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Outside a Free Trade Agreement

A conceptual analysis of market access for firms from non-participating countries

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1 Introduction

1.1 The increasing importance of FTAs

President Donald Trump is suspicious of trade agreements and consequently, the United States is trying to renegotiate NAFTA. The US also pulled out of the Trans-Pacific Partnership (TPP). Nevertheless, the other eleven signatories to the TPP went on and established a free trade area without the US. Hence, the US became a 'third country'.

On the other side of the Atlantic, the European Union is busy with a trade agenda quite unlike that of the American administration. The EU has recently concluded a major agreement with Japan, entered into an agreement with Canada (CETA) and is trying to reach an agreement with Mercosur in South America this year.

The EU is not alone in its pursuit of more Free Trade Agreements (FTAs). Indeed, the number of agreements is increasing worldwide, as has been the case for decades. The stated objective of a post-Brexit UK is to negotiate as many FTAs as possible. Until recently, negotiating FTAs was also part of the the American trade agenda.

Hence, the US is increasingly becoming a third country in relation to other countries' trade agreements. The US is of course not alone in this situation. With over 300 agreements in force, all countries are increasingly becoming third countries to agreements concluded by other nations.

This situation has implications for trading opportunities, as FTAs do have effects on non-participating countries. Third countries that are not parties to an FTA are still affected. This paper discusses the effects of FTAs on firms in third countries. Directly or indirectly, provisions in FTAs are likely to affect third countries even if the FTA provisions "stay in the FTA", i.e., they are not later multilateralised and no new countries join the agreement.

1.2 Third country market access

The paper takes the perspective of an exporting firm in a third country. By exporters, we also mean firms that invest in another country to reach their customers via physical presence. The question to be analysed is the following: if countries A and B enter into an FTA, how could this affect firms in country C?

If the trade agreements serve their purpose and increased trade leads to higher GDP, then the new demand will likely be partially translated into new opportunities for third-country firms as well. Hence, exports may also increase for third-country firms even without any changes in trade policy towards them. However, our question here is whether the FTA can – in itself – also break down trade barriers for firms from third countries. Our focus is on the effect on *market access* (directly or indirectly) for third-country firms. The answer to this question becomes ever more important for every new FTA signed.

In this paper, market access is defined in economic terms, not necessarily following the definitions used in the legal texts of trade agreements and trade negotiations. Therefore, *market access is the de facto opportunity of firms from one country to access another market in order to sell their goods and services, or to invest*. This definition includes indirect market access via global value chains. The question addressed in this paper is how market access can change for third countries as a result of FTAs.

It should be noted that an FTA should not – according to the World Trade Organisation (WTO) third-country neutrality criteria – reduce market access for third countries in any absolute way. FTAs should not raise trade barriers against third countries. Negative effects will only be *relative*, i.e., third countries will not have the same advantages as other countries and may consequently lose competitiveness.

Therefore, the effects on market access for third countries can be divided into three categories. First, some provisions will have no positive (i.e., market opening) effect at all on firms from third countries. Secondly, some provisions will benefit third countries but may benefit FTA countries even more. In both these cases, third countries may lose relative competitiveness. Finally, some provisions will benefit third countries to the same extent that they benefit FTA countries, which means there is no discrimination and the agreement becomes a "global public good".

Third countries could be affected by FTAs in different ways. In theory, new opportunities might constitute real opportunities for some countries and mean little or even be negative for others. For example, stronger intellectual property rights will benefit developed countries more than developing countries.

1.3 Method and scope

The paper is based on a forthcoming report from the National Board of Trade Sweden. To a large extent, it is based on the in-house knowledge of the Board. It is not an empirical study; it scrutinises provisions in a large number of FTAs and does not use statistics or any quantitative techniques to make a case. Rather, it is a conceptual paper focusing on the potential effects for third countries of including certain provisions in FTAs.

The paper discusses provisions that either exist in some FTAs or that could reasonably be included in some future FTA. However, it does not attempt to be exhaustive, and the aim is not to fully cover every conceivable type of FTA provision.

The paper is not limited to FTAs. In addition, other forms of economic cooperation between states, aimed at facilitating trade, are considered. These include Mutual Recognition Agreements (MRA) as well as customs cooperation agreements and side agreements to actual FTAs.

2 Shallow and deep agreements

2.1 The effects of traditional shallow agreements

Traditionally, FTAs have been about tariffs, and this is still the core of many agreements, particularly those involving only developing countries. Tariffs also constitute the lowest common denominator for all FTAs, i.e., one cannot think of an FTA that does not contain tariff preferences for the FTA parties. Moreover, all FTAs have rules of origin (RoO); these determine the "economic nationality" of goods and hence decide which goods are eligible for preferences.

Sometimes agreements that contain only tariffs, and thus only address goods trade and barriers at borders, are called shallow agreements. It is understandable that most analysis of the impact of FTAs on third countries has focused on such shallow agreements, both because there are so many of these agreements and because it is relatively easy to methodologically grasp the issue at hand. Until recently, focus has been on the concepts of “trade creation” and “trade diversion”, i.e., whether more trade is created by FTAs (positive) or whether trade is –on net – mostly diverted into new patterns (which might be negative).

Reducing tariffs only for the FTA partner is negative for the relative market access of third countries. It is self-evident that if A gets a cost advantage when entering the market of B, and C does not get this advantage, then this is negative for C. This situation also applies if it is only the bound tariff level that is reduced, as it reduces policy space for the FTA country and provides A with a certainty that C does not receive. The extent to which tariff cuts matter in reality, however, depends on the cost sensitivity of the products in question as well as a range of other factors.

However, tariffs cannot be seen in isolation. The above only holds in the unusual case when the rules of origin require that the goods must be “wholly obtained” to benefit from preferences, i.e., when 100% of the content of the product in question needs to come from the FTA partner. This only applies to agricultural products. In all other cases, i.e., when non-originating contents (input from a country outside of the FTA) are allowed to some degree, the situation is less clear-cut. This means that there are situations when a third-country firm can benefit from an FTA by acting as supplier to an FTA firm. By being part of a value chain, delivering goods to a firm in the FTA, which in turn exports to the other FTA country, the third-country firm gets indirect

market access from the FTA. It can thus benefit economically from an FTA to which its country its not party.

Such a benefit requires liberal rules of origin, rules that are "leaky" in the sense that they leak economic gains outside of the FTA. Technically, this can be structured in many ways and in many combinations. Perhaps most important, the value-added rule allows a certain percentage of non-originating input. In EU FTAs, this percentage is often set at 50-70%, which means that a very large share of the new export opportunities can indirectly benefit third countries. Other rules are less far-reaching and may sometimes only benefit some selected third countries.

Why do the FTA partners include provisions that benefit third countries like this? The answer, in a world of global value chains, is that it is necessary. The only way an FTA can benefit a country is if the firms in that country can export competitively, which they can only do if they have access to competitive third country inputs without being "punished" for this at the border of the FTA partner. Hence, it is in the self-interest of the FTA partners to have leaky rules of origin that benefit third countries.

Additionally, third-country firms may benefit as suppliers of *services* to the firms located in the FTA. This is an area completely unregulated by rules of origin, and an issue that should not be overlooked, as the value of many exported goods today mostly consists of services inputs.

Thus, third countries might lose in relative terms – focusing on tariff cuts – but they may gain in absolute terms, increasing their export opportunities anyway. Nevertheless, it will always be better for a third country not to be a third country but rather to have direct market access, as then discrimination will disappear.

2.2 The effects of deep and comprehensive agreements

Focusing only on tariffs is far from sufficient – and is even misleading – when assessing the effects of modern deep trade agreements. Due to tariffs being generally low, the tariff parts of the agreements are gradually becoming less interesting in terms of potential commercial opportunities for firms.

Modern agreements often go much further than did old agreements, and FTAs today cover a much broader range of issues and include more numerous and comprehensive provisions. Some of the provisions may relate to areas already addressed by the WTO, but FTAs may make stronger and/or more far-reaching commitments. This is referred to as *WTO plus.* In other areas, the provisions cover entirely new areas that are not regulated by the WTO at all. This is referred to as *WTO beyond.*

The ambition of FTAs to go further than the WTO partly has to do with countries' different political preferences and administrative capacities. In many cases, there is neither any desire nor any realistic way to find a multilateral solution. For example, a multilateral agreement on opening procurement markets, beyond the WTO Government Procurement Agreement (GPA), is not on the WTO agenda. Thus, a country that wants to liberalise procurement markets will

have to do so with likeminded countries bilaterally or regionally outside of the WTO. Simply put, when the aim is to go further than the WTO some issues are better, or only, tackled in FTAs.

For example, the new EU-Mexico FTA is in fact a renegotiated agreement, which will deepen economic ties between Europe and Mexico. Hence, the US is becoming a third country not to a shallow but to a rather deep agreement. The same applies to the situation with Canada, as the CETA agreement is also rather deep.

2.2.1 At the border: barriers for services, foreign establishment and procurement

Some of the non-tariff-related areas covered by more ambitious agreements are, like tariffs, applied at the border. These include market access barriers to services, foreign establishment and procurement. For example, regarding both investments and procurement, there are sometimes, in national legislation, local content requirements and requirements for joint ventures. With regard to procurement, there might also be price preferences for domestic firms. Such policies may hinder foreign firms from investing in an economy and may erect barriers to participating in foreign tenders. The FTAs might result in changes to these policies. The reforms may be discriminatory, i.e., only benefit the partner country, or general in nature and benefit all firms. For example, it is a political choice whether a certain investment-restricting policy should be reformed only in relation to the FTA-partner or in relation to all countries.

However, most provisions aiming at opening up for services trade as well as foreign establishment are administratively complicated to implement in a discriminatory fashion. It is difficult to treat services firms from different countries with different sets of market access regulations. For example, it would be odd to administer a sales quota for a firm from one country while a competing firm from another country operates without a quota. Therefore, services liberalisation (deregulation) is often carried out in a non-discriminatory fashion. Often, FTAs do not directly lead to any liberalisation but rather only to the binding of present openness. Hence, in general, the effects on third countries are small but are as positive for them as for the firms located in the FTA.

2.2.2 Binding domestic reforms – reducing policy space

Many provisions in FTAs today actually have more to do with domestic reforms than foreign market access. The intention is not explicitly to lower trade barriers for foreign countries. Many of these reforms change how an economy operates in ways that are beneficial to firms operating in the economy, regardless of the country of origin of those firms. Therefore, an FTA party could push for these "domestic reforms" in an FTA negotiation. These measures can be, and often are, carried out unilaterally without the need for an FTA. Nevertheless, they are often incorporated in FTAs as a means to lock in unilateral pro-business policy reforms so that future governments and/or civil servants may not alter/ignore them.

If such reforms create a more predictable, competitive business climate and a better-functioning public sector, they serve the interests of not only domestic firms and firms from the FTA partner but also of firms from third countries. Discrimination is often impossible.

Consider some examples of what this could entail. Most regulations affecting the services trade are not applied at the border but concern "conduct requirements" related to the safety, reliability and compatibility of services. Services reforms do not normally aim to change such requirements but rather to make processes more efficient in relation to the aim. Reforms will thus normally affect all firms the same way. Applying the regulations based on the country of origin of firms would not be efficient.

Furthermore, the lifting of bans or limits on establishment is usually applied on an "all foreign capital is welcome" basis. This approach is usually linked to reforms in the free flow of capital, both into and out of the country.

Other examples of this approach include changes to competition policy, reining in state-owned enterprises and reforming subsidy schemes to make them more transparent and perhaps less trade distortive. Such reforms open up an economy to fairer competition and do so in a way that is normally beneficial for third countries as well.

Sometimes, the way the public sector operates in a country may act as a *de facto* trade barrier. This can be addressed in various ways in an FTA, and most of these reforms will benefit third countries. A more transparent and open government, in regard to procurement, stakeholder consultations and publishing relevant laws and regulations on the Internet, benefits all firms by its very nature. The latter is something the EU has begun pushing for recently in its FTA-negotiations.

Finally, increased public sector efficiency and legal reforms, including better trade facilitation, more cost-efficient procurement, anti-corruption schemes and right to legal redress will be beneficial to all trading firms. Why? It would be inefficient to be selectively efficient. Equality before the law cannot be applied in an unequal manner.

2.2.3 Cooperation schemes and the need for political trust

Deep and comprehensive trade agreements also address other "domestic issues" in a way that is impossible on a unilateral basis but that requires active cooperation between parties. This in turn requires trust and administrative capacity and may therefore risk being discriminatory to third countries.

Such agreements may involve work in various committees (to which, by definition, third countries are not invited) enshrined in the FTA, which might find new innovative solutions to trade barriers. Such ideas can be based on stakeholder processes, not open to third countries, or impact assessments, where third country interests are not taken into account.

More importantly, there may be formal administrative cooperation schemes, such as Authorised Economic Operators (AEO), to reduce the number of border controls, or schemes to exchange information between government agencies involved in the licensing of professionals or visa facilitation programmes. Mutual Recognition Agreements (MRA) may also be involved, in which countries mutually recognise goods and services from each other's jurisdictions. What such schemes have in common is that they are designed to facilitate trade between the FTA parties and only them. There is a real risk that they will be negative for third countries, as they may face – with these examples in mind – relatively more formalities at the border. There may be fewer opportunities to export goods without adjusting them unnecessarily and more burdensome procedures for services exports. Regarding services, such cooperation schemes still mostly address sending personnel abroad (mode 4 GATS), and as they are not very ambitious, this means the discriminatory effect will, in reality, mostly be very weak.

The most ambitious effort in this area was the now-abandoned Trans-Atlantic Trade and Investment Partnership (TTIP) negotiations between the US and the EU. The idea was to make TTIP a *living agreement*, evolving over time and providing benefits in the long run by pre-empting trade barriers. Efforts in this highly complex and sometimes controversial area might be, if they succeed, very far-reaching. Close regulatory cooperation between government agencies may lead to less need for duplication of testing, fewer adjustment needs for different markets, fewer contradictory technical requirements, all of which could save producers large unnecessary costs – without lowering levels of protection.

The implications of such regulatory convergence may be felt in important sectors of the economy and may – in the long term – change the conditions under which firms in a sector operate. To what extent this benefits or harms third countries is a completely open question. It *may* benefit all firms in the sense that "one set of rules is simpler than two sets". However, the effect on third countries is also dependent on the outcome of regulatory cooperation and will be different for different sectors. It may be only long after an agreement in this area has been reached that anyone will be able to offer certain conclusions about the effects for third countries.

Also building on trust, but not requiring any cooperation, there might be different policies regarding investment opportunities. These may include requirements for screening and approval of foreign investments as well as limits on foreign ownership/renting of assets and limits on foreign board members, all of which may be reformed in a discriminatory fashion or in a more general way, depending on political trust in other countries.

3 Are FTAs better than the WTO for third countries?

Is there any case where FTAs could be better than multilateral solutions for third countries? Concerning tariffs, the answer is unequivocally no, they are best dealt with in the WTO (and then there is not even any need for rules of origin). Concerning MRAs, AEOs and the like, the question is irrelevant, as such schemes will not be brought into the WTO. However, with regard to market and public sector reforms, there might be a preference for FTAs for third countries. As countries are different with regard to both their administrative capacity and their political

preferences, many such reforms might not advance very far in a multilateral setting. This situation does not mean that reforms are impossible, however; for example, the WTO Trade Facilitation Agreement focuses on increasing efficiency at the borders (i.e., a public sector reform). Nevertheless, some more ambitious undertakings in this area probably require an FTA. Hence, if such reforms are to be implemented, it will be within an FTA. Because the reforms would benefit third countries, this means that it is better to put them in an FTA than by using the WTO framework – where they would not happen at all.

To the extent possible, cooperation schemes should be as inclusive as possible, allowing third-country stakeholders opportunities to participate. Firms from such countries can benefit, but cooperation schemes may also easily discriminate against third countries. In this area, whether an FTA is better than the WTO for non-participating countries depends very much on the details.

4 Conclusion

There is no general answer to the question of how FTAs affect third countries: it depends on what is in the agreement. Some provisions may benefit some third countries, whereas the effects of the same provisions may be negative for other third countries. It is also important to recognise that some provisions will have little effect on any country, as they are not very ambitious and/or not legally enforceable.

To provide some recommendations on how FTAs should be designed to benefit third countries, we can say the following. First, provisions that *should* be part of FTAs are those provisions that are applied on a non-discriminatory basis by their very nature. “Domestic” reforms related to competition, transparency, etc. fall into this category. The more of these provisions included in an FTA, the better for third countries. Such reforms simply mean a country is using an FTA to reform itself and “open up for business” to firms regardless of their nationality.

Secondly, most provisions can be entirely non-discriminatory, but only if there is political willingness. This includes most reforms pertaining to market access for services, establishment and procurement. Liberal rules of origin can increase (indirect) market access for third countries, but less than they do for FTA countries.

Thirdly, there are some provisions that should be limited for the sake of third countries because they do not benefit them at all. However, there are relatively few of these provisions. They include not only tariff preferences with very strict rules of origin but also advanced cooperation schemes – such as AEOs and MRAs – which are designed only for the FTA partners. However, the effects of such schemes on third countries could be mitigated by partially opening them up for use by outsiders. In order for third countries to benefit from cooperation schemes, they likely need to "invest in trust" and administrative capacity so that they too can be invited to participate and benefit directly from any potential gains.

Finally, with regard to regulatory cooperation overall, this *might* benefit third countries, but it depends on technicalities in the sector concerned and cannot be reduced to a simple political

choice. There are great risks and opportunities for third countries when it comes to regulatory cooperation.

To summarise, on balance, it seems that most provisions *can* act as building blocks for a global free trade agenda – if there is political willingness. However, some provisions, unsurprisingly, provide third countries with less new market access than is provided to FTA partners and therefore create relative disadvantages for third countries. Other provisions have very unclear effects.

As for the US in its current state of increasingly becoming a third country in relation to FTAs worldwide, this is not necessarily all negative. The EU and others might, via their FTAs, open new doors to US businesses. However, there is clearly an opportunity cost. American businesses would of course be better off with the US signing up as party to new FTAs rather than only remaining on the outside and hoping for benefits and opportunities to materialise.