISDS practitioners (arbitrators and counsels). Common law and British lawyers have significantly influenced ISDS practice. Following Brexit, ICS proponents may face less internal objection to their judge-based system.

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