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Free Trade Agreements and Countries Outside

An analysis of market access for non-participating countries

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As the expert agency in trade and trade policy, the Board provides the Government with analyses and background material, related to ongoing international trade negotiations as well as more structural or long-term analyses of trade related issues. As part of our mission, we also publish material intended to increase awareness of the role of international trade in a well functioning economy and for economic development. Publications issued by the National Board of Trade only reflects the views of the Board.

The National Board of Trade also provides service to companies, for instance through our SOLVIT Centre which assists companies as well as people encountering trade barriers on the Internal Market. The Board also hosts The Swedish Trade Procedures Council, SWEPRO.

In addition, as an expert agency in trade policy issues, the National Board of Trade provides assistance to developing countries, through trade-related development cooperation. The Board also hosts Open Trade Gate Sweden, a one-stop information centre assisting exporters from developing countries with information on rules and requirements in Sweden and the EU.

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Foreword

The number of Free Trade Agreements (FTAs) in the world keeps growing. The trend is not only towards more agreements, but also towards increasingly deep and comprehensive agreements with an ever growing scope and ambition. The EU-Japan FTA and the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) are two recent examples.

On average, these agreements double merchandise trade between the partner countries after a ten year phasing in period. However, the agreements also affect trade for non-participating countries, often referred to as "third countries". The questions often raised are: what are the consequences of all those FTAs for countries that are not party to the agreements? Are the consequences negative, positive or perhaps negligible?

These questions are not easy to answer. Effects of FTAs on third countries are increasingly difficult to estimate, as the agreements become more complex. The traditional focus on the effects of tariff elimination, whether it causes trade creation or trade diversion, is not sufficient when analysing the effects of broad FTAs with provisions on, for example, services, procurement, intellectual property rights, regulatory cooperation and sustainable development.

The focus of this report is: when country A and country B enter into a trade agreement, what will be the effect for market access for firms in country C? In other words, what is the impact on firms in countries outside FTAs? This is a key question for anyone interested in making FTAs "building blocks" rather than "stumbling blocks" towards global free trade.

With this report, the National Board of Trade aims to contribute with an overview of the highly topical issue of the effect of FTAs on third countries.

This study is part of a series of publications from the National Board of Trade about free trade agreements. The first study ("The use of the EU's Free Trade Agreements") analysed the preference utilisation of EU FTAs. The second publication ("Economic Integration Works") summarised the latest findings about the economic effects of FTAs.

The study has been conducted by senior adviser Henrik Isakson. A number of experts at the National Board of Trade have contributed with their expertise. They are: Anna Egardt, Anna Sabelström, Anneli Wengelin, Björn Strenger, Christopher Wingård, Isabel Roberth, Jonas Hallberg, Jonas Kasteng, Heidi Lund, Karolina Zurek, Kristina Olofsson, Linda Bodén, Magnus Rentzhog, Maria Johem, Patrik Tingvall, Per Altenberg, Sara Emanuelsson, Sun Biney and Ulf Eriksson.

Stockholm, November 2018

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Executive Summary

The number of Free-Trade Agreements (FTAs) continues to grow and increasingly set the rules for world trade. The effects of these agreements go beyond the contracting parties and also extend to third countries. This has often been seen as negative because trade diversion, caused by tariff preferences, distorts trade and discriminates against third countries.

However, a specific FTA is not necessarily negative for a third country that is not party to the actual agreement. The long-term dynamic effects might serve to multilateralise FTAs and FTAs might also spur unilateral trade liberalisation. Notwithstanding any speculation about such effects, a lot of FTA provisions could benefit third countries in various ways. It is these potential benefits that are the focus of this study.

The question in this paper is *how can future FTAs be designed in order to also facilitate market access for third-country firms?* Or, put another way, how can the provisions become building blocks towards global free trade? Market access is defined as both exports and investments.

The study is a mapping exercise, tapping into the in-house expertise at the National Board of Trade in Sweden. FTA provisions are discussed and analysed with the focus on their *likely* effects on third-country firms.

Which kind of FTA provisions are most third-country friendly? To be unequivocally positive for third countries the provisions must (1) create new market access for third-country firms and (2) do this in a way that is non-discriminatory to such firms when competing against firms from an FTA partner country.

Some provisions are applied on a non-discriminatory basis by their very nature, i.e. the provisions *cannot* be administered in a discriminatory manner as they are non-excludable. They are domestic policy reforms that emanate from an FTA. Examples of this include reforms related to open transparency (information portals on the Internet), increased legal certainty and public-sector efficiency (related to trade facilitation or improved regulatory efficiency when dealing with licenses, etc.). This also includes pro-competitive reforms, such as reducing trade-distorting subsidies.

There are also provisions that make it possible to exclude third countries from the benefits, and it is a political choice, both in the agreement itself and in the subsequent national implementation of the agreement, which will decide the potential benefits for third-country firms. For many provisions in this area, the application of an origin concept is unsuitable on a practical level. Thus, it would often be beneficial to also extend the benefits to third countries.

Basically, all FTA provisions related to services belong to this category. They can be crafted either in a discriminatory manner or in a way that treats firms from FTA partners and third countries equally. The same applies to provisions related to establishment, state-owned enterprises and public procurement, where the decision to open up only to the FTA partner or to all countries constitutes a political choice.

Many provisions related to services and establishment do not result in real new market access but legally bind already open markets to remain open. Thus, the effect of increased policy predictability in an FTA normally also benefits third countries.

Furthermore, FTAs may lead to public-sector reforms, including the introduction of stakeholder consultations, impact assessments and notification systems. If so, these reforms may also be crafted in a discriminatory or non-discriminatory manner – depending on political choices.

Many of the provisions mentioned above are used as a means of "locking in" unilateral pro-business policy reforms. The more such provisions an FTA has, the better it is for third countries. It simply means that a country is using an FTA to reform itself and "open up for business" for firms, regardless of their nationality.

What provisions do *not* lend themselves to benefiting third-country firms, i.e. where there is no new market access but only relative discrimination? Such provisions are relatively scarce. Primarily, they comprise two kinds of provisions.

Firstly, there are advanced cooperation schemes – such as Authorised Economic Operator schemes (AEOs) and Multilateral Recognition Agreements (MRAs) – which may form part of deep and comprehensive agreements. These schemes require trust and active cooperation between FTA partners and may lead to third-country firms facing a *relatively higher level* of formalities at the border and experiencing difficulties in having their products recognised. The schemes exclude third countries in the way they work. The same applies to administrative cooperation between government agencies in different countries. Also, provisions related to the temporary movement of persons are normally designed to not benefit nationals from third countries, although the effect is mitigated by the fact that such provisions are usually not ambitious in FTAs.

However, such schemes may also perhaps be partially opened up for use by outsiders. In order for third countries to benefit from cooperation schemes, they must probably "invest in trust" and administrative capacity so that they too can be invited to participate and benefit directly from any potential gains.

The most obvious provisions that do not benefit third-country firms are tariff preferences. This applies to bound levels (the set tariff "ceiling") as well as actually applied levels. It is a

direct competitive disadvantage if a firm has to incur tariff costs that its competitor in an FTA country doesn't have to face. In particular, this could be a problem for developing countries and in the area of agriculture, in which cost competition is fierce.

Nevertheless, the negative impact of tariff preferences on third-country firms might be alleviated by liberal rules of origin, i.e. rules that allow a high non-originating input. Technically, this can be structured in several ways and it comes down to a political choice. It means that third-country firms may benefit from an FTA as suppliers to firms in partner countries.

Taking a value chain approach to this issue makes it clear that third-country firms could benefit from FTAs even when not taking rules of origin into account. The fact that most goods and services consist of value from countries other than the final export country makes it possible for third-country firms to benefit from business they are not directly involved in. It should be possible to benefit indirectly as suppliers to FTA firms that directly benefit from AEOs, MRAs and procurement, etc.

The market access that third-country firms receive *de facto* is often less valuable than direct access, as it is lower down the value chain. Hence, it is discriminatory. But despite this, it seems likely that virtually all FTA provisions provide third-country firms with a certain amount of new market access. An obvious exception to this is local content requirements which, per definition, may prohibit third-country inputs.

There are also a number of provisions which may be applied in a formally non-discriminatory manner, but their real effect on firms will be dependent on the characteristics of the firm, what it produces, the sector in hand and the stage of development of the country where it is operating from.

Regulatory dialogue and harmonisation may have important effects in some sectors of the economy. The extent to which this benefits or harms third countries is a completely open question. It depends on the sectors involved, the countries and their competitive advantages, etc. In principle, "one set of regulations" is better than two sets for third countries but it also depends on what that set of regulations are. Some third-country firms will benefit, others will not.

Intellectual property rights (IPR) provisions are generally not discriminatory but are still not necessarily always positive for third countries. Some third countries clearly benefit from stricter IPR whereas others may lose out. In the same vein, provisions related to corruption and sustainable development will — if enforced — have a positive or negative impact on third-country firms depending on if, from a short-term business perspective, they gain or lose from stricter standards in this area.

What provisions related to regulatory dialogue and harmonisation, IPR, corruption and sustainable development have in common is that the effect on firms has less to do with whether a country is or is not a member of an FTA but more to do with other factors. It may well be that measures in this area benefit some third-country firms more than FTA partner firms.

Hence, being party to an FTA is not the deciding factor. Rather, it is the low capacity or the business strategy of the firms that are the reason they cannot benefit from FTAs. This is a problem that mainly affects developing-country firms and SMEs. On the other hand, it is likely that a global trend towards "rising standards" will continue regardless of FTAs and it is not the design of FTAs themselves that may create these obstacles.

To summarise, most provisions in FTAs either automatically benefit third countries or can be crafted to do so. Even those provisions that do not provide direct benefits mostly benefit third-country firms indirectly, as they can act as suppliers lower down the value chain. Only a few provisions are, by default, negative for third-country firms. However, most provisions probably result in a certain level of discrimination against third countries. In the end, it comes down to FTAs providing third-country firms with more market access in absolute terms, but less in relative terms.

Contents

1 Introduction

The number of Free-Trade Agreements, FTAs[1] in the world continues to increase and there are currently 284 FTAs in force[2]. All WTO members are party to at least one FTA[3]. Regional and bilateral trade agreements drive the trade agenda and this seems likely to continue to be the case.

The purpose of FTAs is often to go beyond what has been agreed by the WTO. Sometimes the ambition is less than this and FTAs only "reaffirm" WTO obligations[4]. Regardless, in the absence of multilateral progress, FTAs are often seen as a "second best" option to advancing global free trade. At the same time, FTAs will often also impact non-members in different ways and may distort world trade.

1.1 Purpose of the paper

A basic requirement in the WTO for an FTA to be permitted is that the purpose "*should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories*".[5] This is referred to as the third-country neutrality criteria. In reality, however, many FTA provisions are not neutral towards third countries. This does not mean that FTAs are necessarily negative for third countries. In fact, many FTA provisions might benefit third countries in various ways. It is these potential benefits that are the focus of this study.

The question in this paper is *how can future FTAs be designed in order to also facilitate market access for third-country firms?*[6]

Market access is defined in economic terms, not necessarily always following the definitions used in the legal texts of trade agreements and trade negotiations. That means that the paper *treats market access as an opportunity for firms from one country to access another market in which to sell its goods and services, or to invest. This includes indirect market access via global value chains. The question for this paper is how a firm's ability to sell abroad is affected by FTAs to which its country is not party.*

The ultimate aim of the study is to contribute to making FTAs building blocks, not stumbling blocks, towards global free trade. If a firm's market access is enhanced due to an FTA to which its country is not party, then that is one step towards achieving this aim.

1.2 Method and scope

Method

This study takes the perspective of a firm in a third country[7]. By "firm", we primarily mean any economic actor that trades internationally or invests abroad or has a potential interest in doing so, regardless of sector and size of the firm.

The study is a mapping exercise, tapping into the in-house expertise at the National Board of Trade in Sweden. 19 experts[8] have assisted with their knowledge, highlighted the most useful sources of information and discussed the likely effects of the provisions in a large number of meetings. Thus, everything in this paper has been subjected to extensive internal peer review.

FTA provisions are discussed and analysed with a focus on their *likely* effects on third-country firms. It is not an empirical study and we do not attempt to prove anything quantitatively. This paper should only be seen as a *platform study*,

providing a brief overview of the issue, and appropriate as a starting point for more research into detailed FTA provisions.

It is important to note from the onset that a third country cannot "use an FTA" by invoking parts of the agreement to legally claim market access. Obviously, FTA provisions are (unless otherwise stipulated) applicable only to the contracting parties of the FTA. However, in order to implement an FTA, the contracting parties must ensure that national laws and regulations are in line with the provisions of the FTA. Sometimes, contracting parties may, in their national legislation, chose to go further than what has been agreed in the FTA. This is referred to as "unilateral add-ons" or "legal spillovers". Regardless of how far a country progresses in its FTA implementation, it is the country's national legislation that will also impact third countries. Due to the existence of add-ons, the effects cannot always be directly attributed to the FTA. Nevertheless, they are an indirect result of the FTA.

Some FTA provisions will have direct effects on existing trade barriers between contracting parties. In other cases, provisions have indirect effects as their implementation will lead to increasing predictability for businesses, by defining policy space for governments, to ensure that future reforms will not negatively affect trade. Both these kinds of provisions are discussed.

From the market access perspective there are, theoretically, three different effects an FTA provision can have on third-country firms:

Firstly, the agreement might be *positive and have the same effect* for third countries as for FTA parties. Sometimes this is referred to as a "*de facto* MFN basis", meaning a third country achieves *most favoured nation* status along with the FTA parties. However, as mentioned above, only the contracting parties to the FTA are legal parties to the agreement. Therefore, the term "*de facto* MFN basis" is misleading and will not be used further in this study.

Secondly, a provision might be *positive for third-country firms if they receive improved market access but, at the same time, can be discriminatory if market access conditions improve relatively more for the parties to the FTA*. In this case, third countries lose a competitive advantage.

Thirdly, a provision might be directly *discriminatory*[9], meaning that third- country firms do not benefit from any new market access at all as a result of the FTA, whereas firms in the contracting parties *do* benefit from increased market access as a result of the FTA. In this context, "discriminatory" means not gaining an advantage that someone else receives.

An FTA cannot reduce market access for third countries in absolute terms as long as it abides by the principle of third-country neutrality and does not increase tariffs or other deliberate trade barriers against third countries. And, as has been seen, with a few exceptions, this has not happened[10].

It should also be made clear that for many FTA provisions, the effects on third countries are very unclear. The effects depend on political choices and the practical implementation of the provisions, much of which has to do with other factors, and not with the FTA as such.

Even if a certain provision is unlikely to benefit third countries it might still be beneficial to overall

global free trade, as long as its effects on the contracting parties are sufficiently strong and positive. This means that even if a certain provision in this study is rated as "discriminatory" it does not necessarily mean the National Board of Trade thinks it should not be included in FTAs, since it might still have a net positive effect on global trade.

Scope

FTAs not only affect third-country firms. They may also affect third countries in other ways, including long-term indirect effects on their economies and society. This has not been discussed in this paper. Furthermore, the paper is not (except briefly in the literature review) concerned with long-term speculation regarding the effects of FTAs on the multilateral trading system.

This study has a *general* focus. Third-country firms are mostly treated as homogeneous, even if, of course, in reality they are very different in terms of sector, size, productivity, capacity, etc. This does not mean the firms we discuss in the paper are "average firms". They are simply firms that share a common interest in exporting to or investing in countries which have FTAs with other countries. They are based in a third country – but there are no other similarities between them. Hence, any discussed effect on such firms is a very general and probable effect and nothing more.

Nevertheless, to the extent possible, an effort has been made to discuss any likely specific effects on small and medium-sized firms (SMEs) or firms based in developing countries. Where it is obvious that the effect on such firms will differ from other firms, which are larger and/or from a more advanced economy, this will be briefly discussed. Such differentiation of firms is an interesting issue to study, but an extensive analysis of this falls outside the scope of this paper.

If FTAs serve their purpose and increased trade leads to higher GDP, then this will create new demand that will partly be translated into new opportunities for third-country firms, too. This means that third countries can benefit from FTAs even if market access conditions remain unchanged for them. However, this is an economic discussion of the more long-term macroeconomic effects of free trade and is outside the scope of this paper. This study is concerned with the issue of how FTA provisions *in themselves* can also break down trade barriers for third-country firms.

This paper does not strictly deal with provisions found in FTAs. Other forms of bilateral economic cooperation between states, aimed at facilitating trade, such as Multilateral Recognition Agreements (MRAs) and customs cooperation agreements are also, to some extent, considered.

The provisions analysed are provisions that either do exist in some FTAs, or provisions that are estimated as likely to be included in future FTAs, according to the National Board of Trade. Where the analysis is based on provisions in existing FTAs, most of them are found in FTAs to which the EU is a contracting party.

It is important to note that this paper does not attempt to be exhaustive. It is broad, but the aim is not to fully cover every conceivable kind of FTA provision. However, the only important issues not covered are the increasingly debated issues related to data flows. The reason for this is that it is still too early to say much about what future FTAs might contain in this rapidly changing area. Another issue, sometimes relating to FTAs, is capacity building. Aid programmes are very different from legal provisions and have therefore not been considered in the study.

1.3 Structure

The paper is divided into two main sections. Firstly, the study deals with *provisions related to the border*, for example, tariffs and trade facilitation. Secondly, the study deals with *provisions applied behind the border*, for example, technical regulations and intellectual property rights. This dichotomy is not always explicit and some trade policies, such as SPS measures, are applied both at the border and behind the border. Still, this serves as a useful structure for the paper.

For each chapter, there is initially a brief presentation of the issue at hand, followed by an overview of relevant WTO agreement/s, if any, in the area. This is followed by a discussion of provisions in the area that can be found in an FTA, and the potential effects these might have on third-country firms. Often in the text we use examples of three countries, in which A and B have formed an FTA to which C is a third country.

The paper is summarised with a table at the end, structuring the effects of the provisions in groups and then commenting on these effects.

Below is a short introductory literature review of the subject.

2 Overview of the issue

2.1 Trade creation and trade diversion

The economic theory primarily associated with the trade effects of FTAs is the theory on trade creation and trade diversion. It is also known as "Viner's ambiguity"[11]. The theory was formulated to explain the trade effects of customs unions and therefore focused on tariffs.

Trade creation is simply new volumes of trade created between the parties as a result of a tariff reduction. If trade between countries A and B increases by 1 billion after an FTA has been concluded, and this can be attributed to the agreement, then it constitutes trade creation.

Trade diversion is when trade, as a result of lower tariffs, starts to take new patterns. If the non-FTA member country C loses some of its exports to country A because country A starts to import from its FTA partner country B as a result of zero tariffs when trading with country B, then trade has been diverted away from country C to country B. This is obviously negative for country C and positive for country B. But has overall resource allocation improved? It depends. If trade is only diverted and not created there is no gain for global trade, just a redistribution of economic activity from third countries to the FTA partners. If trade is both created *and* diverted then the net effect will determine whether it is good for the global economy or not. If more trade is created than just diverted, it will increase global trade flows and may be assumed to be beneficial for the world economy.

To detect trade diversion, you must first analyse if FTAs have any impact on trade flows. If they do not, then, as a consequence, they cannot produce any diversion, either. What do empirical studies tell us about the impact of FTAs? *Ex-post* assessments focus on the trade effects in retrospect. They usually employ a so-called *gravity model* to estimate what trade "should be", given the country pair's economic size, geographic proximity and other variables. Any divergence from that estimate can be attributed to trade policy, such as the existence of FTAs[12].

According to almost all ex post assessments, FTAs do stimulate trade. Baier and Bergstrand (2007) find that trade increases by 100% after a 10-year transition period following the entry into force of an FTA. More recently, Stevens et al (2015) find in a qualitative assessment of 45 FTAs that almost all FTAs lead to growing trade flows, although the magnitude of these gains differs markedly. According to Swarnali (2016), who studied 104 FTAs in the period 1983–1995, using a novel technique called "Synthetic Control Method" (SCM), the average agreement increased exports by 80% after 10 years. The effect was particularly pronounced for country pairs that involved one advanced and one emerging market, in which the emerging market increased its exports more.

When it comes to trade diversion, the evidence is inconclusive. Clausing (2001) found that the Canada-US FTA had substantial trade creation effects but little evidence of trade diversion. Fukao et al (2003) found that NAFTA tariff preferences had both significant trade-creating *and* trade- diverting effects in the industries in which US MFN tariffs were high, but for most industries the tariff preferences made no considerable impact at all. Magee (2008) estimated the effects of trade creation and diversion on late 20th century agreements and found that NAFTA created trade and produced *reverse trade diversion*. This implied that NAFTA made it easier for third countries to export to the US, Canada and Mexico.

Trade diversion seems to have been more common in studies covering areas and time frames when MFN tariffs were still high.[13] This is not unexpected as the effects of cutting tariffs are lower today than a few decades ago, since the cuts no longer engender such major preferences. Thus, both trade creation and trade diversion are more limited. Freund (2010) assessed six Latin American FTAs and found that they were not linked with trade diversion. The explanation in these cases is that external MFN tariffs are lowered after the preferential tariff reductions. Consequently, the lack of trade diversion could be a result of unilateral tariff reductions that reduce the value of the preferences.

Tariffs still matter for companies that participate in trade[14] but are now only one of many components of trade agreements. Focusing only on tariffs is far from sufficient, even misleading, when assessing the effects of modern, deep trade agreements.

Unfortunately, there are very few studies that assess the trade creation and diversion effects of deep FTAs. One study, however, is Acharya et al (2011), which found that almost all new FTAs have led to trade creation and reverse trade diversion, suggesting that FTAs are enabling trade with third countries.

However, some new and ambitious agreements are so recent that it is not yet possible to assess their effects in retrospect. It is then necessary to rely on *ex-ante* assessments, which are less reliable since they are model-based estimates of the future trade effects of an FTA. The models, using *partial equilibrium* and *general equilibrium* techniques, produce results that significantly underestimate the real effects of FTAs, which have been found to be in the range of 10 times higher than estimated[15].

Oomes et al (2016) estimate the effects of six FTAs being negotiated between the EU and East Asian countries, modelling the future agreements on CETA and Vietnam, for developed and less developed FTA partners, respectively. The study found that the effects on third countries are, on average, negative, sometimes positive, but always minimal.

Some recent *ex ante* studies focus on the effects of TTIP. These studies are informative in understanding the risks of trade diversion with an ambitious agreement. All these studies, to a varying degree, find that the main effects of TTIP derive from addressing NTBs in different ways, such as through mutual recognition and harmonised standards, etc. A study by Francois et al (2013), for example, predicts that 80% of the benefits of TTIP comes from deep regulatory integration. The Swedish National Board of Trade (2013) and Fontagne et al (2013), among others,

also predict that the largest gains will come from NTBs. None of this is surprising, given the low average MFN tariffs in both the EU and the US.

However, the estimates on trade diversion vary considerably. Felbermayr et al (2013) find substantial negative effects on third countries regarding TTIP. The countries predicted to be more heavily affected are industrial partners such as Japan, Canada, Mexico, Australia, Norway, Chile and the Central American countries. However, Fontagne et al (2013) predict that regulatory convergence will not take place at the expense of the rest of the world. In fact, Francois et al assume a gain from "regulatory spillovers", i.e. the effects on third countries of regulatory approximation by the EU and US of 20%. This means that they assume that 20% of cost reductions resulting from EU US regulatory approximation will benefit third countries directly. On top of this, Francois also estimates an indirect spillover effect in the form of other countries adopting transatlantic solutions, thereby reducing the cost of trade between themselves and facilitating imports from the EU and US to third countries. This effect is expected to be half that of the direct spillover effect.

To sum up, the results vary. Sufficient empirical analysis is lacking regarding the effects of deep FTAs, which is understandable considering they are relatively recent phenomena. The various results, however, as presented above, including both trade diversion, lack of trade diversion and reverse trade diversion, emphasise the difficulties of assessing the effects of these kinds of agreements.

Leaving the quantitative analysis aside, we now discuss this from the perspective of whether FTAs as *concepts* are good or bad for the global trading system.

2.2 FTAs as building and stumbling blocks

Do FTAs aid the multilateral trading system or are they obstacles? This issue, often discussed in terms of whether FTAs are building blocks or stumbling blocks to multilateral trade liberalisation, have relevance for third countries. If an FTA is a building block, then it will advance global free trade and thus be positive for third-country firms and their market access. For stumbling blocks, the reverse is true. Put another way, if an FTA is a building block then there should be reverse trade diversion. If an FTA is a stumbling block then the opposite is true, it will contribute to trade diversion.

Stumbling blocks

There are a number of reasons that make FTAs, per definition, discriminatory to third countries. The most important argument against FTAs as such is that, taking into account trade diversion, they may distort trade flows by creating artificial comparative advantages. In a situation where the market would naturally lead to trade between countries A and C, countries A and B trade instead. Thus, the economy is not allowed to operate as efficiently as it would under neutral conditions, in which all countries apply the same

trade rules. The less distortions, the better, is a very general proposition supported by most economists. FTAs by their very definition do distort.

The most outspoken proponent of this view is probably Jagdish Bhagwati (2008) who argues that the world trading system is being undermined by FTAs. The agreements create a "chaotic system of preferences that has destroyed the principle of non-discrimination in trade". Bhagwati also argues that achieving multilateral free trade from "the morass of FTAs will be almost an impossible task – like building a mansion from different-sized bricks".

From a business perspective, having to take many different FTAs into consideration can be very complex and costly. This is, of course, particularly true for SMEs. Sourcing products from different markets and selling globally can be very complicated if there are overlapping, perhaps contradictory, sets of trade rules and regulations. The complexity increases even more for the economic actors if the rules of origin are also conflicting. Ideally, one set of rules of origin for all agreements would cause the most minimal distortions (assuming, of course, that the rules are user friendly).

The term *spaghetti bowl*, coined by Bhagwati[16], refers to regulatory complexity caused by FTAs. This phenomena has also been called a *noodle bowl*, reflecting on the particular situation in East Asia where China and Japan act as regional hubs and all other countries serve their interests as spokes in the wheel[17]. According to the theory of hub and spoke, nations involved in bilateral FTAs are either hubs or spokes, the latter being marginalised and the whole set-up distorting trade. From this perspective, the larger the FTAs, the better. The more countries participating, as in the case of CTPP, the less distortions.

Many poor countries depend on unilateral tariff preferences (GSP) that can be withdrawn. With an FTA, these preferences will be bound by an agreement. This creates predictability for exporters and importers in the FTA but not for third countries. Consequently, poor countries may want to negotiate FTAs. However, they may fail to "get the attention of big or more advanced economies". Thus, there is a risk of discrimination against weak countries if FTAs are only negotiated between advanced countries or countries with a promising economic outlook, thus leaving smaller, poor countries outside. Firms in these kinds of third countries can be excluded from business opportunities.

FTAs also absorb energy from WTO negotiations. Negotiating agreements, be they bilateral or multilateral, demands resources. The constraints on budgets, knowledge and a perception among the major players that they have a limited number of negotiating chips, might provide for only one kind of focus. Thus, the negotiation of FTAs might divert the attention of a nation, its politicians or its officials from WTO talks.

Building blocks

FTAs provide the opportunity to advance much further than what is possible in the WTO. By only negotiating with trusted and likeminded countries, it is possible to avoid the WTO *single undertaking*, which requires consent among all WTO

countries. This, in turn, paves the way for otherwise impossible progress on sensitive issues. In many cases there is neither any desire nor any realistic way of finding a multilateral solution. For example, a multilateral agreement on radically opening procurement markets, beyond the Government Procurement Agreement (GPA), is off the WTO agenda.

Simply put, when the aim is to go further than in the WTO, some issues are better tackled in FTAs. This has to do with different optimal levels of governance. When countries have different preferences is it difficult to see that a one-size-fits-all solution through multilateralisation would be optimal either for the welfare of the individual country or on a global level. A high level of diversity of preferences would suggest that the correct level of governance is not on the multilateral level.[18]

FTAs currently cover a much broader range of issues and include more numerous and comprehensive provisions[19]. "Deep" FTAs address trade issues that are mostly found behind the borders, such as technical regulations, intellectual property rights and sustainable development. Commitments are being made that affect measures traditionally thought of as purely domestic. Some of them may be entirely new issues, not regulated by the WTO, so-called *WTO beyond*. Other issues are already addressed by the WTO, but the commitments made in FTAs are more ambitious, referred to as *WTO plus*[20].

New ideas can be developed and FTAs can serve as testing grounds, laboratories or incubators for new global trade rules and market-opening mechanisms[21]. Officials also learn from the negotiation process and this may be used for new agreements[22]. Progress in one area might also lead to progress in other areas as a result of the trust and goodwill created between the countries. Economic integration created in one area as a result of an FTA can lead to increased integration in other areas as well[23].

The rules developed in an FTA can be adjusted to a multilateral or plurilateral environment in new agreements at a later stage[24]. This is the concept of *multilateralising regionalism*[25], advanced by Baldwin (2008). This is connected to the issue of political adjustment. Countries that have already carried out painful reforms through FTAs may exert less resistance to, or even support, similar reforms to multilateral rules. New rules might make their way to the WTO, thereby also benefitting third countries[26].

The concept of *Open regionalism*[27] describes how an FTA may welcome new members (as the EU did in increasing from 6 to 28 members) or, in the case of Ecuador, joining the EU-Andean Pact Agreement[28].

Even if none of the above materialises, FTAs may benefit third countries. To the extent that FTAs contribute to real liberalisation of a market, they will benefit all firms interested in entering that market, including those that do not have an FTA with the country in question. However, the main purpose of FTAs could often be considered as being enhanced legal certainty and, thus, predictability of business. "Lock in of domestic reform" may well benefit third countries, too. These are legally-binding FTA provisions that create a predictable business climate in general. Governments are less likely to be influenced by pressure from special interest groups to implement measures that work against the agreement.

It is this latter aspect that is the focus of this paper: even if FTA provisions "stay in FTAs" and do not spread to other countries, so that third countries remain third countries, how can they still benefit from FTAs? Another way of putting it is to ask how the provisions themselves can act as building blocks by facilitating market access for third-country firms.

3 At the border

3.1 Tariffs

The effect of tariff reductions in an FTA on third countries depends on the rules or origin and the indirect effects on suppliers of inputs, components etc. in third countries.

Assuming strict rules of origin, tariff reductions in an FTA discriminates against the relative market access of third countries. This is regardless of whether the tariff reductions lead to real new market access or just increased predictability.

In principle, the deeper and broader the tariff cuts, the worse it will be for third countries. To the extent this matters a lot in reality partially depends on how price sensitive goods are. Developing countries, often competing with prices, might be more negatively affected. The effects are also likely to be more pronounced in trade in agricultural goods, due to the high MFN tariffs in this sector.

The discriminatory effects of tariff reductions may be alleviated by introducing MFN clauses in FTAs. However, such clauses can only benefit other FTA partners, not third countries in general.

What is a tariff and why do tariffs matter to trade?

Tariffs are fees that are charged when goods cross borders. Here we focus on import tariffs. For most goods they are charged as a percentage of the import price but, in some cases, mostly agriculture, there are fees per unit (litre, kilo, etc.) and/or combinations of tariffs and quotas (TRQs, tariff- rate quotas).

The economic effect of tariffs, apart from the government revenue perspective, is to change the relative competitiveness of firms, to the benefit of firms that are not affected by them. Tariffs also reduce trade as some trade simply becomes unprofitable as a result of the costs incurred by the tariffs.

Tariffs in the WTO

Within the General Agreement on Tariffs and Trade (GATT), WTO members have bound some or all of their tariffs, product by product, at a certain level. Countries cannot then apply higher tariffs than this. These tariffs are applied on a Most Favoured Nation (MFN) basis, meaning they are equal for all WTO members. However, nothing prevents a country from applying lower tariffs than the bound level. If this is the case, then the difference between the applied tariff and the bound level is referred to as "water".

Tariffs in FTAs and their effects on third-country firms

The effects of tariff reductions in an FTA cannot be seen in isolation from the rules of origin. However, for the sake of simplicity, the two issues have been analysed separately. When reading the text on tariffs, it should be noted that some conclusions may have been significantly modified, depending on the rules of origin.

Within an FTA, countries can choose to apply tariffs that are lower than what they have committed to in the WTO. Usually, the vast majority, if not all, tariffs are eliminated or phased out between the FTA parties. Some tariffs may be

maintained because of sensitivities and others might only be reduced but not eliminated. Also, tariffs may only be eliminated for a limited quantity of imports (i.e. tariff-rate quotas).

This results in real new market access if it means that applied tariffs are actually reduced. However, the applied tariffs are sometimes already much lower, or zero, than in the WTO commitments and, in such cases, there is less, or no, new market access. Nevertheless, this is not without merit as it leads to greater predictability for firms in the FTA partner country. According to a study by the WTO, increased predictability can also contribute to increased exports[29]. Hence, as long as FTA firms fulfil the rules of origin (see below), they benefit from not risking tariff hikes.

For example, if a product has a WTO binding of 10% but the applied rate is 5%, and it is agreed in an FTA to lower the tariff to zero, then the result would be a combination of real new market access and increased predictability. In the case of the EU's commitments in FTAs, this is rarely the case, as almost all EU tariffs are applied at the bound level.

Neither increased predictability nor real cuts to the applied tariffs are something third-countries firms can benefit from directly. Theoretically, if tariffs are cut between countries A and B because they enter into an FTA, whereas country C is left outside, this will relatively reduce market access to the markets of countries A and B for country C. This is according to the logic of trade diversion discussed in Chapter 2. The higher the tariffs of the contracting parties to an FTA at the outset and the more they reduce them as a result of the FTA, the worse it could be for third countries. Another way of putting it is to say that the broader and deeper the tariff cuts, the greater the competitive disadvantages will be for third-country firms. This also means that FTAs between high-tariff countries will distort trade more than agreements involving countries in which tariffs are lower and the effects of reducing tariffs are therefore less significant. For manufactured goods, i.e. most goods, this implies potentially greater third country effects for FTAs involving developing countries, since they have high tariffs. For agricultural goods, tariffs are, on average, also relatively high in many developed countries. So here, this distinction does not exist.

However, the effect depends on the trade profile of country C. If the cuts are applied to products which country C does not produce or export in any case, or has no comparative advantage in exporting, the FTA will not have a discriminatory impact on relative market access. Also, price sensitivity comes into play here as the tariff cuts will only matter if demand for the goods traded reacts to the lower import prices.

Hence, in principle, tariff cuts in an FTA are bad for third countries. In reality, for specific products it does not always matter. In very general terms, developing countries often compete with prices more than developed countries. This could suggest that tariff cuts for price-sensitive products will have a greater effect on poorer countries.

For agricultural products, market access is sometimes only improved partially for some tariff lines in FTAs by means of tariff rate quotas

(TRQs)[30]. The volumes within the TRQ face a lower or zero import tariff whereas imports outside the TRQ face a higher tariff. The bilateral tariff rate quotas are reserved for the FTA partner(s) and therefore do not provide any direct benefits to third parties. TRQs are used for sensitive products which normally have high MFN tariffs, in some cases even prohibitive levels. This means that some firms in the FTA partner country that are given access to the TRQ have the opportunity to enter a market that has limited import competition.

Some agreements contain so-called MFN clauses, obliging FTA partners to provide each other with the same benefits that future agreements might confer on other parties.[31] For example, the EU has negotiated such a clause in its Economic Partnership Agreement (EPA) with ECOWAS[32]. If ECOWAS later forges an FTA with another country, then the clause states that the EU should also benefit from any concession to that other country. This can be explained using an example. If ECOWAS applies a tariff of 4% for a product from the EU and then negotiates a deal with Japan, where the same product only faces a 2% tariff, then ECOWAS must also lower the tariff to 2% for the EU. This means that the EU benefits indirectly from its own FTA with ECOWAS, but only in the role of third country to another FTA. Such provisions are negotiated to ensure that competitiveness is not diluted by the FTAs of other countries; it is a kind of "insurance" against losing out as a third country. It might contribute to lowering average global tariffs but it could also stall progress if countries become reluctant to sign potentially far-reaching provisions that bind their policy space beyond the actual agreement.

3.2 Rules of origin (RoO)[33]

If the Rules of Origin (RoO) require the goods to be "wholly obtained" (no foreign input) in an FTA country, there are no benefits for third- country firms that export goods. However, the rules are only this strict for some agricultural products. As third countries often act as suppliers to FTA countries, they might gain "indirect market access" via value chains. With liberal rules, FTAs could limit the exclusion caused by FTAs and even benefit third-country firms.

From a technical perspective, the rules can easily be designed to be more inclusive towards third countries. The extent to which this is actually made possible in FTAs is a political choice, with different solutions for different agreements and products.
Third countries could also benefit as service suppliers to exporters in the FTA.

What are Rules of Origin (RoO) and why do they matter to trade?

Rules of Origin (RoO) are an integral part of every FTA. The rules decide the economic nationality of products and, since only goods produced in an FTA partner country are eligible for preferences, which goods will receive tariff concessions. Thus, RoO are necessary to prevent trade deflection – goods from third countries being transported via an FTA partner in order to pay lower duties.

Without RoO there would not, in theory, be any discriminatory effect of tariff cuts in FTAs. Let us take the example of countries A and B and B and C having an FTA, but not countries A and C. Then, if country C wants to export to country A, it can send its goods to country B and then on to country A to circumvent the tariffs of country A. In practice it may not always be easy as logistics and financial constraints might make such exports uncompetitive. Nevertheless, from a purely third-country perspective, FTAs should not have any RoO or, at least, they should be as liberal as possible. This, however, is not going to happen. If the FTA partners were to be open to the idea of an FTA without rules of origin, they may as well unilaterally open up to tariff-free imports from all countries.

Rules of Origin in the WTO

Preferential rules of origin are not regulated by the WTO. There have been attempts to harmonise the non-preferential RoO but they have failed as the issue has been viewed as being too controversial.

Rules of Origin in FTAs and their effects on third-country firms

For goods that are *wholly obtained* in an FTA partner country, i.e. goods that have been produced with no foreign input (mostly agricultural goods), discrimination can, of course, not be avoided. However, for most goods this is not the case as most goods require a degree of foreign input.

Rules of origin are formulated with the participating members of an FTA in mind. However, in the (common) case of a sector in one of the participating countries being dependent on suppliers in a third country, joined by global value chains (GVCs), it may well be that this country advocates rules that are beneficial to the third country for its own sake. Pure commercial logic might benefit third countries in some situations.

As a rule of thumb, the more liberal the rules, the better it is for third countries. The current EU trend is heading in this direction. "Liberal" in this sense means the rules should, to the greatest extent possible, permit sourcing from third-country firms. The purpose is to increase the potential of FTA partners producing goods competitively, using inputs from various sources, and still achieving origin and, therefore, tariff concessions. When the rules are strict and do not permit much third-country sourcing, this could lead to trade diversion. Let us take the case of country A exporting to country B with inputs from country C. Then countries A and B enter an FTA with strict RoO that do not allow for the continuation of these exports if preferences should be used. As a result, country A stops using inputs from country C and, instead, starts relying on less efficient domestic suppliers in order to benefit from the preferences. Thus, trade has been diverted away from country C, which has lost out. Such distortive effects are not only bad for third countries but also for FTA partners. In this case, country B imports a suboptimal product from country A (it would have been optimal if country A could have sourced freely). RoO should therefore strive to be non-distortive and to achieve this they need to be liberal.

In "RoO technical terms", being liberal can be achieved in a number of ways. To understand this, it is necessary to first understand how origin is conferred. The rules state that origin can only be conferred if a sufficient transformation of the goods has occurred in the partner country. This can be measured using three basic product-specific methods, or a combination of them.

The most common product-specific rule is the *value-added criterion*, which sets a percentage ceiling for the amount of non-originating inputs in goods for them to receive preferences under an FTA. It is not unusual for EU FTAs to allow an average of 50–70 % of non-originating inputs. The higher the threshold, the more third countries can enter the lower stages of the value chain and indirectly export to a country with which they have no FTA.

For goods for which another rule than the value-added criterion is used, third-country inputs can still be calculated as a part of the value. The *tolerance rule*, or the *de-minimis rule*, is a horizontal provision that gives a manufacturer the opportunity to use a minimal amount of non-originating content without affecting the origin of the goods. The limit is often set at around 10%. These rules mean that, as a minimum, all exported goods (except those that require wholly obtained) can have a 10% third country input as a minimum and still receive preferences.

The greater the percentage in the tolerance rule/value added rule and the more sectors/products it covers, the better, especially if the sectors covered are sectors in which third countries have a competitive production capacity and can respond to market opportunities.

The second product-specific method to confer origin is the *change of tariff classification rule.* This rule states that if the goods have received a new tariff classification in the FTA country, a substantial transformation has been achieved. It is possible to envisage opportunities here for third countries by administrating this rule at a very product-specific level (low HS number). By working at the 6-digit level, only very small transformations of goods are necessary to "turn them into other goods," i.e. changing the tariff classification. This fine detail in a rule could make the difference to certain kinds of production in third countries. If country C can produce goods, sends them to country B, which makes a minimal transformation and then sends them on to country B's FTA partner, country A, then country C might reap a large part of the value of the export of these goods, even if country C is outside the FTA[34].

Finally, product-specific rules might also focus on *special technical requirements*. For textiles, for example, there are various stages of production. The rule may state that two of the three steps must be carried out in the FTA partner country in order to confer origin. If, on the other hand, the rule states that only the last step must be carried out in the partner country, then new opportunities arise for third-country firms, lower down the value chain, to benefit as suppliers.

There are also some very specific RoO that can be relaxed in order to benefit third countries. An

example of this is the EU requirement in its FTAs that fish must be wholly obtained. This translates into meaning that the fish need to be caught with vessels registered in the FTA partner country and with a 50% crew or 50% ownership by the partner country in order to benefit from preferences. If reformed, vessels from third countries might benefit from the FTA.

Another non-product-specific rule that is relevant is the *principle of territoriality*. The principle stipulates that the production of goods must be carried out in its entirety in the FTA zone. However, some more modern EU trade agreements permit a small amount (around 10%) of the production process to be carried out in a third country (another territory)[35]. A more lenient approach to the principle of territoriality could facilitate regional value chains. Hence, the more tasks that can be located outside the FTA partner country, the better for third countries, but only some third countries.

Cumulation is also relevant in this context. Certain countries can, for example, be offered *extended cumulation* in which specified third-country products can be treated as if they had originated in the FTA partner country. This is used, for example, in the EU FTA with Vietnam (sourcing of textiles from South Korea)[36]. Extended cumulation is often conditional upon both FTA partners having an FTA with the third country. Hence, this is not an option for all third countries.

There is also *diagonal cumulation*, which is extended cumulation but with the added criteria that the rules have to be identical. The Pan-Euro-Med (PEM) zone of diagonal cumulation is a prime example, in which 60+ FTAs in PEM are linked to a single RoO protocol.

Another cumulation option is *regional cumulation*, such as in the EU GSP, for example, in which a regional group of countries makes up an accumulation zone. If, for example, in a future TTIP, Mexico is allowed diagonal cumulation, then Mexican firms will benefit from TTIP, as suppliers to the EU and US, even though Mexico is not part of TTIP. Countries that are not explicitly mentioned in the cumulation rules cannot benefit in the same way.

Rules of origin do not directly cover services inputs. This means that third- country firms could benefit from an FTA, even if the RoO are very strict, if they are able to deliver services inputs to the value chain. Considering the increasing value of services as a proportion of the production and export of goods, this could mean substantial business opportunities. For some sectors, almost half of the export value from the manufacturing sector is attributable to services inputs[37].

3.3 Trade defence instruments (TDI)

Most FTAs do not affect the use of trade defence measures. Nevertheless, when antidumping and countervailing measures are abolished/restrained within an FTA, the impact could theoretically be discriminatory to third countries. However, this must be seen in conjunction with provisions regarding competition. Then the effects on third countries are very uncertain and may even be beneficial.
As for global safeguards, abolishing them for FTA partners is discriminatory to third countries. However, introduction of intra-FTA safeguards might benefit third countries.

What are trade defence instruments and how do they affect trade?

TDI refers to antidumping, countervailing duties (CVD) and safeguards, all applied to "defend" a country from allegedly "unfair" trade practices in the form of dumped or subsidised imports, or extreme import surges. Whereas the first two instruments can only be used against specific countries after an investigation has shown that dumping or specific subsidies exist, safeguards need no specific justification other than an extreme import surge and are applied horizontally to all countries. There are also safeguards within FTAs that can be used as an "insurance" after having liberalised trade if imports from the FTA partner country grow too much and/or too fast.

The trade effects of TDI may be similar to the effect of a tariff but with an added unpredictability and a "chilling effect" on some trade, as traders hold back in fear of potential measures.

TDI in the WTO

Three WTO agreements regulate TDI. Firstly, there is the antidumping agreement and then there is the ASCM agreement (Agreement on Subsidies and Countervailing Measures), which

regulate both subsidies and countervailing duties. Finally, there is the safeguard agreement.

TDI in FTAs and their effects on third-country firms

It is uncommon in FTAs to formally agree to not use trade defence measures against each other. Only 7% of existing FTAs ban the use of intra-FTA antidumping measures and this mainly applies to countries that normally don't use antidumping against each other, in any case. Examples of such agreements are the European Economic Area (EEA), Australia-New Zealand and Canada-Chile. Another 3% of all FTAs include provisions that restrain the use of antidumping by imposing requirements that make it harder to impose the measures. Nevertheless, if FTAs continue to be increasingly ambitious it is possible that more agreements will include provisions banning intra-FTA trade defence measures[38].

From a free trade perspective, limiting the use of antidumping is a worthy aim. However, from the perspective of third countries it might theoretically be discriminatory. It could lead to a situation in which business practices that could be used in an FTA country cannot be used in a third country without risking antidumping. The chilling effect of the threat of antidumping, and the occasional duty imposed, can put third-country firms at a competitive disadvantage, forcing them not to lower their prices to any great extent. The same logic would apply to any agreement that limited the use of countervailing measures. All other things being equal, such provisions would allow FTA firms to be subsidised without risks – whereas, at the same time, third-country firms would be taking risks when they were subsidised[39].

There is a link between provisions regarding competition and trade defence in FTAs. If the use of trade defence is restricted in an FTA, it is the task of the competition authorities in the partner countries to cooperate more extensively to remedy any potential market-distorting activities. Such cooperation would then entail not only dumping and unfair subsidies driving the prices *down* but also the opposite, i.e. activities that artificially *increase* prices. For firms in FTA countries this might translate into less opportunities to engage in anticompetitive behaviour, whereas for third-country firms such restrictions would not apply. Thus, the FTA might lead to more market access for third-country firms than partner firms – although such access would come at the cost of engaging in commercial activities deemed illegal in FTA countries.

Thus, the effects of provisions on antidumping and countervailing in FTAs are highly uncertain and may be both discriminatory and beneficial to third countries. The effects regarding global safeguards are clearer, as this has nothing to do with unfair business practices. According to the WTO, global safeguards may not be used in a discriminatory manner. Nevertheless, a number of agreements, for example, NAFTA and ANZERTA (and the EU itself, being a regional trading block) have abolished the use of global safeguards for FTA partners. This means that the effects discriminate against third countries. A concrete example of this is when, in 2002, the US introduced steel safeguards against most countries in the world, but not NAFTA partners. This sudden tariff hike negatively impacted EU exporters of steel[40].

Then there is the case of the intra-FTA safeguard that many FTAs have. If exports from country A to B, FTA partners, increase at a level deemed unacceptable by A, then it might impose a safeguard (a tariff up to the level previously applied) as a brake to this development. Such a move could benefit third countries. However, this would only happen after trade had already surged between the FTA parties, possibly to the detriment of third countries. Also, imposing the safeguard has to do with protecting domestic industry and there could be other trade barriers that prevent third countries from using the intra-FTA safeguard to their advantage. Yet another aspect is the potentially chilling effect of risking a safeguard that may cause firms within the FTA to "voluntarily" reduce their exports. If this happens, it will lower the value of the FTA and reduce any potential discrimination against third countries.

3.4 Trade facilitation

Most trade facilitation provisions in FTAs are by nature non-discriminatory, i.e. they also benefit third countries. Examples of this are measures that focus on efficiency and transparency. However, some provisions are based on trust and cooperation between FTA partners, for example, AEO schemes, and can be discriminatory to third countries.

What is trade facilitation and how does it affect trade?

Trade facilitation is about reducing unnecessary inefficiencies at borders, related to the administrative procedures and information requirements involved in cross-border trade. These procedures can take place physically at the border or before the goods arrive but are nonetheless regarded as border measures. The procedures involve customs authorities and also other authorities, not least those carrying out sanitary and phytosanitary (SPS) inspections of food and agricultural products.

A whole range of measures can be taken in order to speed up and reduce costs related to border procedures – while still ensuring that the objectives of border control, such as ensuring correct revenue and that imported products are safe, are met. This includes, for example, enhanced information on border procedures, establishment of contact points, ensuring legal certainty (binding prior notification, right of appeal) and ensuring risk-based inspections (i.e. only focusing on consignments that are considered high risk based on several risk criteria). Also, better cooperation and coordination between national border agencies, or with border agencies of neighbouring countries, facilitates trade. This could, for example, entail joint inspections, coordinated opening hours and exchange of information[41].

Trade facilitation in the WTO

The above issues, and more, are addressed in the WTO Trade Facilitation Agreement (WTO TFA). The TFA, signed at the WTO ministerial meeting in Bali in 2013, entered into force in 2017. The TFA sets a minimum standard for customs and trade facilitation. According to the WTO, "full implementation of the agreement has the potential to reduce trade costs by an average of 14 %," which could lead to growth in global trade of approx. 3% extra annually[42]. This is considerably more than what would be achieved through eliminating all remaining tariffs in the world.

When it comes to SPS border controls (i.e. controls to ensure that plant pests, animal diseases and food safety risks are not spread through trade), the key principles are stipulated in the WTO SPS Agreement. These include applying risk-based controls, based on international standards and carried out without undue delay.

Trade facilitation provisions in FTAs and their effects on third- country firms

Most FTAs have provisions related to trade facilitation, often in a separate chapter, but also in the SPS chapter. In the coming years of Trade Facilitation Agreement (TFA) implementation, such chapters may include provisions that go even further than the TFA, i.e. covering more areas. They may also go beyond the TFA in the form of the inclusion of binding commitments in areas in which the TFA only includes non-binding provisions.

Trade facilitation measures could require infrastructure investments and institutional capacity building, i.e. IT systems and training staff at government agencies. Thus, TF provisions in FTAs may also involve technical and/or financial assistance .

Trade facilitation components in an FTA can be roughly divided into two groups: provisions that require cross-border cooperation and provisions that do not. As for the latter, which include most activities that focus on transparency, efficiency and legal certainty, these are beneficial not only to the contracting parties, but also to third countries. Legal and administrative reforms are costly and time consuming and it would seem irrational and wasteful to carry them out on a preferential basis. For example, preferential access to information and to contact points might be hard to administer. Even harder, not to say impossible, is preferential legal certainty.

Other measures are exclusive to the contracting partners. It is possible for partners in an FTA to agree on a lower frequency of inspections for consignments of certain products from each other, based on trust in each other's legislative and health-protection systems. This benefit then excludes third countries. For example, the application of so-called Authorised Economic Operator schemes (AEOs) that permit simplifications for trusted traders requires trust and cooperation between the parties. If an AEO scheme is part of an FTA this means that – based on mutual recognition of the other party's trusted trader scheme – firms from country A can become certified and then avoid certain controls when their products enter country B, and vice versa. These benefits do not extend to firms from country C. However, if goods from country C pass through country B as part of a value chain on their way to country A, it may benefit firms in country C. Hence, indirectly, depending on trade flows, it might also benefit third countries.

3.5 Cross-border public procurement

The effect on third countries of procurement provisions in FTAs depends on how the provisions are framed.
Price preferences for domestic firms can be reduced/removed in a discriminatory manner, only benefiting the FTA partner, or in a non-discriminatory manner, also benefiting third countries. The same applies to local content requirements. Increasing the number of procuring entities, goods and services covered and/or lowering the thresholds for procurement may also be conducted in a discriminatory manner, or not. Other reforms focus more on procurement processes and transparency and normally also benefit third-country firms.

Discriminatory procurement practices and how they affect trade

In some countries, government procurement is used as a tool to promote national industry and production, for example, through the stipulation of local content requirements or the use of financial incentives in the form of price preferences for domestic firms or products. This may be carried out at a central level or at a regional or municipal level and means that "value for taxpayer's money" takes second place to other, partially social concerns[43]. Such policies clearly discriminate against foreign suppliers in the procurement market and are therefore often questioned in FTA negotiations. Governments in all countries are often the largest buyers of goods and services. Thus, the procurement market offers great business opportunities. For countries that wish to gain access to other markets, procurement is therefore important.

Procurement in the WTO

Government procurement does not form part of the WTO Multilateral Framework. Instead, there is a plurilateral Government Procurement Agreement (GPA), meaning that not all WTO members are covered by the agreement. The aim of the GPA is to "mutually open government procurement markets among its parties for both goods and services". The agreement establishes rules that require open, fair and transparent conditions of competition to be ensured in government procurement for those sectors and those procuring entities in which countries have made commitments.

Procurement in FTAs and its effects on third-country firms

The GPA often serves as a base when negotiating FTAs, with regard to both market access and the provisions that regulate procurement procedures, especially between GPA members. In FTA negotiations with non-GPA partners, the EU generally strives for compliance with the principles of the GPA. In negotiations between GPA members, members usually strive for more far-reaching commitments (GPA+).

In respect of formal market access, this can be improved either by increasing the number of authorities or entities or by increasing the number and types of goods and services covered by the agreement in relation to the GPA. Another way is to lower the thresholds in relation to what

a party has committed to as a party to the GPA. In all cases, this means opening up a larger share of the national procurement market to foreign competition. What it means in terms of actual new market access depends on the specific regulations for each type of goods/service/authority or entity covered. Whether it benefits third countries depends on if this larger share is made available to the FTA partner only or to all countries.

One way of reducing discrimination against foreign participants in the procurement market is to relax local content requirements. This is achieved in US legislation by waiving the application of the Buy American provisions[44] to the products of GPA and FTA parties.[45] The US has also chosen to give access to Canadian suppliers to procurements normally requiring US content[46], by an agreement.[47] Also, in this case, relaxing this type of requirement may be undertaken generally and not just for firms or products originating from a GPA or FTA party.

In TTIP, government procurement was one of the most important areas of negotiation. In the unlikely event of a waiver to the EU in the Buy America legislation, this would only benefit the EU and no third countries. If "Buy American" was changed to "Buy Transatlantic", it would not result in any increased market access for third countries.

In order to increase the opportunities for foreign and domestic firms to compete on equal terms, reducing price preferences is another option[48]. This can only be done for bids from FTA parties or generally, regardless of the nationality of the bidder (or the origin of the products). The same applies to changing/lowering the thresholds for tenders, though it may be practically complex to administer a system with different thresholds for different countries.

The direction to choose in the above-mentioned cases is a political choice. It is a unilateral policy, not directly connected to an FTA, but which may be "locked in by an FTA" as a means of ensuring it cannot be changed, i.e. to cement the policy.

It should be emphasised that, according to the GPA, any GPA plus provisions should legally be extended to all other GPA members. Hence, there is no formal exception to the MFN principle. However, looking at the practice of the GPA parties, this principle tends to have a limited role when concluding FTAs[49], which means, in reality, it is a political choice.

It should be noted that the application of price preferences or local content requirements may be complex since cross-border procurement is sometimes difficult to establish. Not all cross-border procurement takes place using direct imports from a supplier in another country. There are also indirect forms of cross-border procurement, for example, when a domestic supplier uses foreign sub-contractors and/or foreign products (including foreign inputs) to supply the government. Trade and production often takes place in global or regional value chains and firms are often connected to firms in other countries.[50]

Then there are procedural issues. The negotiation of government procurement chapters in FTAs may require substantial reforms to the procurement legislation and practices of the FTA parties, for example, transparency requirements such as notification/publication of upcoming tenders or transparent procedures. Transparency in the procurement procedure reduces corruption and the discretion of the procuring entity to unlawfully favour domestic suppliers or products. Greater transparency and the publication of calls for tenders increase the possibilities of foreign suppliers finding business opportunities in other countries. Measures to increase transparency can be undertaken either by including transparency provisions in FTAs that relate to procurements only covered by these agreements, and/or by increasing transparency more generally by reforming the procurement legislation and system. For practical reasons, these measures have the potential to be implemented more generally and could therefore benefit third countries, providing they have market access in the first place. Generally, it is a political decision and is to be seen as a unilateral measure, but one which can be locked into an FTA.

3.6 Cross-border services (entering the market)

Provisions regarding market access for services can be both discriminatory and non-discriminatory. In most cases, such provisions are applied on a non-discriminatory basis, benefiting firms from FTA countries and third countries alike.
In terms of real new market access, there is often not much in FTAs. FTAs mostly increase predictability only, meaning the discriminatory impact is minimal for third countries.
The discriminatory effects of service liberalisation in FTAs may, in some cases, be alleviated by introducing MFN clauses in FTAs.

This text mainly refers to mode 1 according to the terminology of the General Agreement on Trade in Services (GATS). Mode 3 is addressed in the establishment and mode 4 in the chapter on temporary movement of natural persons. Mode 2 has not been analysed in this paper as there are few trade barriers for this kind of service delivery.

Services trade restrictions and how they affect trade

Barriers for services trade are very multifaceted and can take many forms[51]. In the simplest terms, some barriers are applied at the border (entry requirements for market access and national treatment, corresponding to GATS Articles XVI and XVII) and others behind the border. Here, we discuss the barriers that are applied at the border, which means most of the services provisions in FTAs. Whereas, restrictions behind the border are discussed in Chapter 4 together with behind-the- border restrictions on goods.

Restrictions to trade in services also affect trade in goods as the two are increasingly interlinked.

Services trade in the WTO

For a services sector to be considered completely open, i.e. full *market access*, there cannot, according to GATS, be any restrictions placed on market access and national treatment.

Market access means restrictions concerning:

- Number of service suppliers
- Value of service transactions or assets
- Number of operations of quantity/output
- Number of natural persons supplying a service
- Type of legal entity or joint venture (restrictions on forms of ownership, or forms of cooperation between firms)
- Barriers to participation of foreign capital

The purpose of many of the above-mentioned barriers could be to protect firms from competition by using numerical restrictions (quotas) to limit the opportunities for competitors to enter a market and compete on a level playing field. They are protectionist and also attempt to restrict competition *within* a country to the benefit of firms already established[52]. However, these restrictions often serve other purposes. Examples of this include limited market access for foreign gambling firms (social reasons) or music quotas for radio (cultural diversity).

These six numerical restrictions may be administered discriminatively or in an origin-neutral manner. Most restrictions are discriminative. For example, there could be a restriction on the number of transactions that a foreign firm may make.

There are also other forms of potential discrimination against foreign firms and all these other forms are considered to fall under the heading *national treatment*. National treatment concerns discrimination between domestic and foreign firms. Examples of a lack of national treatment include different taxes/fees for different firms depending on their nationality, different educational requirements for staff, based on nationality of the firm or different licenses required for firms depending on their national origin. Basically, anything that is discriminatory that does not fall under any of the six quotas above has to do with a lack of national treatment.

All numerical restrictions and discriminatory regulations have to be eliminated for the market to be considered fully open.

Services trade in FTAs and the effects on third-country firms

Within an FTA the partners can agree to a GATS-plus arrangement in which broader and stronger commitments are made to apply no restrictions. This is commonly listed in the annex to the FTA, subsector by subsector, mode by mode. These commitments might then result in a real liberalisation of the markets or they could just lead to increased predictability, as the partners voluntarily reduce their policy space to introduce such barriers. This is referred to as "binding water" in GATS.

To what extent do FTAs actually contribute to greater liberalisation and not just to "binding water"? The EU and US primarily bind water, whereas FTAs that involve developing countries can more often include a degree of new liberalisation[53]. However, most services sector liberalisation is usually unilateral in nature in all countries. Thus, services in FTAs should primarily be seen not as a way of opening markets, but as a way of keeping them open.

Better and more secure access to the services markets may, in principle, benefit all firms, from both the FTA partners and any other country. If market access provisions are not geared to foreign firms, but to all firms, this means any commitment will automatically benefit any firm interested in entering the market. This means

domestic firms, partner-country firms and third-country firms. It liberalises the market in a non-discriminatory manner. In practice, this often leads to foreign firms being able to access markets that were previously under more "domestic control" as the restrictions *de facto* served incumbents. There is no difference in principle between foreign firms from the FTA partner and third countries, save for the fact that third countries cannot legally rely on the agreement.

It might generally be too burdensome from an administrative point of view for governments to discriminate against service providers, depending on the nationality of the firm[54]. For example, administering a system in which two firms in the same sector operate under different regimes – one having a sales quota and the other one not – is difficult to envision. Thus, "rules of origin" for services is, to some degree, a concept with little real meaning as it is very hard to enforce such rules in any practical way.

However, there are exceptions to this general rule. All six quotas discussed above *might* technically be liberalised in a manner that does not benefit third countries. This would mean firms from the partner country being allowed into the market on the same conditions that apply to domestic firms, whereas third-country firms would not receive the same right. This can be explained by the existence of some sensitive sector-specific restrictions. In the railway and maritime sectors, transit rights or docking rights can be denied or restricted. This can serve pure protectionist purposes, but there may also be national security reasons. Ports are vital security checkpoints. To the extent that these issues are dealt with in FTAs, the restrictions could be reformed or deleted. This could be undertaken for FTA partner firms or for all firms and it consequently depends on whether or not this benefits third countries. As in many other cases, it has to do with the level of trust between the parties.

An example from the EU can be used. In the EU the competence to regulate transport quotas lies with the member states. They may not impose quotas against each other but may do so against third countries. For example, Italy cannot limit the number of German trucks driving on its highways but it can limit the number of Turkish trucks. The same applies to audio-visual quotas in the media market.

Nevertheless, according to the OECD "the preferential margin of services provisions in FTAs are quite thin: members and non-members both see slightly lower trade costs when an RTA is signed". The OECD also concludes that "regionalism in the case of services seems relatively non-discriminatory and does not lead to substantial trade preferences".[55] There are two reasons for this. Firstly, as mentioned above, a relatively small amount of services liberalisation actually takes place in FTAs. Secondly, to the extent that there is real liberalisation it is often designed in a way that is beneficial to any services firm interested in entering the market, including third-country firms.

Similar to tariffs, there is also the possibility of including MFN provisions in an FTA, thereby benefiting from future FTAs that the partner country might conclude. Assume countries A and B enter into an FTA with an MFN clause for market access to services. Then country A enters into another FTA with country C, with more far-reaching provisions for services. This new market access will then also be automatically extended to country B. As a result, firms in country B might be given better market access to country C even if their country has no FTA with country C. An example of this is when South Korea received better market access to Canada as a result of Canada opening its market to the EU in the CETA-agreement[56].

3.7 Establishment

As a general rule, as long as foreign investors are willing to invest in a country and they comply with the rules and regulations, it is unusual to discriminate against any source of capital. "Rules of origin" for establishment normally make little sense from an economic point of view. Hence, establishment provisions in FTAs are normally applied on a non-discriminatory basis. However, exceptions to this exist and include, for example, discriminatory screening mechanisms and local content requirements.
As with cross-border services trade, many FTAs do not open new markets but only serve to increase predictability.

Establishment restrictions and their effects

Broadly speaking, firms either establish themselves in foreign markets to gain access to resources, land, raw materials, etc., or to gain

access to production facilities, labour and technology. Alternatively, they are interested in access to consumers, or any combination of the previous. From an economic point of view, the value of investment flows and the value of sales abroad by foreign affiliates are considerably larger than the current value of trade flows[57]. At the same time, trade and establishment are mainly not substitutes but complement each other, and many firms are involved in both.

Active establishment[58] by a firm in a foreign country can take many forms. It may be a foreign direct investment (FDI), i.e. an investment made by a company or entity based in one country in a company or entity based in another country. The establishment may take the form of an affiliate, a branch, a representative or a sales office. Establishment encompasses both investments into existing facilities, so-called brown field investments, and entirely new investments, so-called green field investments.

Establishment, investing in a foreign country, is regulated both pre- and post-entry. The pre-entry part concerns *the right to invest* (i.e. market access and national treatment). The post-entry part concerns *the legal conditions* for a foreign firm once it is already established. The latter is discussed in Chapter 4.2 and 4.4. Other issues related to the conditions for establishment, such as taxes. etc, have not been addressed at all.

Sometimes the incentive for establishment may lie in traditional trade protectionism, i.e. when it is hard to export to a country. One way of "circumventing" the barriers could be to establish production in the market instead.

Establishment and the WTO

Establishment is covered in the GATS agreement, as mode 3. Since the purpose of most types of establishment is to provide services to the host market, this is important, although there is no overarching WTO establishment-agreement, i.e. nothing that also covers investment in sectors other than services.

The WTO Agreement on Trade-Related Investment Measures (*TRIMs*) covers only certain measures related to trade in goods. TRIMS bans WTO-countries from requiring local content in foreign operated plants and also prohibits a number of other restrictive measures. However, there are greater opportunities for developing countries to use such measures.

Establishment provisions in FTAs and their effects on third-country investors

Provisions regarding establishment are often found in FTAs. For services, establishment (mode 3 GATS) has long been part of FTAs. Market access, defined with the same six conditions as above for mode 1 services, and national treatment, are key criteria. For goods (both manufacturing, extractive industries and agriculture) this is a somewhat more recent phenomenon, at least for the EU.

The provisions mostly serve to underpin already strong global support for foreign establishment. In general, establishment is seen as positive by most governments of the world, which can be demonstrated by the increasingly welcoming policies that most countries have to attract foreign investment[59].

As with services trade mode 1, discussed above, the main contribution of FTAs in this area is not new market access, but "reducing water", i.e. FTAs serve to increase predictability for firms by binding present levels of investment openness.

Examples of restrictions for establishment include outright bans in some sectors for foreign investments. There can also be restrictions on foreign ownership or requirements to engage in a joint venture with a domestic firm. Furthermore, screening or approval mechanisms may be necessary before establishment can take place.

Also, limitations might be placed on capital repatriation, i.e. requirements to reinvest a proportion of profits in the host country economy. There are also limitations when it comes to the right of foreign firms to own assets (land, real estate, vehicles, vessels) or related to renting, chartering, lending and leasing assets.

There might also be so-called *performance requirements*, for example, related to local content requirements. This may include requirements for investors to set up R&D facilities or to source locally as a condition of being granted the right to invest.

What all these regulations have in common is that, as a part of an FTA, they can be reformed or removed. Changes in the laws governing investments may benefit all countries or only some. For example, regulations regarding requirements for joint ventures might be eliminated for all countries or only for partner countries. Changes in the level of capital involved in an investment to warrant a screening could be changed, for all

countries or only FTA partners, as is the case in ANZERTA[60].

Requirements for local contents may be reformed according to the same dichotomy. Such requirements can be liberalised/abolished by including language reaffirming TRIMS provisions in the FTA or by strengthening them for developing countries, which have some exemptions in TRIMS, or to also include services[61]. An FTA could change local content to "local or FTA partner content" or it could abolish local content requirements completely. The latter would benefit third countries, whereas the first option would be discriminatory.

The discussion above comes down to political choices. To some extent, the choice depends on the level of trust needed for some reforms. For example, capital controls may be eased on a non-discriminatory basis or screening might be used against third countries but not against trusted FTA partners (discriminatory). Consequently, it depends whether or not this benefits third countries.

With regard to attracting foreign direct investments, it seems most countries prefer to have general regulations, not country-specific regulations. The national interest primarily lies in attracting foreign capital, know how, technology etc., and not in the national source of all this. Hence, to the extent this is regulated in FTAs, it is generally beneficial to third- country investors. Also, similarly to services mode 1, it might often be too burdensome from an administrative point of view for governments to discriminate against foreign services providers. However, there are also countries – like China – where distinctions are made between investors from FTA partner countries and third countries in respect of the conditions for their investments.

The effects of any changes on third-country investors depend on whether there are real changes in the laws governing establishment or if it is only about reducing policy space in order for the government to enact laws that deter investment. FTAs might guarantee that the prevailing openness towards investors from FTA partners is not reduced. This can be seen as an insurance and, as always, it is hard to measure the value of insurance until it is used. In the case of countries A and B having an FTA and country A deciding to introduce restrictions on foreign establishment, this might impact investors from third country C, but not from country B. Thus, the lack of insurance will impact investors from country C.

An FTA which opens up the investment regime relatively more than it opens the trade regime can give third-country multinationals much greater opportunities than third-country SMEs. However, multinationals may also be negatively affected by policies that steer investments in a certain direction as they provide incentives for them to do things they would otherwise not do.

3.8 Temporary movement of natural persons (mode 4)

Some provisions in this area are possible to liberalise in a non-discriminatory manner, although this policy area is often very sensitive to the origin of the labour. For example, provisions regarding qualifications and visa procedures are normally based on trust between FTA partners and tend not to benefit third countries. On the other hand, provisions are usually not far reaching and are therefore not so discriminatory in practice.
As with other service provisions, most FTAs serve only to increase predictability in this area.

Restrictions on mode 4 and their effects on trade

The temporary movement of natural persons is GATS terminology (GATS mode 4) and refers to people coming for a limited amount of time to deliver a service. It covers natural persons who are either service suppliers (such as independent professionals) or who work for a service supplier and who visit another country to supply a service[62]. It does not concern persons seeking access to the employment market in the host member country, nor does it affect measures regarding citizenship, residence or employment on a permanent basis.

A high volume of trade could not be carried out without the possibility for firms to send experts to work in other markets. For example, many goods are intrinsically linked to technical consultancy services and barriers to the movement of professionals also become barriers for trade in goods and services[63].

Mode 4 and WTO

All countries have laws that restrict the temporary movement of natural persons. There are a

range of politically-sensitive issues related to migration, border controls and the labour market. Most countries have limited commitments in GATS regarding mode 4 as they wish to retain policy space to adjust their policy in this area. The provisions only cover a limited number of services suppliers.

Mode 4 provisions in FTAs and their effects on third-country firms and nationals

Laws restricting non-citizens or non-residents from performing certain jobs, for example, by means of labour market tests, may be liberalised or made more predictable in some cases and perhaps deleted in other cases. The same applies to laws that make it mandatory to be a member of a professional body – for example, a bar association – to practice an occupation and then not permit membership to foreigners, effectively shutting them out of the market. When reforming this within an FTA it might only be discriminatory to the FTA partner or it might be a more general policy, which benefits all countries. It should be mentioned that these reforms could also be carried out as a commitment in GATS.

Visa issues can also be addressed in FTAs[64] insofar as they focus on time, cost and number of documents, i.e. procedural hurdles. The process of obtaining a visa can often be simplified. Within an FTA, visa-related provisions will normally only confer benefits on the FTA partner as it is very much based on trust between the parties to the agreement. However, as a unilateral add-on, any simplification of the procedures might also benefit third countries.

Another complex issue is the acceptance of foreign diplomas and qualifications. This is not an issue that can be deleted, nor can it even be deregulated, without compromising vital safety or quality objectives. Instead, based on trust between the partners, within an FTA, a framework can be established to negotiate multilateral recognition agreements (MRA). Once such an agreement has been negotiated, it provides procedures that permit the partners to recognise each other's academic and vocational qualifications. This will normally only benefit the partner countries. It requires a high level of administrative capacity and trust amongst the parties. According to GATS, third countries should have the right to enter into negotiations to join the MRA. However, such trust, already difficult to establish between FTA partners, does not normally extend to third countries.[65] For developing countries in particular, this is a problem as both the trust and the administrative capacity may be lacking.

One way for dealing with foreign qualifications is to establish some form of administrative cooperation, such as the EU Internal Market Information System (IMI) scheme[66], to enable relevant government agencies within an FTA to work together to provide information to each other about issues related to diplomas and qualifications. This will not benefit third countries.

4 Behind the border

4.1 Intellectual Property Rights (IPR)

IPR provisions in FTAs might serve the interests of firms from developed third counties whereas firms from developing third countries could, in some cases, lose their competitive advantage if they have based their business models on less strict IPR rules. This is regardless of actual membership of an FTA. In some cases, developed third countries could potentially benefit more from IPR in an FTA than developing countries that are actually parties to the agreement.

What are IPR and how do they affect trade and investments?

Intellectual property rights (IPR) comprise a number of different legal instruments to incentivise creation and innovation, such as patents, trademarks and copyrights. IPR are like a kind of investment protection in which society protects the investment made in order to spur technical and cultural progress. With a time-limited monopoly, the owner of the right can commercialise it before others are able to copy it. Without IPR, innovation would be severely stymied. However, in the case of IPR that are too strong, the temporary monopoly will hinder competition. Thus, there is a need for balance and this applies both between different interests within a country and between countries. The lack of inadequate protection on IPR can be a disincentive to trade and investment, while at the same time IP protection can be used to restrict trade.

IPR in the WTO

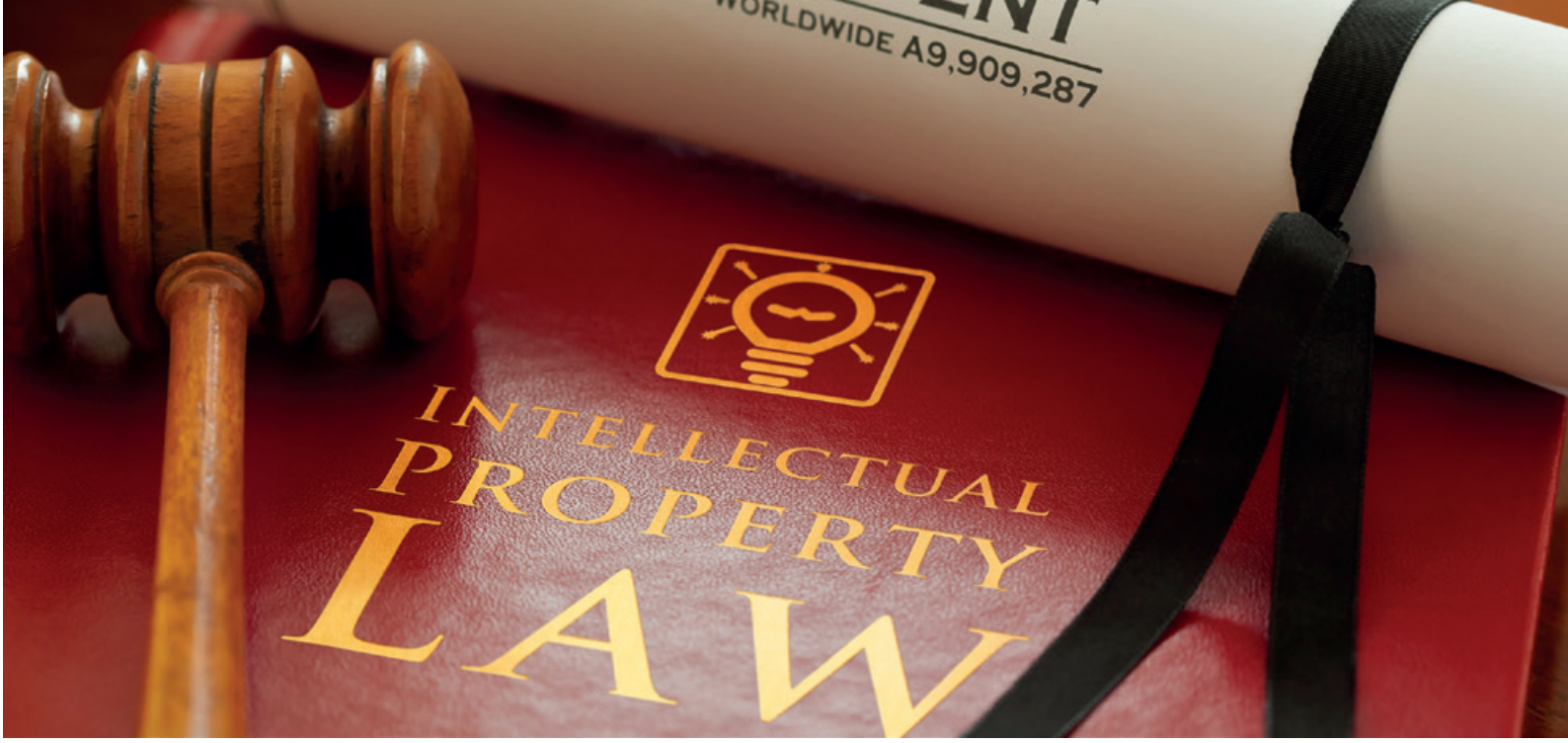
In the WTO, IPR are regulated in one of the three main agreements, TRIPS (Trade Related Intellectual Property Rights). TRIPS establish minimum levels of IPR for all WTO member states, with exemptions and flexibility for the poorest countries. TRIPS protect copyright and related rights, trademarks, geographical indications, industrial designs, patents, layout designs of integrated circuits, undisclosed information and more. The agreement also contains a number of provisions on enforcement of IPRs, including provisions on civil and administrative procedures and remedies, criminal procedures and border measures by customs authorities.

IPR in FTAs and their effects on third-country firms

Intellectual property rights (IPR) are often addressed in FTAs. The provisions are then usually based on the TRIPS agreement.

When one of the FTA partners is a developing country, the provisions may just reaffirm TRIPS. The provisions usually then focus on persuading developing countries to strengthen their IPR laws and enforcement in order to be more closely aligned with the legislation and levels that are applied in developed countries, while taking into account the need to balance IPR against other vital policies.

The provisions may also go beyond TRIPS, as is the case in agreements involving more developed countries. The ambition of the EU, for example, is to reach the same ambitious levels of protection as is the case in the EU. The US pursues the



same ambition in its FTAs. In reality, this often means that the partners should accept a number of new WIPO conventions[67], prolong copyright times, allow for patent term extensions and/or protect the test data of pharmaceutical companies as an exclusive right.

TRIPS contains an MFN clause stipulating that IPR protection cannot be discriminatory, i.e. any advantage, favour, privilege, etc., shall be extended to any other WTO member country. Unlike the case for GATT and GATS, there is no formal exception for FTAs[68] Thus, if covered by TRIPS, a number of the TRIPS plus provisions in FTAs may have to be extended to other WTO members. This is, however, subject to a degree of legal uncertainty[69].

Interestingly, this non-discrimination might leave some firms worse off. If a firm bases its business model on non-adherence to strict IPR standards, then it may not be in the interest of that firm if standards rise. Suppose, for example, there is a less stringent IPR regime with minimum IPR standards or a relatively low level of enforcement in country A and firms in country C benefit from this when exporting goods. Then country A enters into an FTA with an advanced economy, country B and, as a result, IPR in country A are strengthened. When exporting to country A, firms in country C now face "protection" they never sought and from which they do not benefit. It may make them less competitive or it may even deny market access for their products altogether. At the same time firms in country B might benefit from less competition from firms in country C. India, being a country with extensive exports of generic medicines to many developing countries, is an example of a country that could hypothetically be negatively affected by these kinds of measures.

The EU has a strong offensive interest in advancing its own system of Geographical Indications (GIs) in its FTAs. This system goes beyond what is required in TRIPS. If the EU is successful, it may negatively impact third countries. If, for example, feta cheese can only be sold in the US if it comes from Greece, then third country exporters of feta cheese would lose out. They would still be able to access the market with their feta cheese but under a different name, which may make them less competitive. On the other hand, if a country sets up a GI register it may benefit third-country firms if they are allowed to register products that were previously unprotected.

It may be that the FTA partner will lose out from applying stricter IPR standards whereas the third country will benefit from such reforms, even if it is not party to the agreement. This might then be a case of a third country benefiting more from an FTA than some of the parties to the agreement. In the case of TPP it is likely that EU firms would have benefited more from the IPR provisions, in the sense of increasing exports, than, for example, the TPP members Vietnam or Peru[70].

The conclusion could be drawn that IPR provisions in FTAs mostly serve the interests of countries which are "IPR-rich", i.e. advanced economies. FTAs might then be detrimental (from a market-access perspective) to firms from developing countries that are not parties to the FTA, at least in the short to medium term, as long as they are not innovative enough to benefit from robust

IPR. The effects on firms from developed third countries might be positive. For such firms, IPR provisions in an FTA might result in positive spillovers. Thus, the effects of IPR in FTAs have more to do with the stage of development of a country and less to do with membership of a FTA.

4.2 Protecting investments

Investment protection protects investors covered by the agreements but not investors from third countries, whose investments might therefore be relatively riskier. However, mailbox companies may sometimes provide a way for third countries to achieve the same levels of protection.

What is investment protection and how does it affect trade?

Global investment flows are several times larger than global trade flows and selling to foreign customers by establishing a presence in another country is, for many countries, commercially more important than exporting from the home country[71]. However, firms/persons investing in foreign countries need to have their assets protected from discrimination and expropriation. If investors are worried that their potential investments in a country are unsafe, this naturally reduces their incentive to establish themselves abroad. The legal uncertainty then acts as an investment barrier, with the same effect as certain trade barriers.

Investment protection in the WTO

There is no agreement or system in the WTO to protect investments directly. Indirectly, investors may claim their right by using the WTO dispute settlement system, although it depends on the goodwill of their respective governments if they wish to proceed with a case. Negotiations to establish a multilateral agreement to protect investments have failed.

How investment protection is addressed in FTAs and its effects on third countries

There is a high number of so-called BITs (*Bilateral Investment Treaties*) in the world. These agreements protect establishment by nationals and companies of one state in another state. BITs[72] usually contain provisions on fair and equitable treatment, protection from expropriation without compensation, free transfer of means and full protection and security of assets. These kinds of agreements can be made part of FTAs and this has been the strategy of the EU, for example.

BITs normally permit an alternative dispute resolution mechanism, whereby an investor whose rights under the BIT have been violated could have recourse to international arbitration, rather than suing the host state in its own courts. This process is called investor-state dispute settlement (ISDS). The EU has launched a reformed version of ISDS, called the Investment Court System (ICS)[73].

If country A has an FTA with country B which contains investment protection, how does this affect potential investors from country C? Firms from country B receive legal protection in country A that their competitors from country C do not receive, thus lowering their business risks and providing them with more secure market access. Firms from country C lack the same right of legal recourse and therefore face a riskier market. However, firms in country C might still benefit from the agreement by establishing a mailbox company in country B[74].

As is the case for tariffs and cross-border services trade, the establishment chapter may also contain provisions for MFN treatment related to future FTAs. This means that if countries A and B form an agreement and a future FTA partner to country A receives better investment protection than country B received, then country B will automatically be "upgraded" to this higher level by importing legal articles to the agreement between countries A and B. The precise legal ramifications of this, including what it actually covers and how to determine whether a certain protection level is better than another, are unclear, to say the least, and have been the subject of many legal disputes[75]. However, in principle, it means that investors from a country may receive better investment protection from an FTA to which their country is not a member.

4.3 Distorted competition

Some FTA provisions that address distorted competition, including those related to subsidies and competition may, by their very nature, be third-country friendly. Other provisions, regarding SOEs, may partially not benefit third countries. Overall, provisions in this area aim to make an economy more market oriented and benefit third countries, even if they cannot legally claim any rights under the agreement. However, the provisions in these areas are generally rather weak, meaning their effects might be limited.

What is distorted competition and how could it affect trade?

Subsidies[76] or poor competition laws, or the enforcement of such laws, as well as the prevalence of large state-owned enterprises (SOEs), can distort free and fair competition. Free and fair competition may be jeopardised in a market in which some firms are subsidised and others are not, or in which some firms could establish private oligopolies/monopolies and abuse their market power without the government intervening. Large state-owned firms, with or without a monopoly, can – unless they are operating under market conditions – make competition impossible. All of this may be a political choice for various domestic reasons but there is a trade dimension insofar as it makes access to a market harder and competition in that market unfair.

These issues are regulated in different FTA chapters but, as they all deal with various market-distorting instruments, they have all been discussed under a joint heading in this analysis. Three sub headings analyse these issues one by one.

Distorted competition in the WTO

None of these areas are strictly regulated by the WTO, hence the logic of including them in FTAs. Whereas competition is not covered by the WTO at all, and SOEs are only addressed to a limited extent (in GATT), the WTO ASCM agreement (Agreement on Subsidies and Countervailing measures) covers subsidies. Also, GATS have provisions related to subsidies. However, the WTO agreements cover only sector-specific subsidies. Any subsidy that is deemed horizontal[77], i.e. affecting all businesses in the same way, is therefore WTO-compatible. Some horizontal subsidies have no effect on trade, or may even have a positive effect[78], whereas others may constitute vast trade-distorting schemes, such as fossil fuel subsidies and providing natural resources at a subsidised rate.

How distorted competition is addressed in FTAs and its effects on third-country firms

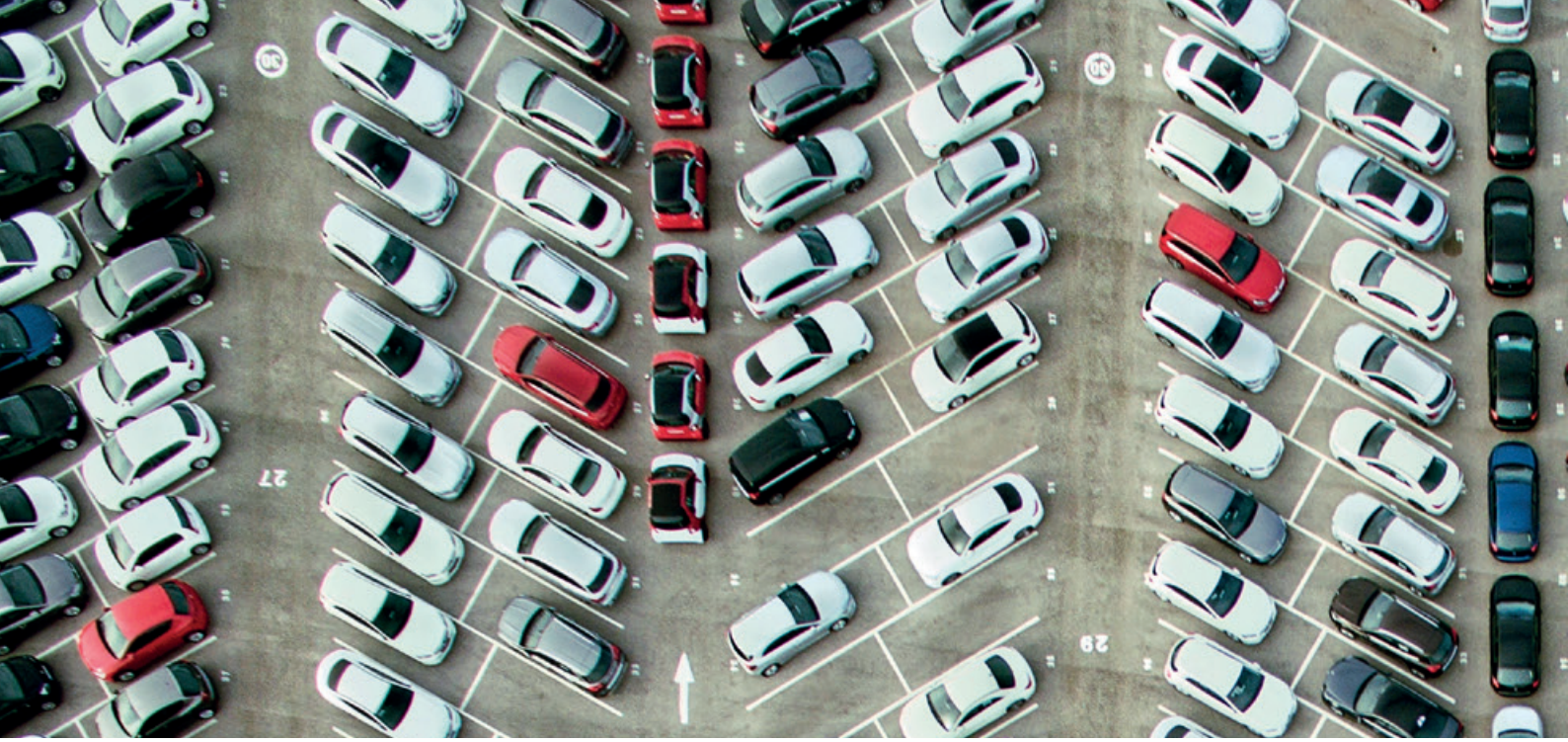
Subsidies

To address trade frictions that arise from trade-distorting subsidies, ASCM plus provisions could be included in an FTA. Normally such provisions aim to increase transparency regarding subsidies. Further information regarding the existing subsidy schemes and who benefits from them could be provided. In most cases, the level of ambition is still low. This, in turn, means that the effects of the ASCM plus provisions will be minimal, for both the FTA partners and third countries. If transparency is exclusive to the FTA partner (for example, a notification system or government agencies providing each other with information) then the effect on third countries will be discriminatory, whereas if transparency is open (published on websites, for example), it will be positive.

It is possible to go further than simply increasing transparency. One option could be to reduce the policy space for subsidies by banning/phasing out further subsidies, also purportedly horizontal subsidies. If the affected subsidies really are distorting trade, then the effect of this would be positive for FTA partners and third countries alike as subsidies cannot be abolished for certain countries only[79]. They have no "geographic target", so if a trade-distorting subsidy is restricted this will benefit all foreign firms that compete with domestic firms in that sector.

State-Owned Enterprises

Some FTAs attempt to restrain the direct role of state-owned enterprises in the economy. Provisions to restrict how SOEs can act could take two forms. Firstly, they may reduce the options of SOEs to operate abroad, i.e. reducing their ability to use their government support to compete abroad with an unfair advantage[80]. Such restrictions on the right to operate abroad may apply only in the FTA partner's own market, to protect it from distorted competition, or in all foreign



markets. The provisions will benefit third countries if they apply to all foreign markets. They may also benefit third countries if they make it easier for their firms to compete in a market otherwise contested by foreign SOEs.

Secondly, and more commonly, they may aim to reduce the role of SOEs in their own home market, in which case, with a more market-oriented economy, this might affect third countries positively. Trade could become fairer, in the sense of being free from government support. There could be new opportunities for private-sector firms, regardless of their origin. However, such reforms can be crafted in a discriminatory manner. There could, for example, be shortlists stipulating which firms are allowed to deliver goods and services to SOEs and under which conditions. Such lists could be amended to accommodate firms from the FTA partner country but not from third countries. The result would then be a more market-oriented economy, but with discriminatory market access to the SOEs.

Government monopoly or government ownership of major firms that compete with private firms causes either a no entry zone for private firms or may cause an uneven playing field. Any breaking up or privatisation of such monopolies/firms will, if national treatment is allowed, benefit all firms regardless of nationality. However, it is possible to permit only domestic firms, or domestic firms and FTA partner firms, to operate in the new marketplace. If such a policy is enacted, the FTA will fail to confer benefits on third countries. This is discussed in chapter 3.7 of the report.

Competition law

There could be exemptions from competition law that result in unlawful cartels or market abuse by private monopolies/oligopolies. This could create an uneven playing field. The solution would be to strengthen competition law and/or its application. By doing so, all firms, regardless of nationality, would be affected in the same way. Competition law is, by its nature, very hard to reform in a discriminatory manner. However, such provisions, at least in the EU's FTAs, are normally limited to notification of potential problems and opportunities for cooperation and are not enforceable. Thus, the actual effects might be limited.

This issue should also, to some extent, be understood in relation to TDI provisions in an agreement, see chapter 3.3 of the paper.

4.4 National regulations affecting trade and establishment (goods and services)

We now turn to the most complex but also probably the most potentially valuable part of modern FTAs: addressing regulatory trade barriers. This is discussed in a very broad sense, covering both goods, including TBT (Technical Barriers to Trade) and SPS (Sanitary and Phytosanitary measures), as well as services. The exact regulatory trade barriers and the instruments used to address them differ markedly between goods

and services although, conceptually, the problems and solutions are largely the same. Thus, even if they are addressed in various chapters in FTAs and normally not considered jointly, for the purpose of this paper they will be analysed jointly.

What are the regulations and how do they affect international trade?

All modern, developed countries have a multitude of domestic regulations and government agencies that regulate various aspects of the functioning of a market economy. Most of the regulations have nothing to do with trade but many of them still have a direct or indirect impact on trade. In this chapter we will deal with the regulations that are generally recognised as having an obvious effect on trade. For goods, this includes productspecific regulations and horizontal regulations that have the purpose of protecting health or the environment in the importing country. For services, they are broader as it is often harder to distinguish services from service providers, plus the fact that services regulations are often in place for more social goals. As a result, issues relating not only to the service but also the production of the service are of significance[81].

As far as goods are concerned, trade agreements usually follow the WTO dichotomy into TBT and SPS issues. For TBT, product requirements comprise technical regulations, standards and conformity assessment procedures. The measures are primarily prepared, adopted and implemented based on various legitimate policy objectives, such as safety, consumer protection or environmental protection. In respect of SPS measures, the aim is to prevent the spread of pests, diseases or food-borne risk that affects human, animal or plant health, or the environment, in the importing country. Example of measures that are considered to be SPS measures include risk analysis, approval procedures, border control and inspection, health certificate requirements and requirements for treatments or packaging, etc.

TBT and SPS measures are justifiable and not considered protectionist as long as they follow WTO principles, laid down in the TBT Agreement and the SPS Agreements. For SPS, a key principle is that measures shall be based on international standards and risk analysis, in accordance with scientific principles. For TBT, a key principle is that regulatory measures shall, as far as possible, be based on international standards and conformity assessment schemes as a means of facilitating trade.

Nevertheless, TBT or SPS regulations may result in barriers to trade if the regulations or application of the regulations violate WTO law or if they are applied in a way that results in unnecessary costs and inefficiencies for trading firms. The aim should be to achieve the desired level of protection in the least trade restrictive way possible.

Regarding services, many regulations that affect services trade are related to post-entry requirements, i.e. they have less to do with market access (including anything from quality standards for auditing to solvency rules for banks). These are “conduct regulations”, which aim to ensure the safety, reliability, compatibility,

etc., of services that have nothing to do with formal market access but are regulated behind the border for reasons not related to trade, but which can still potentially affect trade. Services are regulated by laws, regulations, procedures or administrative measures by authorities and governments at a national, regional and even local level.

Countries may choose to reform services markets within the context of a trade agreement, which then limits opportunities for national policy makers to backtrack on the reform[82]. The purpose is to "lock in" new domestic policies and procedures. When this is the case, assuming third- country firms have market access, then non-discriminatory services reforms will also benefit firms from countries outside the FTA.

High standards and demanding performance requirements are normally not altered solely to accommodate trade. However, if they are altered, this affects the market access of all firms equally, assuming they have the same capacity to fulfil the requirements. It is seldom that national "rules of origin" can be applied here.

Generally, it is often beneficial for a country to have regulations that are similar to those in other countries. One way of thinking about this is to consider network externalities. The more people use the same product, the better off a firm will be, as is the case with Windows versus Mac computer operating systems. The value of using an operations system for an individual user increases with the number of other users using the same system. And any firm that is internationally active is better off with multiple countries having the same set of regulations as its own country[83].

Thus, when regulations are *specific* to each country it is hard for firms to reap economies of scale and creates new entry costs and adaptation costs for each new market. Instead of paying once for the adaptation of a product, and viewing this as an investment, is has to be repeated several times. This has been identified in many studies[84]. This is often a greater problem for firms that export services rather than goods because, to some extent, they need to work *within* the country to which they are selling (mode 3 and 4). The issue can be handled in various ways, depending on the specific situation in a sector.

There are several ways to reduce the trade impact of national regulations. For goods, this is much more advanced than for services although, conceptually, the problems are much the same and the potential solutions and their effects on third countries are also the same.

Below, we analyse two different approaches to dealing with regulatory barriers to trade. The first analysis relates to domestic policies that do not require cooperation with an FTA partner, i.e. unilateral measures that can be carried out without an FTA but may be bound by an FTA. We call this *Good regulations and regulatory practice*. The second approach requires active cooperation with a partner country/group of countries. We call this *formalised regulatory cooperation*.

National regulations in the WTO

Issues related to regulations are addressed in three WTO agreements: The Agreement on Technical Barriers to Trade (TBT), the Agreement on Application of Sanitary and Phytosanitary Measures (SPS) and, to some extent, the General Agreement on Trade in Services (GATS).

4.4.1 Good regulations and regulatory practice

Regulating in "a good way", as a fundamental principle, should be non-discriminatory. With regard to legal reforms and provisions to increase government efficiency, this is clearly also the case. For other forms of provisions related to good regulatory practice the issue is less clear cut.
Regulatory impact assessments may be carried out in a perfectly non-discriminatory manner or they may be deliberately designed to be discriminatory. This is a political choice. The same applies to stakeholder consultations.
Provisions that focus on increased transparency, for example, publishing regulations on the Internet, may be hard to apply in a discriminatory manner. However, there are ways of applying transparency on a preferential basis, for example, notification systems, which may not benefit third countries.
Provisions in this area are mostly voluntary and the effect might therefore often be limited. However, when the provisions result in real changes it is probably mainly to the benefit of the business community at large, including exporters and investors from third countries.

The issue of good regulations and efficient practices for regulatory work goes under many names. In the EU it is called *Smart regulations* whereas the OECD calls it *Better regulation*. It can be applied to any regulatory area, not just what is in focus here.

The overarching aim of such efforts is to make regulations cost effective, i.e. as effective as possible in fulfilling their aim, with the least negative side effects for those who are affected.

These issues are not something specific to FTAs. However, they may be brought into FTAs – both as voluntary schemes and binding provisions.

Below, we discuss four main aspects related to this area[85].

Analysis and evaluation

Analysis and evaluation means using an evidence-based process for the identification and assessment of regulatory alternatives, based on non-discrimination, avoidance of unnecessary barriers to trade and the use of international standards.

A thorough and comprehensive impact assessment, based on scientific methods, does not use selective input or biased methods. If different regulatory alternatives are analysed in such an assessment and it results in new legislation/regulations, this cannot be discriminatory. FTA provisions that require this kind of analysis may affect firms from different countries in different ways, but only because the firms have varying capacities to fulfil their obligations, i.e. not because of their national origin.

This does not mean that all Regulatory Impact Assessments (RIAs) fulfil such high requirements. If, for example, they only rely on selective evidence or if the evaluation is biased, then it could be regarded as being discriminatory towards third-country firms.

Transparency

Transparency has to do with general openness in the regulatory process, which can entail enquiry points, notifications and the publication of regulations, etc. Increased regulatory transparency by nature generally benefits all countries. Publishing accessible updated, clear and reliable information about applicable rules and regulations, serves the interests of all firms, regardless of their origin. Publishing all legislation and regulations in some kind of official gazette such as the EU's *Official Journal*, for example, provides for transparency. Additional information can also be provided as an add-on service.

The EU *Export helpdesk*, with product-specific information about technical rules and SPS requirements, searchable by HS number online, is designed to aid the exports of developing countries, but can, in reality, be used by anyone[86]. The same applies to the EU internal market TRIS database,[87] for notification of technical regulations, which may, to a large degree, be used by third countries. Hence, these databases are non-discriminatory. This also applies to manned enquiry points, which may assist firms with information and provide answers to particular queries.

On the other hand, third-country firms may be interested in other kinds of information than firms from FTA countries, perhaps because they need to comply with other regulations. In such cases, the *de facto* effect of the transparency might be more useful for firms from FTA countries.

The exception to this rule would be if the information appeared on websites that were not accessible to third-country firms (such as parts of the TRIS database) or if the enquiry points were only open to firms from the partner country. However, efforts in this area often have to do with wider attempts to make an administration more transparent, i.e. domestic reform locked into an FTA. If so, the transparency, per definition, should serve everyone.

A more exclusive transparency instrument is notifications, if they are only between parties to an agreement. Such systems, with varying degrees of ambition and operationality, exist, for example, between the Agadir countries[88], within Mercosur, ASEAN and ANZERTA. It must not be discriminatory to third countries if FTA partners point out potential trade barriers in each other's upcoming legislation. It may then well benefit firms in all countries. Still, there is a risk that preferential access to information could be used in a way that is relatively discriminatory to third countries.

Firms are not only interested in a transparent and orderly regulatory process but also an inclusive process that is open to comments from the business community and considers such comments seriously. This should form part of a wider stakeholder consultation process. It is possible to only invite FTA firms for consultations. Or, at least on an informal level, FTA partner firms might gain better access to the regulators in order to offer their views. However, the size of the firm, and thereby its capacity to become involved in consultation, is probably a more important factor than its FTA status.

An extreme example of "bad regulatory practices" is the involvement of competing firms in

granting licenses. This is banned in the EU Services Directive as it allows incumbent firms to have a say in decisions regarding potential competitors. This practice can be simply prohibited in an FTA and, by putting an end to it, all firms will benefit.

Coordination

Effective domestic coordination between regulators involved in preparation, adoption and application of national regulations is another important element of good regulatory work.

Sometimes the problem lies not in the regulations as such but in the application of the regulations by the public bodies. This can lead to regulations being incoherently and inefficiently applied, which could, for example, mean the slow processing of permits, licenses, certificates, etc. This could be attributable to underfunded government organisation, in need of organisational development. It could sometimes also involve corruption. Any development of coordination and organisation within governmental authorities that implement regulations affecting trade will benefit trading firms in all countries.

Review

A review of regulations, i.e. amendments, simplification and repeal must be possible. If opportunities for redress and appeal are lacking this could constitute a serious problem in certain situations. Providing opportunities to appeal various decisions facilitates trade, as long as it is provided in a non-discriminatory manner for domestic firms and firms from other countries.

4.4.2 Formalised regulatory cooperation

The third country effects of regulatory approximation depend on the level of ambition of the cooperation and which sectors and instruments are used. It can significantly affect third countries, both positively and discriminatorily.

If the outcome of a process of regulatory approximation is some kind of harmonisation, for example ACAAs, this may benefit firms in all countries in the sense that it is easier to adapt production to "one set of regulations rather than two sets of regulations". However, the effect on third-country firms also depends on whether the harmonisation leads to a race to the top or to the bottom.

Some forms of regulatory approximation are probably less useful to third-country firms as they are based on exclusive cooperation between government agencies in the FTA member states, designed in a way that ensures that third countries cannot benefit. The benefits of MRAs and their SPS version equivalence, as well as the concept of prelisting food-processing facilities, are based on trust and may not be extended to non-parties. The same applies to administrative cooperation between government agencies in an FTA.

Administrative cooperation

If FTA contracting parties do not set out to change existing regulations but are willing to work more efficiently with their administration, they can engage in administrative cooperation. Such schemes may be of great importance, not least for services.

A lack of transparency or understanding can cause government agencies to refuse to grant licenses. Without a license, many firms cannot conduct their business. The solution may lie in increased administrative cooperation between the relevant authorities in the partner countries in order to facilitate the bureaucratic process. In the EU, the *Internal Market Information System* (IMI), discussed above, is an excellent example of how this could work in practice. It is an institutionalised, structured information exchange system. The problem for third countries is that administrative cooperation is based on trust between cooperating authorities which, in turn, requires a well-functioning civil service. IMI has been partially extended to Switzerland but not to other countries with which the EU has FTAs. Administrative cooperation requires a major effort and is only for partners within an FTA. Per definition, it excludes third countries.

Another more practical aspect of this is that schemes such as IMI require a high level of digital proficiency and thus, when launched, they may serve to keep less developed third countries outside. This is part of a wider problem with a global digital divide and not specific to FTAs.

Regulatory dialogue

The parties in an FTA can enter into a regulatory dialogue. Such dialogue may be the result of negotiations and will become a formalised part of an FTA or may take place outside of an FTA. The dialogue may be structured in different ways,

involving different regulatory agencies and different levels of ambition. However, the main aim is to identify trade barriers and discuss potential solutions in order to achieve greater regulatory convergence. This may remain at the level of a dialogue but could also result in formal agreements.

TTIP had very ambitious plans for a *Regulatory Cooperation Mechanism* (*RCM*), which would work as an arena for regulators on both sides of the Atlantic to meet and discuss drafts for new regulations and try to find common ground. The purpose was to prevent unnecessary technical trade barriers for goods arising in the first place. That is why TTIP was sometimes referred to as a "living agreement". Also, the ideas proposed by the Swedish National Board of Trade about a *Transatlantic Standards Cooperation Scheme* (*TSAS*)[89] would work under the umbrella of RCM. It is difficult to estimate what the effect of RCM on third countries could have been. Would the process have been open to third countries or not? Probably not, in general, but in some technical cases it might have been. Would the new "coordinated regulations" that could have resulted from RCM have been beneficial to third countries? This would have depended on the product, the regulation and the third country on a case-by-case basis.

The Joint Management Committee in the EU-Canada Agreement (CETA) will provide for a continuous dialogue with the aim of identifying common solutions to bridge regulatory gaps between the parties. This might involve issues such as test data and risk analysis methodology, much like the proposed RCM in TTIP. The committee will not have the power to harmonise any legislation on its own. Some of the results of this work may benefit third countries, some of them might not.

Mutual Recognition Agreements (MRAs)

More ambitiously, the parties to an FTA can negotiate sector-specific mutual recognition agreements (MRAs). For goods, this means that they recognise each other's conformity assessment. For services, it means recognising educational and vocational qualifications. This would mean that both parties retain their present regulations and procedures but also agree that the partner country's system serves the purpose set by the domestic regulations equally well, leaving room to accept its regulations/decisions as if they were domestic regulations/decisions. This requires a very high level of trust between the parties, for example, not having to crash-test cars twice – but trusting each other's test data.

Unfortunately, MRAs have proven difficult to establish in reality for goods[90]. For services they have only been established for mode 4 and, for financial services, mode 3[91]. Several agreements between the EU and US on, for example, electrical safety, have had to be withdrawn due to this lack of trust.

Nevertheless, if MRAs were to be established they would probably not benefit third countries. Third countries could be permitted to negotiate access to such agreements but, in reality, it might be too politically sensitive to do so. Trust

between countries A and B does not extend to country C. It is a mechanism that has a strong discriminatory effect. It would be possible to extend it to third countries by stating that recognition by country A in the FTA of goods or services from country C that are not in the FTA should also apply to country B. Nevertheless, this is unlikely to be politically feasible.

Harmonisation

Finally, there can be various kinds of harmonisation. It is possible to envisage using some form of "functional harmonisation" in FTAs. In this scenario countries would agree, within a regulatory cooperation scheme, to establish voluntary common regulatory objectives for a regulatory area but without agreeing on precise methods and legal details, leaving this to the FTA member states. Thus far, this has only taken place outside of FTAs for a number of manufactured goods on a voluntary basis[92]. It is "softer" than real harmonisation as it is voluntary and may not work in an FTA context. A bolder initiative would be to make this kind of pragmatic harmonisation mandatory, i.e. legally binding in the areas in which the parties to the FTA have entered into an agreement. This would be similar to current EU directives, as it focuses on mandatory common regulatory objectives, but leaves room for differences regarding technical details to the member states.

The most ambitious approach would be to fully harmonise regulations in a specified sector, i.e. replace existing regulations with new joint regulations, upheld by a court in a common legal space. This is rare, the European Economic Area (EEA) being the most well-known example. Norway, Iceland and Lichtenstein "import" EU regulations and subjugate themselves to the European court of justice for arbitration[93]. However, there are other examples of the EU "spreading the acquis" to third countries. A novelty is that it is not only for goods, but also for certain services, including financial services and telecom.

The EU association agreements with Ukraine, Georgia and Moldova contain so-called ACAAs (Agreement on Conformity Assessment and Acceptance of Industrial Products). These agreements essentially mean that countries align their legislation to the acquis, i.e. Ukraine, Moldova and Georgia have decided to introduce EU law as their own, in certain prioritised sectors. However, negotiating an ACAA and actually implementing it are two very different things. It requires a sophisticated quality infrastructure. As of now, the only ACAA that is operational is the EU-Israel ACAA .[94]

Another important example of *de facto* harmonisation is the EU-Korean FTA in which South Korea aligned its regulations for motor vehicles to those applied by UNECE. Since UNECE regulations[95] are used to a considerable extent by the EU and are heavily influenced by EU stakeholders, this means Korea largely harmonised its regulations indirectly with those applicable to the EU in its most important export sector[96].

For third countries, full harmonisation might be better than functional harmonisation as the benefits of having one set of regulations instead of two otherwise diminish. However, the main issue for third countries is in which direction the harmonisation will steer the development of regulations. Is it a "race to the bottom" or a "race to the top"? Or it is not a race at all, but rather an alignment of regulations without altering the underlying purpose of the legislation? Depending on what kind of country the third country is, this matters. If the stakes are too high, as would be the case for many developing countries, harmonisation would hurt them, since it might be hard for their firms to meet the stricter requirements. But if harmonisation takes place "at the proper level" for their export profile, then the harmonisation of two sets of regulations into one could be a positive step. For more advanced economies, the latter is also true. However, concerns will be more about whether the new regulations have set the stakes too low, making their high-quality but expensive products uncompetitive.

Specific SPS measures

In an FTA, parties often try to include provisions in the SPS chapter that can facilitate approval procedures, without affecting health protection. For example, in CETA, the EU and Canada have agreed to permit "pre-listing", which means authorities in the export country can inspect and approve individual food-processing facilities for exports to the other party. This is as long as the other party's import requirements are fulfilled. Based on trust, this now simplifies EU-Canadian trade, i.e. in meat and dairy products[97].

Similar to mutual recognition in the TBT area, *equivalence decisions* can also be reached between two parties in the SPS field. Through an equiva-

lence decision, two parties recognise each other's SPS measures as equivalent in protecting against a certain risk, even though the measures might differ. This greatly facilitates trade and simplifies approval procedures and export documentation[98]. However, as with mutual recognition in the TBT field, it has proven difficult to reach SPS equivalence decisions in practice.

These two types of SPS provisions do not facilitate trade for third countries.

4.5 Sustainable development

Sustainable development provisions in FTAs are not aimed at regulating market access. Nevertheless, they might have an indirect effect on third-country firms. This effect may be positive in the short term, if third-country firms do not have to fulfil demanding sustainability criteria. On the other hand, for firms aiming for a "sustainable profile", it might be beneficial to voluntarily comply with the sustainability provisions in the FTAs of other countries. If they do, the effect on their market access will be neutral compared to FTA firms.

What is sustainable development and how does it affect trade?

According to the Brundtland report, sustainable development is "development that meets the needs of the present without compromising the ability of future generations to meet their own needs". It encompasses three dimensions: economic, social and environmental sustainability.

Sustainable development and the WTO

The preamble to the WTO Agreement identifies sustainable development as one of the key objectives of the multilateral trading system. Since the WTO agreement itself does not contain any explicit obligations regarding sustainable development, nor is there any separate sustainable development agreement in the WTO system, this objective should be seen as a guiding principle rather than a legally-binding rule. As such a guiding principle, sustainable development has served as a basis for decisions by dispute settlement bodies and is pursued through measures taken under provisions providing exemptions from the WTO rules, such as Article XX GATT. The application of the sustainable development principle, however, has focused primarily on the environmental dimension, while the more sensitive social issues have received far less attention. The question of labour standards, for example, has barely been mentioned since the 1996 WTO ministerial in Singapore.[99]

On the other hand, in several cases, the United Nations Sustainable Development Goals (SDGs) directly refer to the WTO system as being key to securing the contribution of trade to a global multidimensional sustainability agenda. In particular, SDG 17 on implementation and partnership contains specific trade-related targets, which all refer to the multilateral trading system under the WTO.[100] Due to the limited leeway for pursing sustainable development objectives under the WTO, FTAs have become a new way for developing the trade and sustainability agenda.

Sustainability provisions in FTAs and their effects on third-country firms

Most new FTAs contain provisions related to sustainable development, although they vary substantially in scope, form, focus and enforceability. Regardless of these differences, the provisions differ markedly from other FTA provisions in that they do not primarily seek to increase market access. Consequently, sustainability provisions are not designed to affect market access in any deliberate or direct manner, neither for the participating FTA partners nor for third countries[101].

This is not to say, however, that these provisions have no effect on third countries. They may have significant implications for the environmental and social conditions not only in partner countries, but also for other countries in the regions. This may indirectly lead to changes in the market opportunities facing firms, especially in the sectors which are the focus of sustainability-related provisions.

FTAs might contain concrete positive and negative sustainability commitments. This may imply, on the one hand, commitments to ratify and effectively implement various multilateral agreements or standards, and on the other, commitments to not weaken national levels of protection in order to attract investment/achieve competitiveness, or to use environmental or social concerns as disguised trade barriers.

Sustainability chapters may include the establishment of cooperation schemes, focused on actively engaging the partners in sustainability.

There might also be provisions that promote voluntary private schemes, for example, regarding CSR or private-public partnerships for sustainability.

Depending on the FTA in question, implementation of these provisions will either be based on an incentive-based model, or on a sanctions-based model[102]. Regardless of the implementation method, when enforced, these commitments could indirectly impact third countries. This impact may be positive or neutral depending on the firm's business model and the economic environment in which it is operating.

For sectors in which low wages and/or lax environmental protection are a competitive advantage it could be beneficial to third countries to not fall under a demanding FTA regime. If countries B and C compete to access country A's market, and country B has to raise its standards and country C does not have to raise its standards, this could, from a short-term perspective, benefit country C. In this sense, the FTA discriminates against firms from the partner countries by imposing higher standards on them.

However, it might not be in the interests of country C to compete with a "race to the bottom" strategy. On the contrary, and particularly for firms not competing with low prices, firms in country C might benefit from adopting equivalent standards to country B in order to compete in the market of country A. This is the case even if there is no legal obligation for the third-country firm. Assume, for example, that an FTA between countries A and B promotes adherence to internationally-recognised standards for CSR, which results in them becoming *de facto* mandatory to comply with in order to export to country A. Then, firms in country C will also have to comply with them, out of their own business interests. When they do so, they will be in the same competitive situation as the firms in the FTA. Hence, the effect on market access will be neutral.

4.6 Corruption

Corruption provisions in FTAs may reduce corruption in a country. If so, it is a "public good" and might benefit any third country trading with the country in question. However, it could have negative consequences on some third-country firms, depending on whether their business strategy benefits from corrupt practices.

What is corruption and how does it affect trade?

Corruption in terms of international trade is often connected with the handling of licenses, border procedures and procurement contracts. When the approval of a single official is needed for a business to be able to win a contract or carry out a transaction, there is always an increased risk of corruption. Corruption, for instance in the form of bribes can, in practice, lead to hidden extra costs, such as a tariff, but much less transparent. Corruption also undermines the rule of law and prevents good governance, which indirectly harms the functioning of an economy, including the ability of its firms to trade[103].

Ironically, from a very short-term perspective, corruption can increase efficiency by "greasing the wheels" and helping firms overcome bureaucratic hurdles, particularly in countries characterised by weak national institutions or a complex regulatory environment. Still, in the long term, high levels of corruption are likely to supress growth and corruption is regarded as one of the main barriers to world trade[104]. This is not only a result of corruption itself. Anti-corruption measures can lead to an increase in regulation or other bureaucratic mechanisms being put in place to prevent corruption, which can, in turn, create incentives for more corrupt practices in order to bypass these bureaucratic procedures, resulting in a vicious cycle.

Corruption provisions in the WTO

Corruption is not explicitly addressed within any existing WTO agreements, with the exception of the Government Procurement Agreement (GPA), where it is mentioned in a non-binding clause in the preamble. However, there may be aspects of some agreements that could indirectly impact the level of corruption. The WTO Trade Facilitation Agreement (TFA), for example, includes many provisions that promote transparency, good governance and reduced manual handling, which indirectly reduce corruption.

How is corruption addressed in FTAs and what is its effects on third- country firms?

Anti-corruption is increasingly a chapter of its own in modern FTAs. Sometimes, anti-corruption also forms part of the chapters on trade facilitation and procurement. Corruption can also be indirectly addressed in provisions related to transparency. The US has the most far-reaching anti-corruption provisions in its FTAs. Not least, the TPP text had ambitious and enforceable anti-corruption provisions.

Agreements usually contain provisions on the criminalisation of active and passive bribery, sanctions against individuals and entities convicted of corruption offences, as well as protection for whistle-blowers. Agreements can also contain references to international conventions against corruption, such as the United Nations Convention against Corruption and the OECD Anti-Bribery Convention. However, it is worth noting that the effectiveness of these provisions depends to a large extent on national enforcement, and international accountability mechanisms and dispute-settlement mechanisms are often very limited when it comes to addressing corruption issues[105].

Thus far it seems unclear whether anti-corruption provisions in FTAs have had any direct effects. As far as we know, no sanctions or dispute settlement have taken place regarding corruption in FTAs. Since the effect on FTA partners may have been limited thus far it is reasonable to assume that there may not have been any great effects on third countries, either.

If the anticorruption provisions were to have real effects on corruption in FTAs, what would be the effect on third countries? As discussed above, there would be "legal spillovers". If corruption levels in country A decrease as a result of an FTA with country B, it is likely that this would also affect firms in country C that trade with country A. The provisions might lead to a generally lower level of tolerance of corruption and higher penalties, which cannot really be applied in a discriminatory manner. Lower levels of corruption would then facilitate trade and reduce a number of trade-related costs in general.

On the other hand, if corruption provisions lead to disproportionate levels of new bureaucracy, this might not benefit third-country firms. Also, as mentioned above, some corruption could probably "grease the wheels" of the economy and increase trade. To the extent that third-country firms base some of their business strategy on corruption, provisions that limit the opportunity for corruption might complicate their affairs. Thus, overall, it is very hard to say what effects, if any, corruption provisions in an FTA might have on third countries.

5 Summary and conclusions

5.1 Summary of the provisions and their effects

In the table below the provisions discussed in the analysis are grouped according to the *likely* effect they may have on third-country firms. The table serves as a way of seeing the overall pattern.

Firstly, the table lists provisions that improve market access and are non-discriminatory from the perspective of third-country firms (*positive and non-discriminatory*). Then there are the provisions that improve market access for third-country firms but not as much as for FTA partner firms (*positive but discriminatory*) and, finally, provisions that only improve market access for FTA partner firms (*discriminatory*). Groups 1 and 2 indicate new market access for third-country firms, whereas groups 2 and 3 thus indicate relative discrimination. These three groups are followed by a group for which the effect is highly uncertain. The results from the table are analysed in more detail below.

Provisions that are positive and not discriminatory

There are some provisions which must, by their very nature, be applied to third countries in the same way they are applied to the contracting party; provisions that *cannot* be administered in a discriminatory manner. These are non-excludable and affect third countries to the same extent as FTA partner firms. This includes some, but not all, measures related to transparency. Transparency provisions relating to, for example, applicable regulations and the publication of tenders are useful for all firms interested in a market. The key is if the transparency is "open", published on the Internet, or only provided on a discriminatory basis.

The same applies to reforms to increase efficiency, regarding, for example, trade facilitation or general regulatory efficiency in awarding licenses and granting permits. Its potential efficiency is to the benefit of all trading firms. It would not suffice to be selectively efficient.

Also, legal reforms that aim at a more predictable legal environment belong to this category. An FTA that results in internal legal reforms spills over to all firms. Equality before the law cannot be applied in an unequal manner.

There are also some other provisions which will automatically benefit third-country firms. This includes such different provisions as those involving changes in competition law or its application, or measures designed to reduce the policy space for subsidies or reduce/eliminate trade-distorting subsidies.

Many of these provisions are used as a means of "locking in" unilateral pro-business policy reforms. This applies to both new reforms and already- existing legislation that needs to be "protected" from legislative changes. Such reforms create a more predictable and competitive business climate and a better functioning public sector that not only serves the interests of domestic firms and firms from the FTA partner but also of third-country firms.

However, there are also more traditional trade policy provisions that may benefit third coun-

FTA provision	Comment on consequences on third-country firms (TC = third-country firms)
Positive and non-discriminatory	
"Open transparency"	Transparency, not contained in closed websites or in an exclusive notifications system, regarding regulations and processes for trade facilitation, procurement, subsidies and technical requirements, etc.
Administrative reforms	Increased government efficiency, for example, in trade facilitation and granting of licenses
Legal reforms	Increased legal certainty, for example, right to redress
Competition law reformed and/or better applied	Impossible to discriminate
Reducing policy space for providing subsidies	Cannot have a geographic target
Reduction/elimination of trade distorting subsidy schemes	Cannot have a geographic target
Lowering thresholds for tenders	Impractical to implement in a discriminatory manner
MFN clauses in FTAs	Can benefit TC, but only FTA partners (as such benefits are dependent on a previous agreement with one of the parties)
Intra-FTA safeguard	Benefits TC more than FTA partner, reduces the value of the FTA for the members
Positive but discriminatory	
Change in tariff classification rule	The lower the HS level, the better for TC
Value added criterion	The higher the percentage, the better for TC. Usually benefits TC.
Tolerance rule	The higher the percentage, the better for TC. Usually benefits TC.
Relaxing of principle of territoriality	Benefits selected TC
Cumulation	Benefits some, usually neighbouring, TC
Discriminatory	
Cuts in applied tariffs in FTAs (resulting in new market access and/or increased predictability)	Cannot benefit TC, assuming strict RoO
Tariff elimination within TRQs	Cannot benefit TC, assuming strict RoO (which is the case as these are only used for agricultural products)
Strict RoO (wholly obtained products for agriculture)	Cannot benefit TC
Not using global safeguard against FTA partner	Not legal in WTO, but exists anyway
Authorised Economic Operators (AEOs) and other "control-reducing schemes"	Will not benefit TC, if scheme is limited to firms registered in contracting parties
Border cooperation schemes	Cannot benefit TC, based on trust between FTA partners.
Pre-listing of food-processing facilities	Cannot benefit TC
MRA for goods, services and worker qualifications (called *equivalence* for SPS)	May theoretically benefit TC, but most likely will not (based on trust)

FTA provision	Comment on consequences on third-country firms (TC = third-country firms)
Administrative cooperation regarding qualifications and regulations	Based on trust and administrative capacity, only for FTA partners
"Closed transparency"	Information published or shared in a non-open way, provides FTA firms with an information advantage
Reducing policy space for mode 4	Always directed at partner country
Provisions with uncertain effects	
Reducing policy space for services and establishment (binding water)	Political choice, mainly benefiting TC
Elimination of market access restrictions for services/ establishment	Political choice, mainly benefiting TC
Granting national treatment for services/establishment	Political choice, mainly benefiting TC
Simplification of visa procedures	Political choice, simplification of procedures might spill over to TC
Reform of performance requirements for establishment	Political choice, mainly benefiting TC
Reducing price preferences in procurement policy	May benefit TC, political choice
Relaxing local content requirements in procurement and for establishment	May benefit TC, political choice
Covering more procuring entities	May benefit TC, political choice
SOE reform in FTA partner country	May benefit TC, a political choice
SOE reform in home country	May benefit TC, a political choice
Breaking up of state monopolies	May benefit TC. Depends on establishment provisions, often benefiting TC
Investment protection	Cannot benefit TC (unless TC firms use another agreement as their "basis for a dispute)
Impact assessments	May benefit TC, a political choice on how to design them
Stakeholder consultations	Consultations may be open to everyone. If not, the outcome may still serve to pre-empt trade barriers in general
Intra-FTA notifications	Notifications provide FTA partners with opportunities to comment on regulations that third countries do not receive, but may serve to pre-empt trade barriers in general
Special technical requirements (RoO)	Reforms may benefit TC, depending on the form of the rule
Limits/bans on antidumping and countervailing measures	Seen in isolation, discriminatory to TC. But uncertain in conjunction with competition provisions
Regulatory dialogue	May benefit TC, depends on outcome of dialogue in each case
Harmonisation (in a broad sense)	May benefit TC, depends on country, sector
"Reaffirm TRIPS" provisions	Must "benefit" all TC equally under the law, but some TC will, in reality, not benefit. In some cases, TC may benefit more
TRIPS plus provisions – stricter IPR legislation and/or application	Some of them must "benefit" all TC equally under the law, but some TC will, in reality, not benefit. In some cases, TC may benefit more
Introduction of Geographical Indicators (GIs)	May make third-country firms with no GI less competitive but also makes it possible for them to register their own GIs
Sustainable development provisions	Effect on TC unclear, depends on firm's business strategy
Anti-corruption provisions	Effect on TC unclear, depends on firm's business strategy

tries in FTAs in a non-discriminatory manner. There are MFN clauses for tariffs, services and investment protection, in which a third country can indirectly benefit from FTAs if it has managed to insert such provisions in an FTA with one of the partner countries.

The intra-FTA safeguard is a very special case as it is an internal trade barrier within an FTA which may serve to hold back intra-FTA trade and thus mitigate the discriminatory effects of the FTA on third countries.

Provisions that are positive but discriminatory

As can be seen in the table, not many provisions fall into this category, in which third-country firms can benefit from the FTA, but less so than firms in FTA countries. This has to do with Rules

of Origin (RoO). Third-country firms may benefit if the rules are liberal, i.e. they permit a high degree of input from outside the FTA. This can be structured in several ways: a high value-added criterion that permits a large proportion of non-originating inputs (or a generous tolerance rule), relaxing the principle of territoriality, allowing for extended cumulation or applying the tariff classification rule at the most detailed level possible.

Although it is not a "provision" in any FTA (thus far), is should also be mentioned that services providers in third countries might benefit from FTAs indirectly as suppliers to goods producers in FTA countries that are benefiting from preferences.

Provisions that are discriminatory

Here we find the most basic element of all FTAs, tariff cuts. Assuming very strict rules of origin, tariff reduction cannot (with the exception of a MFN clause in a previous agreement, see above) benefit third countries. This applies to bound and applied levels as well as conversion of tariffs to tariff rate quotas (TRQs). It also applies to temporary tariffs in the form of the discriminatory use of global safeguards. The actual effect of tariff reductions may, however, be mitigated by liberal rules of origin, as discussed above.

There are a number of provisions for which the requirement for active cooperation between the FTA partners and the exclusion of third countries by the way they work is a common denominator. They include Authorised Economic Operator (AEO) schemes and similar programmes (including border cooperation schemes and pre-listing of food products) to reduce the number of border controls. Third-country firms may face *relatively* more formalities at the border. Active cooperation is also required for Multilateral Recognition Agreements (MRAs), used to facilitate trade mainly in goods but also in services, and for worker qualifications. The same applies to administrative cooperation between government agencies in different countries that deal with validation of licenses and qualifications.

Such schemes are mostly found in FTAs with developed countries: modern, deep and comprehensive FTAs. They require trust between the parties and a high level of administrative capacity. Such trust is rarely extended to third countries.

Also, provisions related to the temporary movement of persons are normally designed not to benefit nationals from third countries, although here the effect is mitigated by the fact that such provisions are normally not ambitious in FTAs.

Transparency in the form of non-open information, contained in, for example, websites not open to anyone may aid FTA firms by providing them with an information advantage that third-country firms do not receive. This, however, appears to be unusual.

Provisions with an uncertain effect

As can be seen in the table, there are a high number of provisions that have uncertain effects on third countries. The uncertainty, from a simplified viewpoint, can stem from either political choices or the characteristics of the third-country firms (or a combination of both). Hence, in the first case, it is a choice in the FTA countries and, in the second case, it depends on if the third-country firm is capable or not of benefiting from a provision.

Political choices

Let us start with those provisions in which the effect is the outcome of political choices. Basically, all provisions related to services and establishment belong to this category. Contracting parties to an FTA have a choice regarding whether to introduce reforms (liberalisation or binding current openness) in a non-discriminatory manner, i.e. open up sectors to all third countries – or if they want to only open up sectors to the other contracting party. By their nature, however, most service regulations do not lend themselves to the practical application of an origin concept. For example, operating two sets of licenses for the same approval – one license for domestic firms and one license for foreign firms – may be impractical. Therefore, provisions in this area usually benefit all firms that operate in and export to a country, thereby also benefiting third-country firms.

With regard to establishment, the lifting of bans or limits is usually applied on an "all foreign capital is welcome basis". This is usually linked to reforms in the free flow of capital, both into and out of the country. However, there are, for example, screening procedures and quotas that may be administered in a discriminatory manner, if there is a political will to do so. It may not have to do with protectionism; the element of trust is also important. Not all foreign investors, for example, may be seen as trustworthy.

This category also contains several provisions regarding procurement, in which it is an easy political choice to decide whether or not the provisions should benefit third countries. Again, the motivation could have to do with trust and not only protectionism.

The effects on third countries of breaking up state monopolies and introducing limits to the activities of state-owned enterprises is an open question and depends on how the agreement is framed in this area. In some countries this is a very important issue, whereas in other countries the issue may not be of importance.

Investment protection is a special case insofar as it is designed to be used by firms in one country against the government of another country and should then be of no use to third-country firms. However, third-country firms may use the agreement of other countries if they have a mailbox company there.

Impact assessments and stakeholder consultations may be carried out in an open and horizontal manner that benefits all firms, but they may also be organised with a limited group of FTA stakeholders or mainly focus on the interests of the FTA partners. Hence, it is a political choice whether or not this should benefit third countries. Notifications are connected to this. As long as intra-FTA notifications really are intra-FTA, they will discriminate against third-country firms. Nevertheless, they may – in the same manner as impact assessments and stakeholder consultations – benefit third countries indirectly if they serve to pre-empt or solve trade barriers that are of importance to third countries.

Finally, there are some border-related measures that have very uncertain effects, partly due to political choices. Regarding rules of origin, special technical requirements may be crafted to benefit third countries and this has to do with both politics and the technical nature of certain kinds of production.

Limits/bans on antidumping and countervailing measures in FTAs are coupled to provisions regarding competition and the effects could be positive for or discriminatory to third countries. Thus far, such provisions are unusual in FTAs.

Characteristics of the third-country firm and its economic environment

The remaining provisions that have uncertain effects belong to the category in which the effects have less to do with a political choice to discriminate. These parts of the agreements may not be concerned with issues of discrimination. The measures may be applied in a manner that is formally non-discriminatory to FTA countries and third countries but their real effect on firms will depend on the characteristics of the firm, what it is producing, the sector at hand and the stage of development of the country from which it is operating.

There is regulatory dialogue and harmonisation. Efforts in this highly complex and sometimes controversial area might, if successful, be very far reaching. Its implications 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. The extent to which this benefits or harms third countries is a completely open question. It depends on the sectors involved, the countries and their competitive advantages, etc. In principal, "one set of regulations" is better than two sets for third countries. However, it also depends on the nature of the set of regulations. Some third-country firms will benefit, others will not.

IPR provisions are generally not discriminatory but are still not necessarily always positive for third countries. Some third countries clearly benefit from stricter IPR whereas others may lose out. Also, when it comes to the subcategory of GIs in IPR, some third countries may benefit whereas others, probably the majority, may lose out.

Provisions related to corruption and sustainable development are similar to IPR in the sense that they are not aimed at regulating market access. Nevertheless, they will, if enforced, affect market access. Whether this effect is positive or negative will depend on if firms conduct corrupt practices and operate under lower levels of environmental and social protection. If they do, they may, at least in the short term, lose out from stricter standards in this area. Otherwise, it may be beneficial to them.

A common denominator for all the provisions related to regulatory approximation, IPR, corruption and sustainable development is that the effect on firms has less to do with whether or not a country is a member of an FTA but more to do with other factors. It may well be that measures in this area will benefit some third-country firms more than FTA partner firms. Simply put, membership of the FTA is not the deciding factor.

Horizontal factors that mitigate discrimination

There are some issues that are horizontal in nature and that more or less affect all the above provisions.

Dynamic changes caused by FTAs

There may, over time, be dynamic changes caused by FTAs that could affect third countries. Many FTAs have provisions for committees in which representatives of the member states meet to discuss trade barriers and various other practical issues related to the functioning of the agreement. If such committees are successful, in the sense that they accomplish practical changes in how the agreement is applied, this will also affect third-country firms. Whether these effects are beneficial or discriminatory depends, of course, on their content and application.

Apart from the immediate legal spillovers or add-ons discussed in the paper, when an FTA is implemented in national legislation, there may also be other more long-term spillovers. For example, there could be gradual changes in laws regarding competition, investment protection and antidumping, to name a few, that could have been inspired by the FTA. Such changes may, but do not have to, be positive for third countries. In the case of tariffs, it could be that tariff reduction as part of an FTA might spur continued unilateral tariff reductions.

Another possibility is that FTA provisions spread into other FTAs or into the WTO, or that other countries join the FTA. All this might gradually lessen any discriminative impact of the FTA on third-country firms, but this is by no means certain and is not the focus of this paper.

Global value chains

The fact that most goods and services consist of value from countries other than the final export country makes it possible for third-country firms to benefit from business in which they are not directly involved. Then they may have indirect, but discriminatory, market access, as discussed above, with regard to rules of origin. However, these phenomena go beyond rules of origin. It should be possible to benefit indirectly as suppliers to FTA firms that directly benefit from border "control-reducing schemes", MRAs and procurement, etc. Even provisions for something as exclusive as visas may indirectly benefit third-country firms. If, as a result of an FTA with country A, firms in country B can more easily send experts to country A to deliver services, then firms in third country C may sell more to the firms in country B. With few exceptions, it should be possible to benefit as suppliers to firms in FTAs. An obvious exception to this is local content requirements, which, per definition, may prohibit third-country inputs.

This means that most provisions that fall under the headings *discriminatory* or *uncertain* above could perhaps be recategorised to fall under the heading *positive but discriminatory*. The provisions do not provide third countries with any legal rights to market access and the access they receive *de facto* is indirect and often less valuable than direct access, as it is lower down the value chain. Hence, it is discriminatory. However, despite this, it seems likely that almost all provisions in an FTA provide third-country firms with some new market access.

5.2 Concluding remarks

When considering global value chains, it may be that almost all provisions in an FTA create some new market access for third countries. From this perspective, the more an FTA is filled with the better for third countries. The deeper and more comprehensive the agreements, the better.

However, there are two problems with this way of thinking. Firstly, the same provisions that may increase market access for some third-country firms may also create obstacles for other third-country firms if they result in a "raising of standards" with which such firms cannot comply.

This problem mainly affects developing country firms and SMEs. On the other hand, it is likely that a global trend towards "raising standards" will continue regardless of FTAs and it is not the design of FTAs themselves that may cause these obstacles. Rather, it is the low capacity or the business strategy of the firms that explain why they cannot benefit from FTAs. The solution to this lies in capacity building. Generally, the solution cannot be an absence of "higher standards" but must be to build capacity in order to comply with standards.

The other counter argument has to do with distortions in market access. There are many provisions, perhaps a majority, which are discrimina-

tory. It is likely that the net effect of FTAs is discriminatory. Third-country firms will have more market access than without an FTA but it may often be less valuable than it is for firms within an FTA, as they are forced to operate lower down the value chain as suppliers. When they compete head on against firms in an FTA, they may find themselves at a competitive disadvantage.

Then the question is what is most important for third-country firms? Absolute market access or relative market access? If maximum absolute market access is desirable but with the least possible relative disadvantages to third countries, four major objectives should be sought.

- Firstly, focus on FTA provisions that aim to improve market orientation and public-sector efficiency. This usually includes public-sector reforms (transparency, legal certainty, efficiency) and pro-competitive reforms. These are non-discriminatory by nature.
- Secondly, for areas in which discrimination is a choice, such as services, establishment and procurement, choose to introduce non-discriminatory provisions.
- Thirdly, introduce as liberal rules of origin as possible to mitigate unavoidable discrimination.
- Finally, to the extent possible, allow third countries opportunities to benefit from MRAs, AEOs and other cooperation schemes.

To summarise, FTAs create new market access for third countries but they also create relative competitive disadvantages.

Areas for new research

This study has only discussed the likely effects of various FTA provisions on third countries., Efforts could be made to *econometrically estimate the effects of the provisions*. There are major data and methodological problems in some areas but the data available and the techniques to analyse it are also improving.

Quantifying the economic effects of non-discriminatory vs. discriminatory FTA provisions in cases where such choices can easily be made could also be of particular interest to further studies. For example, if a country opens up its procurement market in a non-discriminatory manner as opposed to opening up only to FTA partners, what would be the difference in terms of the economic effect?

An interesting topic for new research in this area is *how to build trust and capacity to involve third countries in cooperation schemes*. Can MRAs and AEOs etc. be organised in a way that ensures that third-country businesses and their interests are also taken into account?

The EU-Canada agreement (CETA) is often described as the most advanced FTA the world has seen thus far. Bearing this in mind, the effects on third countries of CETA is of particular interest. Does CETA divert trade between the US and Canada to the EU and Canada, for example?

Above are just some of the many interesting issues that could be analysed in this vast field of research. The need for analysis will not diminish as FTAs will probably continue to dominate the global trading system for the foreseeable future.

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Notes

1 In WTO terminology the acronym is RTA, Regional Trade Agreement, but in this paper we use the acronym FTA

2 As of January 2018 (WTO RTA database)

3 Hardy (2017)

4 Sometimes FTAs even contain WTO-minus provisions but these are outside the scope of this paper

5 GATT Article XXIV, paragraph 4. The corresponding article in GATS is article 5

6 Some issues discussed in the paper extend slightly beyond market access issues but are still included as they form important parts of current FTAs and deserve mentioning.

7 When we refer to third-country firms we mean firms that are based in that country and have their main economic activities there. This does not mean they are necessarily owned by a firm/person in that country. In reality, this might be unclear, but for the analysis in this paper the distinction is important to note.

8 Kristina Olofsson, Maria Johem, Christopher Wingård, Jonas Kasteng, Ulf Eriksson, Sara Emanuelsson, Anneli Wengelin, Anna Egardt, Magnus Rentzhog, Jonas Hallberg, Björn Strenger, Heidi Lund, Sun Biney, Linda Bodén, Karolina Zurek, Isabel Roberth, Patrik Tingvall, Per Altenberg, Anna Sabelström

9 This is the term used by the WTO. It might not always mean the same thing as in everyday jargon

10 This can actually happen when, for example, countries join in a customs union and agree on a joint tariff schedule, which might raise some tariffs for third countries. Then, according to the GATT, the countries that receive less market access have the right to negotiate for compensation in the form of better market access to other products.

11 Viner (1950)

12 Swarnali (2016)

13 Baldwin (2014), Won and Winters (2002).

14 National Board of Trade (2016:3)

15 Kehloe (2003) and Corcos, del Gatto, Lion and Ottaviano (2012)

16 The term was first used by Jagdish Bhagwati in 1995 in the paper: "US Trade policy: The infatuation with free trade agreements"

17 Baldwin (2009)

18 Baldwin (2014)

19 The number of FTAs with deep coverage reported to the WTO has been increasing more rapidly than those reported with a shallower coverage. Also, many old FTAs are now being updated. Source: Dür et al (2012)

20 Lejarraga (2014)

21 According to Estevadeordal and Suominen, this is primarily in the areas of services, investment regulations, customs procedures, trade facilitation, environment, intellectual property rights and e-commerce

22 The Trade in Services Agreements, TiSA, are seen as making use of and building on the regional negotiation of services in existing FTAs. They are plurilateral agreements made possible because of the extensive experience acquired by participants through bilateral FTAs. Source: OECD (2014)

23 Estevadeordal and Suominen (2009),

24 ibid

25 Baldwin (2008)

26 Baldwin (2014)

27 Bergsten (1997)

28 Ecuador initially participated in the negotiations, dropped out and then joined the final agreement.

29 Osnago, Piermartini and Rocha (2015)

30 It should be mentioned that TRQs are not only positive for firms that may use them. They also bring administrative costs and unpredictability. Nonetheless, they may be better than paying the full tariff

31 This also applies to chapters on services and investment protection, see chapters 3.6 and 4.2 of the paper

32 Article 16 in the EU ECOWAS EPA. Note, however, that this does not apply to all countries with which ECOWAS may sign an agreement.

33 The text concerns preferential rules of origin, not general rules of origin

34 In reality, this may be rare. The EU's rule is normally applied at the 4-digit level, sometimes even at the 2-digit level and only rarely at the 6-digit level.

35 For example, the EU-Georgia DCFTA permits 10%. European Commission (2014)

36 European Commission (2016)

37 Cernat and Kutlina-Dimitrova (2013)

38 National Board of Trade (2013). However, TDI can be used in the EEA for agricultural products and fish.

39 However, any agreement containing subsidies will also have other effects. See Chapter 6.2.

40 European Commission (2002)

41 For an analysis of what the TF Agreement involves that affects the SPS measures of countries, see "New Trade Facilitation obligations in the SPS area", National Board of Trade, 2017.

42 WTO World Trade Report 2015

43 The EU's IPI proposal (International Procurement Instrument) has another purpose, namely, to discriminate against those countries that discriminate against the EU, i.e. a kind of countervailing action

44 According to Buy American (1933), federal contracting authorities are obliged (under certain circumstances) to buy goods or inputs produced or manufactured in the US.

45 Trade Agreements Act (1979).

46 Buy America requirements for procurements in the American Recovery and Re-investment Act (ARRA) of 2009.

47 US—Canada Agreement on Government Procurement.

48 Price preferences have the same effects as a tariff (but also for services) in the sense that they make foreign procurement more expensive and therefore incentivise the national procurement agencies to buy local goods and services

49 One reason could be that procurement chapters are part of a broader FTA, covering multiple topics, and that FTAs as a whole are exempted according to GATT Article XXIV. With regard to MFN and FTAs see, for example, Kamala (2015) and Arrowsmith (2003).

50 National Board of Trade (2011)

51 For the most comprehensive list of services barriers, consult either the OECD or the WTO Services Trade Indexes (STRI)

52 The EU Services directive bans all these practices in its blacklist

53 Roy (2011)

54 See, for example, Rentzhog and Anér (2014)

55 Miroudot and Shepherd (2012)

56 Official Journal of the European Union, 14 May 2011

57 For more about this, consult the Foreign Affiliate Trade Statistics (FATS) database

58 As opposed to portfolio investment in financial assets, which is a less active way of investing, without any direct control over the assets. Unlike portfolio investments in the equity markets, establishment is defined by a substantial ownership (at least 10% of the shares) and long-term direct influence over the asset into which the investment is made.

59 National Board of Trade (2016:2)

60 Australian government (2016)

61 TRIMS provisions are often not observed in reality, hence the idea to reaffirm a WTO agreement. It should also be mentioned that local content requirements are also sometimes regulated in the GATS commitments of countries

62 According to GATS it must be a services firm. In the EU's FTAs it can also be a manufacturing or agricultural firm.

63 National Board of Trade (2015:4)

64 ASEAN is an example of an agreement that has visa provisions

65 However, it is possible to envisage a situation in which the parties agree to accept qualifications from third countries that have been accepted by one of the parties. For example, within TTIP, the EU recognising Swiss degrees, resulting in the US accepting this EU recognition, thereby benefiting Swiss companies

66 The system is used between the EU and Switzerland for this purpose.

67 World Intellectual Property Organisation

68 There are exceptions to this rule relating to IPR that predate TRIPS (art. 4 d) as well as IPR that fall under the auspices of the WIPO (art. 5).

69 Van den Bossche and Zdouc (2017). See also Lukauskas, Stern and Zanini (2013)

70 On the other hand, developing countries may benefit from robust IPR in other ways and, in the long term, by attracting investments and technology. However, this is outside the scope of this paper

71 For example, in the case of Swedish sales to the US, the value of local sales is 5—6 times larger than the value of Swedish exports to the US. Source: National Board of Trade (2014)

72 There are also IIAs (International Investment Agreements) that cover more parties. However, the only IIA in force is the Energy Charter Treaty (ECT).

73 Despite its name, ICS is still a dispute resolution mechanism and not a formal court. See http://europa.eu/rapid/press-release_IP-15-5651_en.htm

74 An example of such a case is Mobile Corporation et al vs the Bolivian Republic of Venezuela. ICSID Case No ARB/07/27 Decision on Jurisdiction, 10 June 2010.

75 This depends on the content of the specific agreement. The EU's agreements make clear that such upgrading should not take place. National Board of Trade (2016:1)

76 The text does not deal with subsidies for agriculture, which have their own specific regulations

77 Unlike specific subsidies for specific firms or sectors which, by definition, are discriminatory towards any of these firms' competitors

78 An example of a positive effect would be subsidies to close overcapacity in certain sectors

79 Export subsidies, which have a geographic target, are already banned by the ASCM. Also, agricultural export subsidies have been banned more recently.

80 This is part of TPP

81 Why this is the case can be explained by a simple example. It is easy to distinguish the production of scissors from the characteristics of scissors. It is less easy to distinguish the haircut from the barber

82 See, for example, Baldwin (2014) and Levy (2009)

83 See, for example, Baldwin (2014) and Henk (2004)

84 See for, example, National Board of Trade (2016:4) and European Commission (2016)

85 The structure of the text is inspired by the Code of Good Conduct, a document for the development of standards often referred to in the area of TBT.

86 In several recent FTA negotiations the European Commission has argued that the SME chapter should provide an obligation for the partner country to establish its own "Trade helpdesk". If this were to happen, third countries would also benefit. See http://trade.ec.europa.eu/tradehelp/

87 See http://ec.europa.eu/growth/tools-databases/tris/en/

88 According to article 23 of the Agadir Agreement, not yet operational, member states need to consult with each other before any technical trade barrier is erected. See Bilaterals.com https://www.bilaterals.org/?agadir-agreement-2004&lang=en

89 See National Board of Trade (2015:3). Note that the TSAS idea was never taken up as a formal negotiation position by the EU

90 In the case of the EU and US, it has thus far only worked in the area of marine equipment. See EMSA (2011)

91 For example, the EU-Switzerland financial services MRA. See National Board of Trade (2010)

92 The model has been used in UNECE for telecoms, earth-moving machinery and some other sectors. See http://www.unece.org/tradewelcome/steering-committee-on-trade-capacity-and-standards/tradewp6/thematic-areas/using-standards.html

93 This is not formally how it works, as it is the EFTA court that has the final say. However, in reality, these three countries have adopted virtually all EU legislation in the specified areas. See http://www.efta.int/eea

94 Protocol to the Euro-Mediterranean Agreement (2009)

95 Regulations adopted by the United Nations Economic Committee for Europe Working Party 6 on regulatory cooperation and standardisation policies

96 National Board of Trade (2015:1)

97 National Board of Trade (2015:2)

98 The EU and New Zealand have such an agreement regarding milk. See National Board of Trade (2015:1)

99 Bartels, (2015)

100 See, in particular, targets 17.10—17.12: https://sustainabledevelopment.un.org/sdg17

101 National Board of Trade (2017:2)

102 The US mainly uses a model based on sanctions, whereas the EU uses an incentive- based approach

103 National Board of Trade (2017:1)

104 World Bank (2017)

105 Transparency International (2017)

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