

The Politics of the Australia—U.S. Free Trade Agreement:
A Two-Level Game Theory Approach

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Abstract:

Using the two-level game theory model conceptualized by Robert Putnam in 1988, this paper analyzes the politics behind the 2005 Australia—U.S. Free Trade Agreement (AUSFTA) from the domestic level (Level II), with regard to lobbying efforts by the U.S. sugar industry as well as the pharmaceutical industry, and from the international level (Level I), analyzing how the AUSFTA symbolized both an opportunity and strategy for Australia to strengthen economic ties with the U.S. in line with their political as well as military alliance. It is thus argued that the U.S.'s “win-set” (Putnam, 1988)—which refers to all possible agreements that can be ratified and achieved—shrank because of domestic pressures due to lobbying, but that the U.S. was able to use its significant economic dominance as well as its military ties with Australia to leverage its bargaining power and expand Australia's “win-set” (Putnam, 1988), leading to a deal that ended in unequal concessions and outcomes, putting Australia at a significant disadvantage. It is thus argued that because the effect of such bargaining power is stronger in bilateral trade agreements as opposed to multilateral negotiations, they may be more conducive to asymmetrical gains.

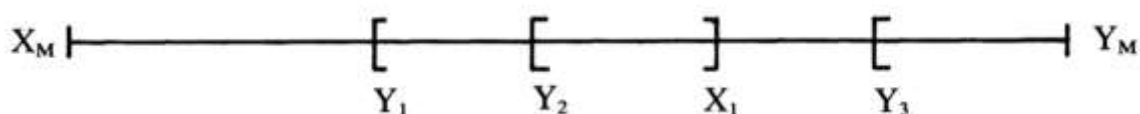
Introduction:

The AUSFTA was signed on May 18th, 2004 and came into effect from January 1st, 2005, becoming Australia's third free trade agreement (FTA) (Australian Government Department of Foreign Affairs and Trade, n.d.). The agreement was seen by the majority of trade officials as a mutually beneficial deal that would lead to a number of economic benefits on both sides (Stoler, 2004), but also as a prime example to showcase to the rest of the world a bilateral alternative to potential multilateral agreements from the Doha Round (Speagle, 2011). However, the deal was achieved through negotiations that came from much contention, with two prominent examples being the sugar industry and the pharmaceutical industry. The

objective of this paper is to examine the negotiations behind AUSFTA from a political approach utilizing the two-level game theory model, in order to answer the question as to why such a deal that led to asymmetric results came to be signed, and to shed a light on understanding how effective bilateral trade agreements actually are.

Two-level games, which were first theorized by Putnam in his 1988 paper, characterize how politics at the domestic (Level II) and international (Level I) layers interact in international negotiations. While domestic constituents, such as lobby groups or politically influential industries, put pressure on their government to incorporate their interests in policymaking, representatives at the international negotiation table must bargain for an outcome that will not only be agreed to by all trade representatives there, but that will also be successfully ratified back home, and they thus play the two domestic and international games simultaneously (Hwang and Hyun-Jung, 2014). Furthermore, according to Putnam (1988), “win-sets” (Putnam, 1988) in Levels I and II refer to all possible agreements that could be achieved in that level; therefore, this automatically means that any final agreement in Level I must fall within the Level II “win-set” (Putnam, 1988). This is illustrated in Figure 1 below:

Figure 1: Illustrating “Win-Sets” (Putnam, 1988) Between Country X and Country Y



Source: Putnam, R. (1988). Diplomacy and Domestic Politics: The Logic of Two-Level Games. *International Organization*, 42(3), p. 441.

According to Putnam (1988), Y_M and X_M are the maximum possible results or outcomes for countries Y and X, while Y_1 and X_1 are the minimum deals that can be ratified in their respective countries (therefore agreements between Y_1 and X_1 can be agreed upon). However, if Y’s “win-set” (Putnam, 1988) shrinks from Y_1 to Y_2 (from domestic pressures due to industry

lobbying, or public protests, for example), agreements within the range between Y_1 and Y_2 can no longer be successfully ratified in country Y, and therefore country Y is in a favorable position in the negotiations (Putnam, 1988). If Y pushes to go as far as Y_3 , however, there is no longer a range of “win-sets” (Putnam, 1988) in which both countries would be able to agree upon, and the deal fails (Putnam, 1988).

Studies using two- (or even three, because the European Union (EU) is often treated as its own level) level games have been conducted for numerous trade negotiations, such as EU-Korea by Hwang and Kim in 2014, Korea-US by Koo and Jho in 2009, and EU-South Africa by Larsén in 2007, as well as policies such as the Common Agricultural Policy (CAP) in the EU (Patterson, 1997), and EU external migration policy (Reslow and Vink, 2015), but none have been conducted as of yet for the AUSFTA. The objective of this paper is thus to fill this gap in literature, using the sugar as well as pharmaceutical industries as two examples.

Main Arguments:

Level II

The U.S. Sugar Industry

The U.S. sugar policy has been characterized by protectionism for the past few centuries, beginning with the implementation of tariffs in the 18th and 19th centuries, and numerous Sugar Acts in the 20th century acting as import quotas and price supports (Schmitz and Christian, 1993). In the context of the AUSFTA, under the Farm Security and Rural Investment Act of 2002 signed in the farm bill that year by President George W. Bush, the sugar industry was protected through nonrecourse loans and tariff-rate quotas that limited imports (Beghin and Elobeid, 2017). Sugar protection has in large part been supported by the domestic sugar industry, dominated by Florida-based corporations such as Flo-Sun and U.S. Sugar, who have exerted their influence through giving millions of dollars to political action committees (PACs) and politicians in both Republican and Democratic parties (Lukas, 2004).

Access to the U.S. sugar market was thus unsurprisingly a major target for export-oriented Australia. Doing so was projected to give the country gains worth over \$400 million (International Centre for Trade and Sustainable Development, 2004). However, despite Australian Trade Minister Mark Vaile's public statement that "sugar must be part of the deal" (Vaile, 2004), intense lobbying in the U.S. led to its exclusion from the final deal in order for U.S. trade officials to be able to pass the deal through Congress (Zoellick, 2015), signifying a shrinking of the U.S.'s "win-set" (Putnam, 1988). To appease the Australian sugar industry, \$440 million in adjustment assistance was allotted by the Australian government, funded through additional tax revenue, coming at a predicted net cost of approximately \$70 million (Dee, 2005).

The U.S. Pharmaceutical Industry

Australia's Pharmaceutical Benefits System (PBS) is a domestic system in which the Commonwealth of Australia effectively subsidizes pharmaceuticals for citizens. It does so by using reference pricing (a system where the price of the drug is "referenced" to prices of other drugs that have the same or similar effects (Searles, 2009)) to calculate the true value of a potential new drug, after which it uses "national bargaining power" in order to counter the monopoly held by pharmaceutical companies who hold the patents, which works to bring the price of medicines down considerably, to about three or four times less than in the U.S. (Faunce, 2015). On the other hand, reference pricing is illegal in the U.S. because it is seen as a form of price control, which has led to intense lobbying by the Pharmaceutical Research and Manufacturers of America, which historically has conducted lobbying against any policies that would directly threaten the profits of its members (Searles, 2009). The AUSFTA deal presented itself to U.S. pharmaceutical companies as an opportunity to target PBS, and senior members in the industry in fact worked hand in hand with trade negotiators in the Industry Functional Advisory Committee on Intellectual Property Rights for Trade Policy Matters (Faunce, 2015)

to develop a provision that in the end worked to attack reference pricing in Annex 2Cⁱ of the deal through demanding stronger intellectual property rights, despite the fact that Vaile publicly stated that “the PBS, in particular the price and listing arrangements that ensure Australians access to quality, affordable medicines, remains intact” (Harvey et al., 2004). Such demands were predicted to delay the market entry of PBS-approved cost-effective generic drugs by delaying processes in which those products would receive market approval from the Therapeutic Goods Administration (Harvey et al., 2004). This was predicted to result in increased costs to run PBS, by \$1.5 billion in the following three years from 2006 to 2009, as well as affecting medicine supplies and non-PBS medicines that are sold in the country (such as over-the-counter drugs); this would lead to an overall result of higher costs for both the government and consumers, threatening the very existence of PBS (Harvey et al., 2004). On the other hand, figures in the Australian pharmaceutical industry had no such collaborations with the Australian trade officials (Faunce, 2015); clearly, this demonstrates the wide difference in domestic pressures the two countries faced.

Level I

The U.S. and Australia originally had opposing views on trade policy. Australia is well known as the founder of the Cairns Group, a group of countries that seek to liberalize trade in agricultural products, and under the Labor administrations of previous prime ministers Hawke and Keating, the country was a strong promoter of multilateral trade negotiations. In comparison, the U.S. has maintained a strong protectionist stance (through the passing of numerous farm bills, for example), and the Bush-led administration promoted bilateral agreements, abandoning multilateral ones. However, these differences were overshadowed by a growing political alliance between George W. Bush and the Australian prime minister, John Howard, especially as Australia became a staunch supporter of the Iraq War (Quiggin, 2010), particularly during the invasion in 2003. The government’s own Foreign Affairs and Trade

White Paper *Advancing the National Interest* published in 2003 stated that an FTA would align the countries' economic relations with their close political and military alliance (Commonwealth of Australia, 2003). Furthermore, at 4% of the U.S. GDP (World Bank), Australia saw signing a bilateral FTA as a way to improve its position in global trade through gaining openings to bigger markets (Bisley, 2004), an important factor because the country is dominated by export-oriented sectors, such as agriculture. This makes it clear that the power balance between the two countries was unequal from the start.

Thus, despite widespread public rejection—with only 34% of total public support, according to a 2005 poll conducted by the Lowy Institute, which also marked the “most comprehensive single survey ever taken of Australian public opinion on foreign policy” (Lowy Institute, 2005)—and government-commissioned studies, as well as widely circulated independent research that demonstrated little or marginal economic benefit, 14 months of negotiations later (as well as a personal visit to Australia by President Bush), Prime Minister Howard agreed to the deal despite objections by the Trade Minister and trade negotiators.

Analysis:

The two-level game theory approach has proved to be a useful tool in analyzing trade negotiations. While domestic lobbying shrank the U.S.'s “win-set” (Putnam, 1988) at Level II, the U.S. enjoyed bargaining power through its economic size as well as its political and military connections with Australia, thus expanding Australia's “win-set” (Putnam, 1988), which allowed for what many deem an asymmetric deal to be signed.

This also brings bilateralism versus multilateralism into question. The surge of bilateral FTAs continued (Urata, 2002), especially against the backdrop of the WTO's stalled Doha Round. While the Australian government argued that “bilateral liberalisation ... can compete with and stimulate multilateral liberalisation” (Commonwealth of Australia, 2003), this claim remains dubious and the value that bilateral deals bring is questionable; as in the AUSFTA

case, bilateral structures can strengthen bargaining power that one country has over another, forcing the other to make concessions that make the deal asymmetrical. Notably, since the deal, U.S. surplus in trade in goods with Australia doubled to \$13 billion, and surplus in services grew five times to \$15 billion (Office of the United States Trade Representative, n.d.). This shows that bilateralism may be more conducive to win-lose situations than win-win.

Conclusion:

The contribution of this paper is that it is the first study to analyze the AUSFTA from the existing two-level game theory framework conceptualized by Putnam. The findings have determined the motives behind the result of the deal, especially concerning Australia, which viewed the deal as a way to strengthen its military and political ties with the U.S., as well as to gain an opening to bigger markets, which is especially important for the export-oriented country. Furthermore, it was observed that while the U.S.'s "win-set" (Putnam, 1988), or range of agreements that can be ratified, shrank at the domestic Level II due to domestic pressures and lobbying, Australia's "win-set" (Putnam, 1988) at the international Level I expanded due to the aforementioned political goals of trade negotiators as well as the government. This created a common opening for an agreement to be reached. Further studies using the two-level approach in bilateral FTAs can thus help elucidate the factors behind similarly asymmetrical results.

Endnotes:

ⁱ An annex applies to only one country in a bilateral deal.

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