

# Beyond Tariffs: Multilaterising Deeper RTA Commitments

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## 1. INTRODUCTION

The WTO has been little more than an “innocent bystander” to the rapid rise of regionalism. World trade is now governed by a “Spaghetti Bowl” of unilateral, bilateral and multilateral trade agreements. This regionalism is here to stay. Even if the Doha Round finished tomorrow, bilateral and regional initiative will continue to be signed. The economic inefficiencies of this situation are well appreciated, but perhaps more corrosive to multilateralism is the support that undisciplined regionalism gives to the dominant influence of large trading powers. The problem will only get worse as the newly emerging trading powers add new tangles of trade agreements to the Spaghetti Bowl and the potential for conflict among large trading powers intensifies.

The WTO faces a choice: should it attempt to engage in creative efforts to keep regionalism as multilateral-friendly as possible, or should it continue to be an innocent bystander? Baldwin (2006b) argues that changes in the global economy – especially the spatial unbundling of the manufacturing process and attendant offshoring of tasks – have changed the political economy of the Spaghetti Bowl of preferential tariffs. Nations have demonstrated an interest in ‘taming the tangle.’ These changes also open the door to new WTO-led initiatives that could further multilateralise, or at least plurilateralise, the Spaghetti Bowl of tariff preferences.

The goal of this paper is to consider whether the Spaghetti Bowl problem also exists for non-tariff barriers (NTBs) and whether getting the WTO more closely engaged with preferential NTB liberalisation would enhance the chances that these initiatives remain/become multilateral-friendly.

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**Plan of paper**

The paper starts by reviewing the economic and political-economic logic of how two major multilateralisations of tariff preferences succeeded in the 1990s. The subsequent section considers whether the Spaghetti Bowl problem extends to non-tariff barriers by reviewing research on RTA provisions in six NTB areas: technical barriers to trade, trade in services, government procurement, competition policy, and investment performance measures. After this, the paper extracts that lessons of the six case studies (Section 4) and then discusses a number of ways in which WTO might engage in keeping these regional NTB commitments as multilateral-friendly as possible (Section 0).

**2. MULTILATERALISATION OF TARIFF PREFERENCES**

The last ten years have witnessed an important reduction in tariffs worldwide. The tariff liberalisation, however, resulted from a tangle of unilateral, bilateral and plurilateral initiatives – the famous Spaghetti Bowl effect. During the same period, however, the world has also witnessed two massive multilateralisations of the tangle of tariff and the attendant miasma of rules-of-origin. This section, which draws heavily on Baldwin (2006b), discusses the problems with the Spaghetti Bowl, the two multilateralisation initiatives and the political economy forces that drove them.

The goal of this section is to establish a baseline for comparing how the Spaghetti Bowl as developed with respect to non-tariff barriers, and how multilateralisation has or could proceed in non-tariff barriers.

**2.1. The preference Spaghetti Bowl and its multilateralisation**

As far as tariff preferences are concerned, there are three key economic aspects to the Spaghetti Bowl.

## 1. The preferential tariffs themselves.

Preferences, i.e. geographically discriminatory tariffs produce well-known economic inefficiencies. These can be so great that even the countries benefiting from the preferences may end up worse off – a result known as Viner’s Ambiguity since Jacob Viner pointed it out in his celebrated 1950 book, *The Customs Union Issue*. Third parties are almost surely harmed by such preferences. Note the size of ‘margin of preference’ matters; if a nation’s MFN tariff is zero or almost, an RTA cannot create much discrimination.

## 2. Rules of origin (ROOs).

Preferential tariffs always involve ‘rules of origin’ since customs officers must be able to identify where an imported good is made in order to know which tariff to apply. ROOs often act as a subtle form of protection. In particular, ROOs often prevent firms from choosing the most efficient international supply network since they fear that their exports may lose ‘origin status’ and the preference it confers. In this way, ROOs can act like ‘frictional’ trade barriers; they raise the cost that firms face when they sell across an RTA border.<sup>2</sup>

## 3. Rules of cumulation (ROCs).

Rules of origin always involve ‘rules of cumulation’ – namely rules on where value can be added and still count as local. The most common ROC – bilateral cumulation – allows firms to count the value that

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<sup>2</sup> Of course firms always have the option of paying the MFN, so tariff-equivalent of the frictional barrier is limited by the height of the MFN tariff.

is added in either of the two nations. Permissive ROCs can mitigate the protectionist content of ROOs by expanding firms' choice when it comes to their international supply networks. See Box 1 for how ROOs and ROCs interact with preferences.

**Box 1: Rules of origin and diagonal: when duty-free trade is not free trade**

Consider a simple thought-experiment. Think of a network of bilateral FTAs among nations A, B and C, and compare this to a world where each of the 3 nations embraced MFN free trade. In both cases, tariffs worldwide would seem to be zero. However, if the FTAs have restrictive ROOs and/or bilateral ROCs, the 3 bilaterals are likely to produce trade that is less than fully free. The point is that ROOs would prevent firms from setting up the most efficient international supply networks. Bilateral cumulation, as opposed to diagonal or full cumulation, can similarly distort the purchase pattern of intermediate inputs in a way that does not occur under MFN free trade.

Some definitions:

Bilateral cumulation is where inputs originating in one country are considered as originating in the other. This is a feature of all FTAs.

A diagonal cumulation 'zone' is to bilateral cumulation as customs unions are to FTAs. Under diagonal cumulation, a set of nations adopt a common set of ROOs, i.e. the zone becomes what might be called a 'ROOs union.' Once a product enters the diagonal cumulation zone, its origin is determined by the common ROOs and it can therefore never lose its origin status by crossing a border inside the zone. This relaxes the constraints on firms' the choice of suppliers compared to bilateral cumulation, but it still favours suppliers inside the diagram cumulation zone.

Full cumulation is rare, usually limited to customs unions. Any value added inside the zone, regardless of whether it involves a component bought inside or outside the area, counts toward domestic value added. This matters since origin status is normally an all-or-nothing proposition. For example, some of the value that is added to a component in a diagonal cumulation zone may not be counted, if it is not sufficient to grant a component origin status.

**What's wrong with the Spaghetti Bowl?**

This discriminatory tariff liberalisation is inferior to multilateral liberalisation on three main counts:

- Economic inefficiency. Multiple tariff rates introduce economic inefficiency into the trade system, with this problem being especially severe in industries with complex international supply networks.
- Stumbling blocs. The existence of preferences may help or hinder moves towards multilateral liberalisation. To the extent that preferences hinder multilateral tariff cutting, RTAs are a problem for the global trade system.
- Hegemony. The world of trade negotiations is governed by something of the law-of-the-jungle where nations with big markets have more leverage than those with small markets. The WTO's rules – especially the non-discrimination clauses – tend to mitigate the power of current and future trade hegemony (the US, EU, Japan, China, India and Brazil). The jungle law is much more in evidence when, for example, the US sits down to discuss an FTA with, say, Costa Rica. Than it is in a WTO Ministerial.

**How can the tangle of tariff preferences be multilateralised?**

Logically, there are two ways of eliminating the Spaghetti Bowl as far as tariffs are concerned.

1. Set all nations' MFN tariffs to zero.

This eliminates the distortions of 'geographically discriminatory import taxes' by eliminating the discrimination. It simultaneously eliminates the distortions of non-harmonised ROOs and bilateral cumulation since it eliminates the incentive to prove origin.

- 2) Switch to diagonal rules of cumulation.

If a group of nations has a complete set of bilateral FTAs among themselves, they can reduce the distortionary effect of ROOs and bilateral ROCs by switching to a harmonised set of ROOs and diagonal cumulation. (Roughly speaking, switching to diagonal cumulation creates what might be called a ROOs customs union in that it imposes common external ROOs and means that a product can never lose origin status by crossing an internal border.) This reduces distortions of the international economic production pattern within the zone, but does little to improve the efficiency of the global production pattern.

**Two real world examples.** The world has seen both types of multilateralisation. They both happened in 1997. The first was the Pan-European Cumulation System (PECS).<sup>3</sup> The second was the Information Technology Agreement (ITA). Both started from a tangle of preferences and rules of origin – a 'Spaghetti Bowl' situation – but one where the MFN tariffs were fairly low, so the margins of preference were rather modest.<sup>4</sup>

As we shall argue, the initial conditions (i.e. low MFN tariffs) meant that the gains and losses from 'taming the tangle' were fairly small to begin with, so a modest shift in the political economy forces against maintaining the tangle could result in its sudden elimination. This modest shift was provided by the unbundling, or fragmentation, of manufacturing. This section considers that basic economic and political economic logic behind the two episodes of multilateralisation of regionalism.

## 2.2. The political economy of Spaghetti Bowl and its multilateralisation

The multilateralisation of regionalism involves the removal of trade barriers. Understanding this sort of trade liberalisation – as is true of all trade liberalisation – involves some mental gymnastics. One has to explain why it became politically optimal to remove trade barriers that governments had previously found politically optimal to impose.

The place to start the gymnastics is with an understanding of the political economy logic that produced the Spaghetti Bowl in the first place.

**Political economy forces that created the spaghetti bowl.** The Spaghetti Bowl of RTAs did not emerge by mistake. The politically optimal structure of a bilateral RTA depends upon the comparative advantages of the two nations and the particular political strengths of various interest groups at the time the deal is signed. Since these forces are usually different for every bilateral relationship, it is natural that RTAs vary greatly – especially as concerns their list of product exclusions, and ROOs that reduce the degree of liberalisation implied for certain products.

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<sup>3</sup> PECS is sometimes referred to as the PanEuroMed zone after it was enlarged to include a number of Mediterranean nations.

<sup>4</sup> Note however that a concept like the Effective Rate of Protection is necessary to understand the true importance of preferences. Since the nominal tariff is applied to the full value of the good and the good can lose origin status due to minor shifts in the location of production, the nominal margin-of-preference often radically under-estimates the extent to which a particular slice of the value-added chain is protected.

This logic accounts for one of the major stylised facts about ROOs – their hub-and-spoke nature, i.e. large trading powers like the US and EU tend to have similar ROOs and exclusions for all their bilateral RTAs. This is to be expected since they have the negotiating leverage to more or less dictate the terms of their ROOs.<sup>5</sup> Powerful vested interests that get exclusions or protectionist ROOs for one RTA typically get them for all.

**Asymmetry of the Spaghetti Bowl.** While the hub-and-spoke nature of the spaghetti bowl arose from well-understood protectionist interest, its economic implications are subtle. If a firm is located in the hub market, the world does not really look like a spaghetti bowl. Due to the hub-and-spoke pattern of ROOs and ROCs, a firm located in the hub faces only one set of ROOs for its exports in the hub-and-spoke zone. For example, US-Mexico, US-Canada and US-Chile exports all use what are known as NAFTA rules of origin. The situation is quite different for a firm located in one of the spoke nations. A Mexican firm faces different ROOs for its exports to various partners since the EU-Mexico FTA uses the EU rules of origin, the US-Mexico FTA uses NAFTA rules of origin, and the Japan-Mexico FTA uses a third set. In short, the economic costs of the Spaghetti Bowl syndrome falls more than proportionally on firms located in the spoke economies.

Two costs in particular are worth highlighting since they play a big role in driving multilateralisation. The first is the cost of adapting production techniques so that the firm's product meets the criteria of multiple rules of origin (or that of the RTA with the most stringent ROOs). The second is that bilateral cumulation hinders efficient source of parts. For example, if a good needs 50% of its value added in, say, the US or Mexico, Mexican firms can source from either market. However, if a Mexican firm sources from the US, the value added will not count towards origin status when it comes to its exports to the EU, thus discouraging the Mexican firm from buying from the lowest-cost supplier.

In a nutshell, rules of origin serve their protectionist intent in a way that creates more problems for firms located in spoke-nations than for firms located in hub-nations.

#### **Political economy logic of the Pan-European Cumulation System (PECS)**

Given the political economy logic discussed above, the emergence of a Spaghetti Bowl syndrome in Europe in the 1990s should have been expected. What may not have been expected is the volte-face that occurred in 1997 with the implementation of the PECS. To understand the shift, it is necessary to identify the changes that re-arranged the political economy forces that produced the European Spaghetti Bowl in the first place. The focus here is on the globally-observed phenomenon of 'unbundling' of manufacturing processes (Baldwin 2006a), which is sometimes called fragmentation, or slicing up the value-added chain.

As competition from low-wage nations mounted in the 1990s and the coordination of distant activities became easier with cheaper, EU firms unbundled their manufacturing processes and offshored the production of some components to low-wage-low-productivity nations, especially those in nearby Central Europe. This shifting of manufacturing from the 'hub' to 'spoke' meant that EU firms started to suffer more from the asymmetric effects of the Spaghetti Bowl. Moreover, the downsizing of production in the EU (due both to the unbundling and offshoring and the rise in competition from emerging nations such as China) meant that there was less EU-based production to benefit from the protectionist ROOs.

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<sup>5</sup> For example, EU total imports exceed 3 trillion dollars while the import-markets of its regional partners are a tenth or a hundredth as large.

**‘Us’ becomes ‘them’.** These changes induced some EU firms (maybe even some of those that pushed for the asymmetric Spaghetti Bowl in the first place) to become advocates for taming the tangle. They pushed the EU to 1) harmonise rules of origin so as to avoid the cost of meeting the actual and documentary requirements of multiple sets of rules of origin, and 2) allow diagonal cumulation, so their factories in the ‘spoke’ economies could source inputs from a wider range of nations without fear of losing the origin status. Of course, a complete analysis of the situation would require examination of the changes in the political economy alignment in the ‘spoke’ economies as well, but given the hugely asymmetric export dependence of the spoke economies on the EU, the EU was in the driver’s seat when it came to reform. The switch was made even easier since most of the spokes hoped to be EU members in just a few years.

Nations inside this zone of harmonised preferences tended to be more attractive to FDI from the EU, so the formation of PECS started a domino effect. Turkey joined in 1999 and it is being extended to the Euro-Med FTAs gradually with a completion deadline of 2010. Joining PECs requires nations like Tunisia to sign identical FTAs with PECS-rules of origin with all of the other PECS members. The diagonal cumulation only comes into effect when the new member completes its system of FTAs.<sup>6</sup>

#### **Political economy logic of ITA**

The same sort of political economy logic can account for the emergence of the ITA which eliminated the spaghetti bowl problems in a different way. Instead of keeping the tariff preference and harmonising the ROOs and ROCs, the ITA made ROOs and ROCs non-operative by granting duty-free treatment to imports from all destinations.

The political economy forces driving this policy move was, however, quite akin to those behind PECS. By the mid 1990s, tariffs were quite low on electronic components all around the world due to an ad hoc collection of multilateral, regional and unilateral tariff cuts. In fact, the EU was the only major trader to charge significant tariffs on such goods. Since the tariff cutting in IT goods was not conducted under the aegis of the GATT, trade was marked by a Spaghetti Bowl.

From the mid 1980s onward, the production of IT goods witnessed a massive unbundling of production and an attendant explosion of the trade of parts and components. This big increase in unbundling/outsourcing – together with the acceleration of the product cycle – turned the Spaghetti-Bowl’s hindrance of efficient sourcing from a headache to a huge problem for IT manufactures all around the world. ‘Us’ and ‘them’ became completely blurred. In this setting, it is fairly easy to see why the major producing firms wanted to ‘tame the tangle’.

#### **Lessons: Spaghetti bowls as building blocks**

The key elements in both instances of multilateralisation are:

- ROOs and bilateral ROCs acts like frictional (i.e. cost-raising) trade barriers since they raise the cost of competitors located in other RTA nations. The hub-and-spoke pattern makes this asymmetrically costly for firms producing in spoke-nations.
- Unbundling of the manufacturing process erodes political support for existing ROO/cumulation protection since it downsizes the import-competing industries that benefited from them. Additionally, unbundling creates new political economy opponents of the ROO/cumulation protection since the firms

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<sup>6</sup> See [ec.europa.eu/taxation\\_customs/customs/customs\\_duties/rules\\_origin/preferential/](http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/) for details.

that offshore production facilities to ‘spoke’ economies find themselves on the “wrong” side of the ROO/cumulation protection.

### 3. MULTILATERALISING DEEPER FTA COMMITMENTS: CASE STUDIES

Does the Spaghetti Bowl problem extend to non-tariff barriers? Most RTAs address non-tariff barriers. Indeed it is striking that many WTO members accepted RTAs that include disciplines whose discussion they firmly rejected at the multilateral level. This section considers the extent to which RTAs have created a Spaghetti Bowl in six areas of deeper RTA commitments: technical barriers to trade (TBTs), trade in services, government procurement, competition policy, and investment measures. It also considers the extent to which such RTA commitments have been or could be multilateralised.

#### 3.1. Technical barriers to trade

The steady lowering of tariffs has redirected attention to non-tariff measures with technical barriers to trade (TBTs) being one of the most important categories.<sup>7</sup> The WTO has engaged in some TBT liberalisation, but much greater progress has been made in regional and bilateral arrangements. This section considers the extent to which preferential TBT commitments create a Spaghetti Bowl problem and how the commitments might be multilateralised.

##### Technical barriers to trade are different

With the goal of protecting the health and safety of consumers, animals and plants, of protecting the environment, and of protecting consumers from fraud, most governments regulate the sale of most goods. Such regulation is an essential part of good governance. However, the resulting standards, regulations and rules can act as protectionist measures. Specifically, they are frequently designed in a way that raises the foreign firms’ costs more than would be necessary to fulfil the good-governance objectives. Such regulation is a TBT to the extent that it is not in the ‘least trade restrictive’ means of achieving the regulatory objective. It is useful to distinguish two forms of TBTs: (i) the content of the product norm (i.e. the precise standard, regulation, rule, etc.),<sup>8</sup> and (ii) testing (i.e. testing procedures that are necessary to demonstrate that a product complies with a particular norm, also called ‘conformity assessment procedures’).<sup>9</sup>

**Complexity and the ‘trust issue.’** Product regulation is intrinsically complex and this complexity of the key to the distinctiveness of TBT liberalisation (Baldwin 2000). First, it implies that

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<sup>7</sup> This point is not new. The last time ‘globalisation’ was in fashion – when it was called internationalisation and interdependence – Robert Baldwin (1970 p.2) wrote: “The lowering of tariffs has, in effect, been like draining a swamp. The lower water level has revealed all the snags and stumps of non-tariff barriers that still have to be cleared away.”

<sup>8</sup> Many authors break the norms into standards (usually defined as voluntary norms, like the GSM standard for cell phones), and regulations (mandatory norms, like prohibition of lead paint on toys).

<sup>9</sup> The extent to which a particular regulation or testing procedure is a trade barrier is extremely difficult to ascertain. Much product regulation is highly technical and thus its impact can only be understood by industry experts. Since these experts usually work for companies whose bottom lines are affected by the rules, it can be difficult or impossible to get unbiased advice.

protectionism is finely interwoven with good-governance regulation.<sup>10</sup> Second, it means that reducing the protectionist content of product regulation without lowering regulatory quality requires trust; the liberalising governments must believe that the other government is capable of establishing and enforcing highly technical rules in a transparent and credible manner. This ‘trust issue’ plays an important role in understanding why TBT liberalisation is so different to tariff liberalisation.

#### **TBTs commitments in FTAs**

Piermartini and Budetta (2007) undertake a survey of the TBT provisions in a representative sample of 70 FTAs. They find that 58 of these include TBT provisions. Importantly, these include all the largest regional arrangements. Since the internal trade of NAFTA and the EU alone account for about a third of world trade – and both have important TBT commitments – the TBT commitments in RTAs clearly matter for the world trade system. Corresponding to the two forms of TBTs, we classify TBTs provisions in regional trade arrangements liberalise trade in two ways; by

1. harmonising the norms so that only one norm applies to all the RTA partners, or
2. making it cheaper and/or faster for firms to certify that their products meet the norms of the RTA partner.

Piermartini and Budetta (2007) also list RTA commitments concerning transparency (e.g. prior notification of new norms sometimes with a right to comment before the norm is adopted), institutional cooperation (e.g. establishment of a committee to discuss standards), and dispute resolution.

The two deepest RTAs in the world – the EU and the Australia-New Zealand Closer Economic Relationship (CER) – involve substantial harmonisation and mutual recognition of product norms and testing.<sup>11</sup> Although the EU’s rules affect a very large share of world trade (nations that embrace the European norms account for about 40% of world imports), the EU and CER provisions do not create a Spaghetti Bowl. Indeed, empirical evidence suggests that the EU’s Single Market programme increased access at least as much for third-party firms (Mayer and Zignago, 2005).

Apart from the European and CER arrangements, the main liberalisation elements of regional TBT agreements concerned the mutual recognition of testing facilities in certain sectors such as pharmaceutical and electrical equipment. These are called Mutual Recognition Agreements (MRAs). For example, in the MRA signed between the US and the EU, the EU recognises the right of certain US laboratories to certify that goods meet EU norms and thus can be sold in the EU. Likewise, the US recognises the right of certain EU laboratories to certify goods as meeting US norms. This is a cost-

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<sup>10</sup> It is often asserted that TBT liberalisation engages sovereignty issues that tariff cutting does not, but this is incomplete reasoning. Many tariffs are used for valid policy goals, – e.g. protecting jobs of low wage workers – but the WTO rejects the raising of bound rates as a legitimate means of attaining such goals since tariffs are not the least-trade-restrictive means. The transparency of tariffs makes this an easy distinction to make. It is radically more difficult to objectively determine whether TBTs could be less trade restrictive and accomplish their valid policy goal. In short, the key difference between regulatory protection and tariffs is obscurity, not sovereignty.

<sup>11</sup> The EU and EFTA extend mutual recognition in norms and testing to each other quite broadly in the European Economic Area agreement. The EU also encourages its other nearby trade partners (e.g. its bilaterals with Mediterranean nations) to unilaterally adopt EU norms, but the EU does not grant mutual recognition of norms or testing. See Baldwin (2000) for an examination of the various harmonization efforts that have been made in Europe, and Piermartini and Budetta (2007) for an overview of TBT provisions in RTAs around the world.



lowering liberalisation since before all the US-norm testing had to be done in the US, and all the EU testing in the EU.<sup>12</sup>

**No rules of origin.** From the world perspective, it is very important to note that the typical testing-MRA does not contain rule of origins. The MRA in essence expands the list of laboratories that can certify a product meets a particular norm, without requiring that the origin of the product be established. Consider, for example, a US laboratory that has been named under the US-EU MRA as capable of certify that product meets EU requirements. This US laboratory can then be used by a Canadian firm that wishes to export its goods to the EU.

The lack of ROOs has the effect of automatically multilateralising the preferential TBT liberalisation. For example, the EU-US MRA might seem to put Mexican firms at a disadvantage in the EU market. However, the fact that Mexican firms can use US laboratories to demonstrate that their products are in conformity with EU norms goes a long way to reducing the discriminatory effect of the MRA. To see the point by analogy we can compare it to an FTA between country A and B that has no ROOs. Without ROOs, third nations, say nation C, can always take advantage of the A's duty-free access to B by trans-shiping their goods via nation A. While this does put nation-C firms at somewhat of a disadvantage compared to nation-B firms, the disadvantage is limited – it can never exceed the trans-shipment cost. Similarly, having a testing laboratory in the US provides US firms with an edge that Canadian firms don't have, but the advantage is limited to the extra cost of getting Canadian products tested in the US.

In short, weak rules of origin can be thought of as “automatic multilateralisers” in that they greatly reduce the Spaghetti Bowl problem.

### **Multilateralisation**

While economists widely agreed that multilateral tariff cutting would be superior to the equivalent preferential liberalisation, the situation for TBT is much more nuanced – a fact that is recognised explicitly the WTO's TBT Agreement.

First, global TBT liberalisation is not necessarily optimal. The EU and EEA is only group of nations that have made substantial progress in eliminating TBTs across the board. This was achieved through a combination of harmonisation to a European standard on essential norms, and mutual recognition on the rest (Baldwin 2000, Vancauteran 2002). Given the wide gaps in incomes levels and governance capacity, a similar liberalisation is unthinking at the global level. There is no reason to believe that Europe's norms – or any other for that matter – would be optimal for the rest of the world, or vice versa (Bhagwati and Hudec 1996).

Second, the most common form of bilateral TBT liberalisation compromises testing-MRAs. Since these do not have rules of origin attached, they are systematically less trade distorting than preferential tariffs. As mentioned, one can think of a testing-MRA as acting something like a preferential tariff without a rule of origin.

Third, the ‘trust issue’ makes deep liberalisation at the multilateral level impossible. The WTO's TBT Agreement recognises as much by encouraging MRA among members. It encourages global content-of-norm liberalisation by calling upon members to adopt international standards wherever possible. Notably, the TBT Agreement does not impose the same strictures on TBT preferential liberalisation as

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<sup>12</sup> Somewhat confusingly, the liberalisation of some norms is also referred to as Mutual Recognition Agreements, especially in service sectors. We the need arises, we keep the concepts distinct but referring to testing-MRA and norms-MRA.

it does on preferential tariff, or services liberalisation. For example, there is no requirement that testing-MRAs apply to a wide range of sectors. Nor is there any explicit requirement that the MRA not raise barriers against third party goods.

Fourth, TBTs are cost-raising, i.e. friction barriers, and the simple economics of frictional barriers tells us that preferential liberalisation is systematically less harmful to economic efficiency than is preferential liberalisation of tariffs. For example, Viner's ambiguity – which tells us that in the case of preferential tariffs, even the members of a bilateral may lose – disappears in the frictional barriers case. See Appendix B for details.

**Modalities.** The distinctive features of TBTs imply that multilateralisation is both less necessary (since MRA are less distortionary and FTAs) and much more difficult (the trust-issue). Nevertheless, it is useful to think about modalities for multilateralisation. The first point is that the lack of rules of origin in testing-MRA came about for practical reasons (Baldwin 2000), not due to WTO rules. Thus one step would be to encourage or require future testing-MRAs continue the practice of eschewing ROOs. The second is that the transparency provisions in RTAs could multilateralised, especially those concerning prior notification on new standards and regulations. Indeed the WTO itself might play a role in this.

Since deep TBT liberalisation is unlikely to extend beyond advanced industrialised nations, the pattern of preferences is more like a two-tier system than a Spaghetti Bowl. A third way to multilateralise TBT liberalisation would be to counter the exclusionary impact of a two-tier system directly. The WTO could actively seek to offset any anti-developing nation bias arise from regional TBT liberalisation. The WTO TBT Agreement already contains hortatory statements about providing technical assistance to developing nations. The WTO could more explicitly promote the TBT equivalent of GSP. For instance, industrial nations might directly or indirectly subsidise conformance assessment procedures for products made in developing nations, or pay for the establishing of certified testing facilities. Similarly, the current TBT Agreement has discipline on members charging foreign firms certification fees that are too high. To offset the cascading effects of discriminatory TBT liberalisation, the WTO might encourage a subsidisation of fee charged to firms based in developing nations.

Finally, TBTs would be less of a trade barrier if national norms were more similar. Thus one way to multilateralise TBT liberalisation is to encourage harmonisation of standards. This is already part of the TBT Agreement – and the subject of numerous standard bodies worldwide – but it would seem that the WTO could help raising the issue of standards harmonisation to the political level and perhaps facilitate negotiation of harmonisation across sectors, including across the services and manufacturing sectors. The existing international forums for standards do almost nothing to encourage the sort of cross-sector compromises that the WTO system is so good at.

**Unbundling and political economy forces.** The multilateralisation of preferential tariffs was, according to the arguments in Section 2, driven by the unbundling and offshoring of manufacturing. Unbundling confused the us-verse-them distinction and this in turn made it easier to cooperate on taming the tangle. Just as the Spaghetti Bowl came to be a building bloc with respect to tariffs, ever widening unbundling may lead firms to lobby for a multilateralisation of TBTs, especially in regions where trade in parts and components are particularly intense. While the trust-issue limits the applicability of the logic, this reasoning may account for the fact that it has been relatively easy to liberalise TBTs in electrical machinery and electronic components in East Asia (although in this case the main vector for liberalisation was the widespread adoption of international standards).

More generally, the role of unbundling may help explain why international standards have been adopted in some industries but not others. In products such as cell phones protocols and high definition

video, firms still seek idiosyncratic standards in order to garner an advantage in their local market. However, in industries where production is highly fragmented, the loss of scale economies and organisation simplicity is high enough for all firms to want to agree on common standards – at least for parts and components. As unbundling proceeds and spreads to more industries, opportunities for further regional TBT liberalisation are likely to arise. The WTO could use its role as fair-broker and convenor of negotiations to help ensure that this regional liberalisation is woven constructively into multilateral liberalisation efforts

### 3.2. Multilateralisation of trade in Services preferences

Trade in services is growing more rapidly than trade in service and nations increasingly view access to world-class services as an essential aspect of competitiveness. The rapid multiplication of FTAs has been accompanied by an explosion of regional commitments on services liberalisation, the so-called GATS-plus arrangements (Fink and Jensen 2007; Roy, Marchetti and Lim 2006). This section considers the Spaghetti Bowl problem with respect to Services provisions in FTAs and discusses how it might be multilateralised.

#### Barriers to trade in services

Barriers to trade in services are distinctive from those on imported goods since trade in service is different. Trade in goods happens when a product is made in one nation and sold in another. Trade in services is a richer phenomenon. Some service trade resembles goods trade in that the producer and consumer remain on opposite sides of the border – think of internet translation services. However, many services requires the producer and consumer to be physically close to each other. Either the consumer goes to the producer – e.g. someone travels for medical treatment – or the producer goes to the consumer – e.g., a foreign bank establishes a local branch. According to WTO jargon, these types of trade in services are mode 1 (cross-border), mode 2 (consumers move) and mode 3 (firms move).<sup>13</sup> In addition to the need for proximity, services trade is different since many services are intangible. Intangibility makes it hard to determine what crossed the border and when, so governments have found it difficult or impossible to impose border measures like tariffs. Moreover, the intangibility has led governments to pursue their regulatory goals (protecting consumers, etc.) by regulating service providers rather than the service itself.<sup>14</sup>

#### GATS+ RTAs

RTAs in services can provide preferential market access in two main ways. The first is to assure that service providers from RTA partners are treated as local firms when it comes to regulation and taxation. This preferentially extends national treatment in areas where the nation has not yet committed to national treatment in the GATS. The second is to providing better market access to the partner's service providers. Since governments typically regulate service providers instead of the services themselves, one part of market access concerns the recognition of professional qualifications for individuals and regulatory certification for firms. Just as in TBTs, complexity and trust are dominant considerations, so

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<sup>13</sup> There is a fourth mode which is akin to immigration or guest worker programmes; it is rarely addressed in PTAs, so we shall leave it to the side in this paper.

<sup>14</sup> In goods, this would be akin to regulating clothing producers instead of setting norms for clothes.

preferential services provisions shares many of the features of preferential TBT agreements discussed above.

**‘Third party MFN.** Fink and Molinuevo (2007) distinguish a third type of provision that concerns current and future non-discrimination with respect to national treatment and/or market access. In particular, some RTAs explicitly rule out discrimination among RTA members (so-called regional MFN). Another type of MFN provisions concerns the preferences that a nation may grant to third parties in the future. Colloquially, this commitment says: ‘whatever preference we give to someone else in the future we automatically give to each other.’ This provision, called non-party MFN in the jargon, is somewhat akin to unconditional MFN in the pre-GATT era. It means is that current RTA partners will never have less than the best preferential access, so maybe it should be called ‘most preferred access’ status. In some service RTAs, the most-preferred-access status is guaranteed (so-called ‘hard’ third-party MFN commitments). In others, there is only the soft commitment that the RTA partners will consider favourably requests for the extension of future preferences to service providers from current RTA partners. (See Fink and Molinuevo 2007, and Dee, Ochiai and Okamoto 2006 for details.)

**ROOs.** Service RTAs include rules of origin that establish which services and/or service providers are eligible for preferential treatment. These rules or origin are quite different to the ROOs associated with preferential tariffs.

When it comes to cross-border services trade (mode 1) officials must determine where the service came from. Given the statistical and conceptual difficulties of measuring intermediate inputs in services, ROOs for mode-1 trade tend to be extremely simple. If the provider of the service is located in a RTA partner nation, then the service is considered as originating in that nation and thus eligible for preferences.<sup>15</sup> Rules of origin for mode-2 trade also tend to be simple or absent. A control point occurs at the immigration post of the exporting nation (i.e. as the consumer physically enters the exporting/producing nation), so the issue of the exporters’ origin is immaterial and the origin of the consumer is readily verified if necessary.

The rules of origin for trade in services that involve a local presence (mode 3) face a very different challenge. When a government extends preferences to service providers in their RTA partner, it is necessary to establish which service providers are eligible for the preferences. For example, which banks can extend mortgages to home owners? For a variety of reasons, most service RTAs include very liberal rules of origin when it comes to mode 3 services. Most service RTAs in East Asia, for example, extending RTA benefits to firms (‘juridical persons’ in the jargon) that are constituted or otherwise organized under the laws of one of the RTA partners and that have substantive business operations in the same nation.<sup>16</sup> These ROOs avoid the difficult question of a firm’s nationality, or the nationality of the people who control the corporation. Obviously, such “leaky” ROOs reduce the Spaghetti Bowl problem a way that is akin to the lack of ROOs in TBT MRAs. For mode-3 trade, service suppliers from third nations can profit from the market opening negotiated under the RTA. The only requirement is that they establish a legal presence and a certain level of commercially active in one of the RTA

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<sup>15</sup> In principle, these weak ROOs of could produce trade deflection. For instance, a service provider in one PTA partner might be outsourcing the service jobs to providers located in third nations. Typically this is a minor issue since either the mode-1 market access barriers are low or nonexistent at the MFN level so pure trade deflection is not commercially attractive, or trade in the type of service is forbidden on an MFN and preferential basis, e.g. online gambling.

<sup>16</sup> This is not to say these nations make it easy for foreign firms to establish a judicial presence, but any firm that does manage to do in one FTA partner will enjoy the preferences, e.g. national treatment with respect to taxes and regulation.

partners. The exception that proves the rule is China's RTAs with Hong Kong. This contains rather strict provisions intended to exclude service providers that are not owned and controlled by residents of either Hong Kong or the mainland.

Note that liberal ROOs are required by the GATS Article V.6 for RTAs involving developed country WTO members.<sup>17</sup>

### **Multilateralisation**

As Fink and Jenson (2007) argue persuasively, the preferential agreements concerning trade in services have not created a Spaghetti Bowl in the way tariff preferences have. In essence, the special features of most service FTAs have provided what might be called "multilateralisation on autopilot". The "leaky" ROOs automatically multilateralise the preferential market access to a certain extent since third-nation service providers can free-ride on the preference by paying to cost of establishing a presence in one of the partner's markets. Unless all of the partners have equally restrictive MFN market access restrictions, the liberal ROOs tend to have the effect of lowering all RTA partners' MFN market access to that of the most liberal member (plus the extra establishment cost). Likewise, the hard and soft most-preferred-access clauses (i.e. third party MFN) tend to automatically tame the tangle.

The discussion hereto has also made clear the similarity between many of the issues surrounding preferential agreements in TBTs and those in services. It is not surprising therefore that the options for multilateralising service RTAs are quite similar to those for preferential TBT agreements. The first point is that WTO should encourage use of "leaky" ROOs in future RTAs concerning trade in services. The second point is that WTO should encourage the adoption of global standards for the regulation of service providers as a way of reducing the tension between the protectionist and legitimate motives driving service sector regulation. The positive example here comes from the "Decision on Disciplines on Domestic Regulation in the Accountancy Sector" that was agreed by the WTO Working Party on Professional Services in 1998. The Working Party on Domestic Regulation is already engaged in the task of exploring whether the success in international standardisation in accounting could be reproduced in other service sectors.

Much of the liberalisation of services by developing nations – especially the ones that are rapidly industrialising – resembles the unilateral tariff cutting that they are also engaging in. As in tariff cutting, these nations appear unwilling to bind their very low applied rates in the multilateral setting. GATS-plus commitments in services are especially marked in sectors that directly affect their attractiveness to FDI that boost their export competitiveness. Examples include trade-related financial services (insurance, letters of credit, etc.), distribution services (express package delivery and courier services), construction, business services, and telecommunications. The GATS-plus RTA – especially a North-South RTA – provides the developing a means of locking in the opening and thus providing assurances to investors that the reforms will remain in place. Of course, GATS scheduling would also play this role, but this route suffers from free-riding and the presumption of special and differential treatment in

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<sup>17</sup> The article requires that a service supplier that is a "juridical person" (i.e. legally established) with 'substantive business operations' in any other PTA member nations must be granted the preferential treatment; in short, the rule of origin must be based on where the firm operate rather than its nationality. Fink and Jenson (2007) assert that this rather requirement may have been included in the GATS for political economy motives that resemble the spaghetti-bowls-as-building-blocs argument. That is, in a world of large multinational service providers, us is them, and so allowing strict rules of origin would be likely to harm the commercial interests of the most influential service providers all around the world.

negotiations. This line of reasoning suggests that the WTO might create lock-in mechanisms that help developing nation Members lock in their policy reforms without going all the way to GATS scheduling.

Finally, as in TBT and tariff preferences, the ongoing process of unbundling and offshoring is likely to foster the liberalisation trade in services. The combination of falling communications costs and the unbundling of manufacturing and service sectors should create an incentive for nations to abandon idiosyncratic services standards as a way of boosting the competitiveness of their own exporters and improving the attractiveness of their nations as destinations for foreign direct investment.

### 3.3. Trade remedies

The number of countries that have enacted and used trade remedies – antidumping measures, countervailing duty measures, and safeguards – has grown sharply since the 1980s (Prusa 2005). The application of these measures has seen duties applied to affected imports at levels many times the prevailing MFN tariff rate and considerable uncertainty has been created by the mere threat of such remedies and during the associated investigations (Blonigen and Prusa 2001). Trade remedies have been subject to multilateral GATT/WTO disciplines since the beginning, but liberalisation at the multilateral level has proved slow. As in so many other areas, RTAs have provide another vehicle for the reform trade remedies.

#### Trade remedy provision in RTAs

Teh, Prusa, and Budetta (2007) provide an illuminating overview of the trade remedy provisions in a representative sample of 74 RTAs. Only nine of these RTAs forbid the use of antidumping measures between the parties.<sup>18</sup> Likewise, only five RTAs rule out the use of countervailing duties and safeguard measures.<sup>19</sup> These agreements are essentially limited to the deepest regional integration initiatives, i.e. the EU and its neighbours, and the CER, where the abolition of remedies is accompanied by deep political cooperation (or even supranationality) on competition and state aids policies. Some RTAs include provisions that allow for greater discrimination across trading partners in the application of trade remedies. For instance in 14 RTAs, parties have agreed to exempt other parties from any global safeguards that they impose under the respective WTO agreement. (This is an example of exactly the opposite of multilateralising regionalism, with RTAs undermining an established non-discriminatory multilateral norm.)

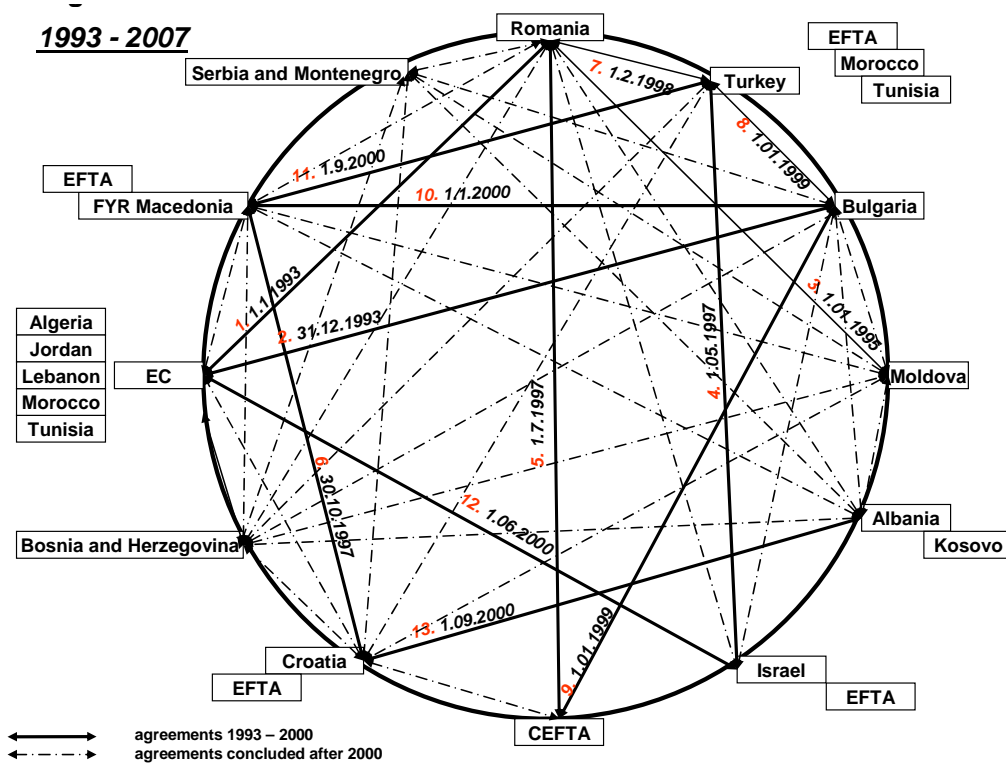
Other provisions in RTAs appear to reduce the probability that an exporter from a party is found to have traded unfairly in the first place or to have caused injury to an import-competing sector. On the

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<sup>18</sup> As in most areas of deeper integration, the European Economic Community was the pioneer in the preferential liberalisation of trade remedies. Right from its founding in 1958, the Community forbade Members from imposing antidumping or countervailing duties on each others' exports. Instead, the Community adopted a common competition policy and a common state aids policy. The idea was that the common policies – implemented by the supranational European Commission and overseen by the supranational European Court of Justice – would satisfy Members' legitimate need to discipline unfair competition by firms located in other Member States, or trade distorting subsidies provided by other Members (see Baldwin and Wyplosz (2005) for details.) This practice of substituting common competition and state aids policies for trade remedies was extended to other rich Western European nations via the 1992 European Economic Area agreement. This switch potentially liberalises markets since it involves meeting legitimate regulatory goals with less trade distorting measures.

<sup>19</sup> None of these FTAs require a party not to use a trade remedy against all of its trading partners which would, of course, represent the greatest multilateral benefit from the FTA provisions in question.

face of it the latter provisions might be welfare-improving, however care is needed here. A welfare analysis of these latter RTA provisions ought to take account of the fact that the pre-RTA application of trade remedies was very often discriminatory, second-best considerations, and the possibility that commitments to forgo or discourage using trade remedies against RTA trading partners may increase the probability that non-parties to a RTA are subject to trade remedies.



**Figure 1: FTAs with Joint Committee provisions affecting antidumping and safeguard measures.**

There is one feature of trade remedy provisions in many RTAs that is fairly prevalent, even if it is not global. Many RTAs include provisions that stipulate that any antidumping or safeguards investigation of firms located in a RTA party must be notified to a ‘joint committee’ of the RTA parties, and that consultations between the parties may follow and an amicable solution possibly found. Although this does not reduce the application of remedies *de jure*, it is likely to do so *de facto*. What was previously a purely unilateral act (investigating trade remedies and taking measures) now becomes a matter that automatically invokes trade-diplomacy issues as well. Reminders from trading partners of the totality of the benefits of the bilateral trading relationship may discourage the application of trade remedies in the first place. Teh, Prusa, and Budetta (2007) note that these provisions are commonly found in RTAs with the EU. Our investigation has revealed that there are plenty of RTA agreements with non-EU members

that include provisions for notifying joint committee when trade remedies are undertaken<sup>20</sup>, although it should be said that many of these RTAs have parties that are in Europe (generously defined) or in the Mediterranean.

Figure 1 identifies the 52 RTAs notified to the WTO which have Joint Committee provisions relating to the application of trade remedies.<sup>21</sup> Interestingly, many of these RTAs involve countries in Eastern Europe and the Mediterranean. It also shows that these Joint Committee clauses proliferated after 2000 and now extend across the Mediterranean as well.<sup>22</sup> Since the threat of remedies hinders unbundling and efficient regional supply networks – the “Euro-Med Factory” – the RTA provisions on remedies helped guard the benefits of lower tariffs from being reversed by trade remedies. The above argument might also partly account for the fact that, despite all of the economic restructuring and unemployment witnessed in Eastern Europe, these nations did not become heavy users of trade remedies such as antidumping.<sup>23</sup>

### Multilateralisation

The effect of production unbundling and offshoring on the level of corporate support for harmonising and liberalising preferential rules of origin was discussed in Section 2. Here we argue that pervasive unbundling and the associated international outsourcing of parts and components may well have implications for the spread of certain trade remedy provisions found in RTAs and, perhaps eventually, for securing greater support for new multilateral rules on trade remedies. Indeed, the spread of Joint Committee provisions among Euro-Med RTAs suggests that unbundling and offshoring have expanded the constituency pushing for trade remedy reform. There are three reasons for this:

- RTAs may reduce tariffs to zero but keeping them at zero is important. Countries wishing to attract export-oriented FDI appreciate that their cost advantages can be readily offset by punitive trade-remedy tariffs. This creates a demand for trading partners to forgo or at least to limit recourse to trade remedies. A related motive affects incentives in the investing company’s home-nation.
- After production unbundling, countries may find themselves applying trade remedies against imports shipped by the foreign subsidiaries of “their” multinational firms. In other words, unbundling blurs the distinction between “us” and “them.” Indeed, governments that seek to form a coalition for

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<sup>20</sup> Moreover the fact that Korea sought similar provisions in its FTA with the U.S. (establishing a consultation process for antidumping investigations) suggests that the potential benefits of such provisions have been perceived outside of Europe too. The US could not agree to Korea's request. It was argued by some US observers that had Korea's request been accepted it would have allowed Korea to interfere unjustly in the US' application of its own antidumping law, which was precisely the point of the request.

<sup>21</sup> With the admission of the Central European states (and signatories of the CEFTA agreement), Romania, and Bulgaria to the European Union admittedly the total number of currently operative agreements with Joint Committee provisions is less than 52. As will become clear soon, however, we would argue that the original pre-EU accession FTAs are interesting precisely because they included these Joint Committee provisions at exactly the time when Eastern Europe was seeking to establish itself as an attractive location for outsourcing and for the production of parts and components.

<sup>22</sup> In the figure, those jurisdictions outside the circle are ones which have FTAs with joint committee provisions with the country closest to it on the circle. For example, EFTA, Morocco, and Tunisia have FTAs with joint committee provisions in with Turkey.

<sup>23</sup> Of the Eastern European nations destined to become EU members, only Poland became a moderate user of antidumping measures; see Evenett and Vermulst (2005).



remedies reform may seek a RTA-related commitment to counter domestic demands for trade remedy investigations in those industries where some firms have unbundled production and others have not.

- Firms seeking to source parts and components from abroad do so with cost minimisation and security of supply in mind, amongst other considerations. Trade remedies that disrupt prior contractual arrangements are particularly unwelcome, especially in sectors with very thin profit margins and little room to pay extra tariffs. Another critical factor to bear in mind is that outsourcing firms want to source parts and components made to specified standards from the cheapest possible location. Given unforeseen fluctuations in exchange rates and unanticipated cross-country differences in wage growth (and more generally, in the growth of production costs), a firm engaged in outsourcing is not content with measures that discourage the use of trade remedies in any one bilateral trade relationship, but in as many bilateral trading relationships as possible. This underlies the producer support for the spread of a common or similar set of rules on the application of trade remedies.

Very few RTAs have abolished trade-remedy tariffs. Although these include the largest RTA, they are not indicative of an appetite for multilateral initiatives that forgo the use of trade remedies. Many other RTAs, however, adopt subtle reforms that may hinder uses of remedies – especially in cases where production has been unbundled and offshored within the region, so the distinction between “us” and “them” is blurred. Such RTA clauses add a diplomatic component to an otherwise unilateral action. Some WTO members may resist this pressure, arguing that it involves an intrusion into their independent rights to enforce so-called fair and unfair trade laws. Nevertheless, as outsourcing continues the balance of commercial interests seeking security from imports and those seeking security of supply chains will likely shift, facilitating the potential multilateralisation of measures to limit the application of trade remedies. The WTO might consider facilitating this trend with study groups and negotiating forums. It might also consider hard or soft law provisions that reduce the potentially that such Joint Committee clauses create new discrimination.

### 3.4. Government procurement

Government procurement is big business. It is not uncommon for developing and industrialised country governments to spend 15 to 20 percent of their GDPs on goods and services (Audet 1998, Trionfetti 2000). In a world where there are 14 economies in the trillion dollar-plus category and 40 economies in the one-hundred billion dollar-plus range,<sup>24</sup> government procurement represents a substantial commercial opportunity.

In many nations, these opportunities are systematically denied to foreign firms. Indeed, nations have never agreed to liberalise government procurement markets on a fully MFN basis. Liberalisation to date has involved a degree of exclusiveness in the RTA context as well as in the in the WTO context. This section considers the extent to which RTA commitments on procurement create a Spaghetti Bowl problem and how the commitments might be multilateralised.

#### Liberalisation initiatives: the GPA and RTAs

The WTO's Government Procurement Agreement (GPA) is a club whose objective is to open up its members' procurement markets on a preferential basis to other club members. Roughly speaking, the

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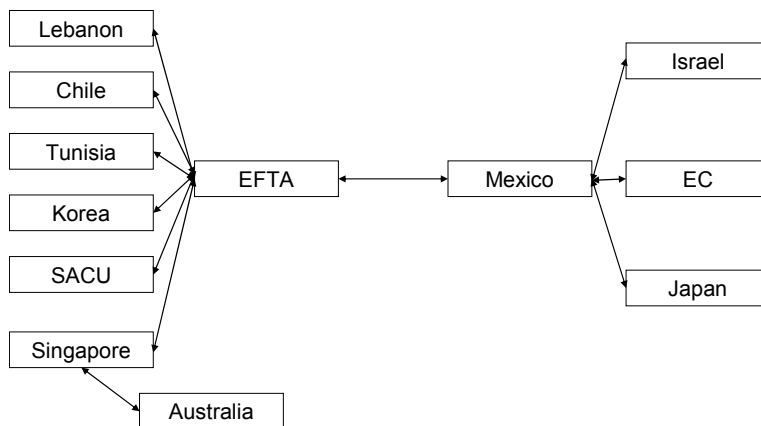
<sup>24</sup> Measured in purchasing power parity terms. Data taken from the World Bank's World Development Indicators for the last year available (2005).

GPA rules out discrimination but only as concerns club members.<sup>25</sup> Measures against non-members are allowed and are often applied since the GATT/WTO has few disciplines on such measures.

The GPA was revised during the Uruguay Round of trade negotiations and a number of WTO members became members. Other WTO members can seek to join this agreement, but only a minority have. Currently, counting European Communities as single member, this plurilateral accord has 12 other members (principally industrialised countries.) In principle countries that join the WTO (including China) are supposed to eventually accede to the GPA as well, providing for a large number of potential "exogenous shocks" to the magnitude of procurement covered by the GPA's disciplines.

**ROOs and foreign subsidiaries.** The GPA forbids discrimination in public procurement processes against foreign subsidiaries based in a GPA signatory. It also rules out the application of special rules of origin for procurement; GPA members must apply the same set of rules-of-origin to determining preferences in public procurement as they do in determining preferences in tariff rates.

**Procurement in RTAs.** Like the GPA, the government procurement provisions in RTAs typically open state purchasing to foreign competition on a preferential – often bilateral – basis. A description and taxonomy of the content of the government procurement chapters of almost 30 FTAs can be found in Bourgeois, Dawar, and Evenett (2007 section 4). The provisions vary considerably across agreements in detail and content. The most detailed contain provisions on the scope and coverage of disciplines; the definition of government procurement, associated entities, and related matters; the methods and manner in which state purchases can be conducted; rules of origin; the allowable rules on the qualification of suppliers; time-limits employed in state procurement procedures; and institutional matters.



**Figure 2: FTAs with most-preferential-access provisions on procurement.**

**Third-party MFN.** As in many GATS-plus RTAs, many RTA procurement provisions require third-party MFN guarantees so as to limit the extent to which preferential procurement is undermined by subsequent RTAs. Specifically, these procurement-related provisions require that each party's

<sup>25</sup> The application of price preferences against non-domestic bidders is disallowed between GPA members, thereby creating a margin of preference over non-members. Other measures in the agreement seek to limit or eliminate discrimination against suppliers whose governments are parties to the GPA. The state bodies whose procurements were covered by this agreement were negotiated by members and bound in the resulting agreement, adding to transparency and predictability. Taken together, these measures confer substantial commercial advantages over suppliers from jurisdictions that are not members of the GPA.

government purchases treat the other party's commercial entities no worse than those entities from any other third party. This implies that if nations A and B sign a FTA with such a provision and B subsequently signs a FTA with a nation C that grants the latter's firms more generous access to B's procurement market, B must unconditionally extend the more generous access to firms in A. Note that this provision is a one-way ratchet towards liberalisation; if the B's new RTA grants C worse access than it gave A, then A's access does not change.

As in services FTAs, there is also a 'soft' variant of the most-preferential-access clause. These imply that the better access is not automatically granted, but rather negotiated. This is something like the distinction between conditional and unconditional MFN (using the pre-GATT meaning of MFN).<sup>26</sup> Some RTAs trigger such negotiations, or, more weakly, consultations following the conclusion of a FTA with a third party that includes more generous access to national procurement markets than the original FTA.

Interestingly, some nations have included such provisions for procurement-related matters but not for other forms of trade in their FTAs, suggesting that there is something intrinsic to the nature of competition in procurement markets (perhaps the rents in such markets are on average higher or exporters in procurement markets are more concentrated and potentially better at lobbying for their own interests.) Such a provision can be seen in defensive terms – allowing a FTA partner to claim back some of the lost profits brought about by greater competition in another country's procurement market through rights to sell to a greater number of government entities or on less onerous terms. As Figure 2 shows, these clauses have been used by middle-sized trading nations and blocks, notably EFTA and Mexico.

### **Multilateralisation**

From the multilateralisation perspective, it is important to stress the importance of rules of origin. The GPA forbids discrimination against non-party subsidiaries in GPA nations. At first sight, this may seem to be a "leaky" ROO of the type seen in many services RTAs. However, this simply means that 'origin' of the company does not matter but the origin of goods sold to governments does and this is determined by the standard ROOs. For example, if the a US government office puts out a large tender for printing equipment, the procurement provisions in NAFTA allow firms in Mexico to bid on the contract if the printing equipment is considered as made-in-Mexico under the standard NAFTA ROOs – even with the firm is the Mexican subsidiary of a Japanese corporations. Since the ROOs may differ for each RTA among GPA members and each GPA member has its own non-preferential rules of origin, preferences under the GPA tend to create a Spaghetti Bowl of preferential access – at least as far as trade in goods is concerned.<sup>27</sup> When it comes to services, the application of typical, 'leaky' service ROOs tends to less the Spaghetti Bowl problem due to the 'automatic multilateralisation' property of 'leaky' ROOs.

There have been, however, some distinct developments in the government procurement disciplines contained in RTAs that either extend or facilitate the extension of preferential market access. If more of these provisions are adopted in RTAs, and as we shall argue there are identifiable incentives for certain parties to include them, then a considerable widening of access to state procurement markets may be

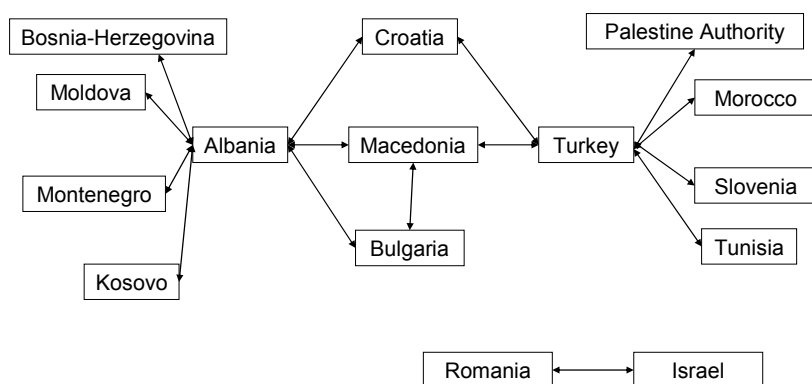
<sup>26</sup> On the pre-GATT meaning of MFN and broader history of the MFN concept, see Yanai (2002).

<sup>27</sup> The difference can be illustrated with analogy to EFTA. EFTA is a 'free trade lake' since it is club where members extends duty-free treatment to all members and apply that same rules of origin to all EFTA members. If each EFTA member were free to impose different ROOs on imports from different EFTA members, the implied market access would look like a tangle of 'canals' rather than a 'lake.'

possible. In turn this may make it eventually easier to negotiate a multilateral WTO accord on government procurement-related matters.

As mentioned in the services section, these third-party MFN, or most-preferential-access clauses automatically reduce the geographical discrimination implied by proliferating RTAs; they are thus multilateralisation on autopilot – or perhaps one should say ‘plurilateralisation’ since the deeper preferences are only granted to the existing set of RTA partners.

Third-party MFN provisions foster liberalisation in another way. They allow one nation to free ride on the negotiating clout for of future RTA partners. Continuing with the example, a most-preferential-access clause means that A can free ride on C's negotiating clout with B. In this respect one can understand why nations with small procurement outlays may wish to include this provision in their FTAs if they expect that, subsequently, their FTA partners will negotiate another FTA with a larger country that is likely to demand and receive greater preferential access to state contracts. Interestingly, we found several such provisions in FTAs between smaller states in Eastern Europe (South-Eastern Europe in particular) and in the Mediterranean. Many of those states have gone on to negotiate FTAs with the European Union, which certainly does have plenty of negotiating clout. Figure 3 suggests that Albania, Macedonia, and Turkey have pursued such strategies in the past.



**Figure 3: Southeast European FTAs with most-preferential-access provisions on procurement.**

**Domino effects.** Another mechanism through which preferential market access is extended – and in the limit multilateralised – is through domino-like effects triggered by the consequences of lower exporter profits that follow from selective market opening (Baldwin 1993). Arguably such an effect can be discerned in the GPA enlargement that followed the EU's expansion 25 members.

The incumbent 15 EU members were members of the GPA but the 10 members who joined were not. EU membership granted the 10 newcomers preferential access to the EU15 procurement markets, so EU enlargement meant other GPA members faced heightened competition in the EU15 from the 10 newcomers and heightened competition in the 10 from the EU15 incumbents. According to the domino logic, the non-EU GPA members accelerated GPA membership for the 10 newcomers in order to offset this new ‘trade diversion’.<sup>28</sup> The EU enlargement changed the array of vested interest in a way that

<sup>28</sup> Indeed, the United States Trade Representatives' 2004 Annual Report On Foreign Trade Barriers explicitly acknowledged that "negative commercial consequences in some instances" may follow EU enlargement. Moreover, the same report states the US desire to see the new EU member states be bound by the provisions of the WTO GPA, which would effectively open the latter nations' state purchases to US exporters.

fostered a GPA enlargement.<sup>29</sup> The representative of Israel noted that "[h]is delegation hoped that this was the beginning of a process whereby parties to the Agreement would bring in more countries, and not stop at a one-time historic moment" (WTO 2004), suggesting that dynamics involved were of a more general nature and not EU-specific.

Thinking ahead, the accession of a large trading nation like China – which is obliged to eventually join as per its accession agreement – is very likely to trigger a similar domino effect as other nations seek to offset the resulting discrimination their firms would face relative to GPA members.

### 3.5. Competition policy

Since Adam Smith (and possibly before) it has been recognised that the benefits of international commerce can be reduced by the exercise of market power. Rents have provided a powerful rationale for state measures to promote competition in markets and, by the same token, strong incentives for corporations to lobby for and against such measures. In a multilateral trading system where the reciprocal exchange of market access is central, fears about the impact of anti-competitive practices have often been expressed in terms of nullifying or impairing previously-negotiated improvements in access to foreign investment. Moreover, as foreign direct investment (FDI) has grown, concerns about the anti-competitive conduct of incumbent firms in countries receiving FDI, in particular the conduct of state-owned or state-influenced firms, has further raised the profile of competition-related matters in trade negotiations. Finally, as international market integration has progressed more and more countries have enacted and begun enforcing national competition laws, although the relationship between these two trends is not that well understood.

Despite the economic logic linking trade and competition policy, attempts to agree binding multilateral disciplines have failed. The inter-war experience in Europe – where cartels were a serious barrier to trade (Wurm 1993) – led to the inclusion of competition policy provisions in the Havana Charter. The US Congress balked at ratifying it, not least because of concerns about the proposed disciplines on monopolies and the like. More recently, WTO members decided in 2004 not to launch negotiations on a multilateral framework on competition policy. There is, therefore, no comprehensive set of binding multilateral rules on competition law and its enforcement.

There are, however, provisions in the TRIPs, TRIMs, and GATS agreements that refer to anti-competitive conduct. Moreover some scholars argue that the national treatment provisions in the GATT apply to the legislated contents as well as to the application of competition law. As a result, it would not be difficult for non-WTO-related initiatives on competition law and policy to go beyond existing multilateral disciplines in this area.

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<sup>29</sup> Four of the 10 newcomers states had already applied for GPA membership, but the accession procedures were taking many years and involved bilateral negotiations with (in principle) every existing GPA member. In view of the EU enlargement, the GPA committee agreed to an expedited administrative procedure. At a meeting on 23 April 2003 a consensus of the existing GPA members was reached in favour of accession. On 8 December 2006 the GPA committee also agreed to allow in Bulgaria and Romania following their EU accession.

### Competition policy in RTAs

While binding disciplines at the multilateral level are largely lacking, progress has been made in RTAs.<sup>30</sup> Solano and Sennekamp (2006) review the competition chapters of 86 FTAs. The overwhelming majority of these are of the North-South type. The provisions they found were on adopting, maintaining, and applying competition laws; coordination and cooperation between competition enforcement bodies; provisions addressing specific forms of anti-competitive behaviour; competition principles reflecting core principles including non-discrimination, due process, and transparency; provisions to exclude or alter the recourse to trade remedies; dispute settlement; and measures involving special and differential treatment for developing countries.

For our purposes, it is also noteworthy that Solano and Sennekamp identify two broad models for competition provisions in RTAs:

- A “European” model that focuses on measures to adopt and apply competition law and specific measures addressing anti-competitive conduct; and
- A “North American” model that principally contains provisions on coordination and cooperation between competition enforcement agencies.

Anderson and Evenett (2006) evaluated the Solano and Sennekamp study and argued that the latter omitted potentially important competition-related provisions that were not included in the competition chapters of RTAs. The overlooked provisions often referred to ensuring that monopolies, state-owned enterprises, and formerly privatised firms do not engage in anti-competitive conduct. Moreover, the telecommunications chapters of many RTAs made specific reference to anti-competitive conduct. (Here a common concern is the terms upon which rivals can access an incumbent firm's distribution network.) Furthermore, some RTAs contain competition-specific provisions relating to the granting of public subsidies to individual firms competing in national markets (so-called state aids provisions in EC parlance.) These competition provisions can be thought of as “taming the state” and are quite different in conception and specificity<sup>31</sup> to many of the substantive disciplines relating to national laws concerning private sector anti-competitive conduct.

The foregoing remarks are particularly relevant here because of the alleged spread of the so-called NAFTA competition provisions throughout parts of Latin America. The NAFTA models contains at least the following elements: provisions concerning the adoption and maintenance of “measures” (which are not necessarily laws) to proscribe anti-competitive conduct (Article 1501); measures relating to the conduct of monopolies and state enterprises (Articles 1502 and 1503); and specific provisions relating to monopolies in the telecommunications sector (Article 1305). We examined whether these particular NAFTA provisions could be found in the RTAs concluded in the 10 years after NAFTA was signed and in agreements where at least one party was located in North America and Latin America.<sup>32</sup>

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<sup>30</sup> The focus here on binding disciplines is to be distinguished from the development of non-binding international accords on competition law and its enforcement that have been developed under the auspices of UNCTAD, the OECD, and the International Competition Network.

<sup>31</sup> The specificity of these provisions is a strong indication that they were drafted with the advice of and in consultation with the affected private sector interests. These may well be provisions deliberately designed to tackle known and serious problems facing commercial interests that operate or plan to operate abroad.

<sup>32</sup> We are interested in the extent to which other nations have adopted the use of these specific provisions, which were originally proposed for inclusion in NAFTA by the US. For this reason we ignore the FTAs signed by the US in the 10 years after NAFTA.

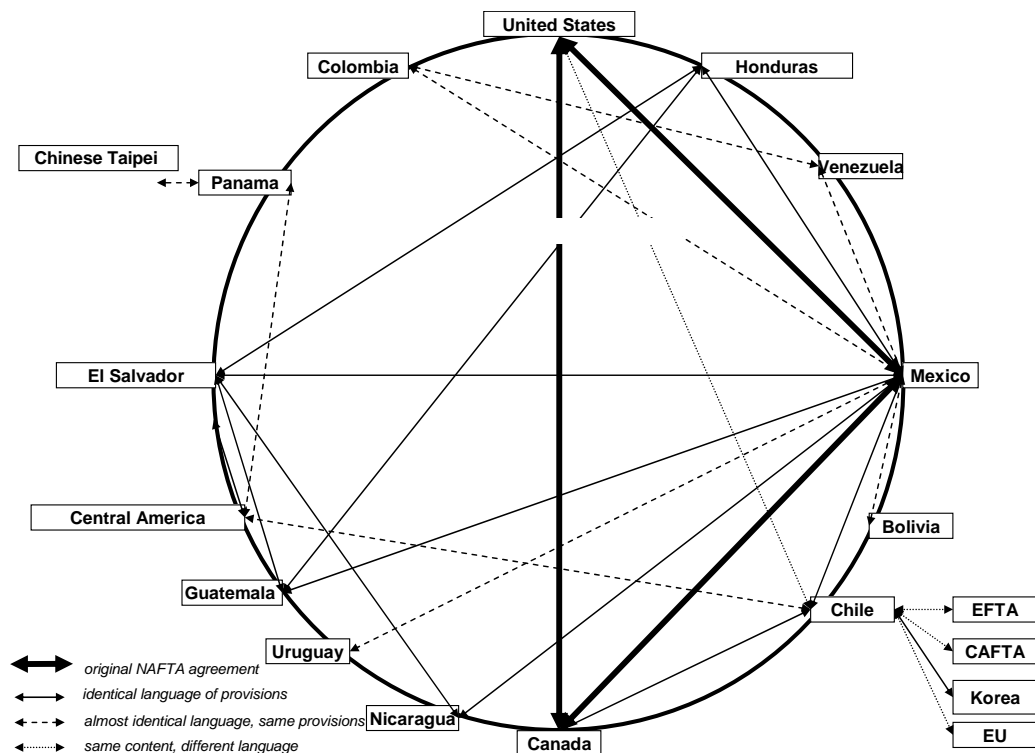


Figure 4: Spread of NAFTA Art. 1305.1

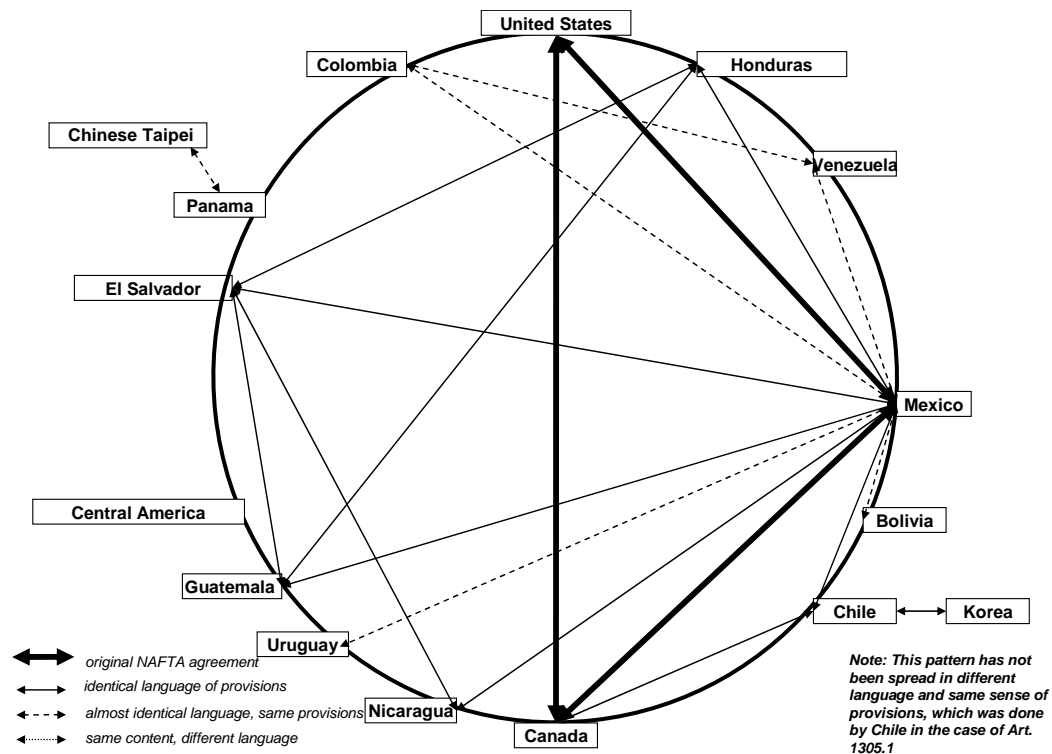
Figure 4 and Figure 5 show how two important competition-related NAFTA provisions on telecommunications have spread within and outside the Americas in the 10 years since the NAFTA was signed. (Article 1305.1 of the NAFTA proscribes telecommunication monopolies from engaging in anti-competitive conduct.) It is clear that Mexico and Chile have included this provision in a number of the FTAs that those countries have signed. The spread of this provision is such that Asian economies, such as Chinese Taipei and Korea, are now supposed to abide by the strictures contained in Article 1305.1 of NAFTA.

Article 1305.2 of NAFTA refers to steps that each party shall take to prevent anti-competitive conduct by telecommunications firms. This article has spread widely within Latin America, as evidenced by Figure 5. Comparing the figures suggests that Article 1305.2 may not have spread as far as Article 1305.1; even so 16 nations have signed up to FTA provisions identical or similar to Article 1305.2.

**Multilateralisation**

As far as multilateralisation is concerned, it is important to note that very few RTAs have explicitly discriminatory provisions; RTA provision on competition policy generally insist on core principles that include non-discrimination, due process, and transparency. Thus although the commitments are made in preferential trade deals, their effect is multilateral. A US firm in Turkey has the same rights before Turkish competition authorities as an EU firm even though Turkey’s competition policy was the result of bilaterals with the EU (Kulaksizoglu 2006). Nations without explicit competition policy is where discrimination based on nationality can be a problem. (CARICOM is the exception that proves the rule; it contains conditional MFN rules on mergers and acquisitions that favour CARICOM firms.) This suggests that the Spaghetti Bowl may not be much of a problem with respect to competition policy.

The so-called NAFTA model, with its greater reliance on state-to-state actions could open the door to Spaghetti Bowl problems; only parties to the RTA are granted rights. For example, NAFTA gives the US government a mechanism for encouraging the Canadian government to take action while EU governments have none. In practice discrimination is not thought to be a major issue; the distinction between the discriminatory impact of the two models is minor in practice.



**Figure 5: Spread of NAFTA Art. 1305.2**

The spread of the NAFTA-style telecommunications provision can be thought of multilateralising regionalism in two respects. First, the number of countries that have signed RTAs with such provisions indicates that a pervasive norm has been established. As more RTAs with these provisions are signed the norm will grow in country coverage. Second, harmonisation to a single regulatory regime for telecommunications liberalises trade in the same way that adoption of an international standard liberalises TBTs. A common set of rules that governments apply to private firms in many nations tends to foster competition and trade. Moreover, since the regulator regime principle concerns the relationship between the regulating government and all firms, it cannot be considered preferential.

In this light, it is useful to reflect upon the political economy forces driving the spread of what are effectively multilateral disciplines via RTAs.

**Political economy drivers.** In the case of the European model, a crucial point is that the EU offers many tiers of preferential market access to its trade partners (Baldwin and Wyplosz 2005 Chapter 12). The highest – so-called Single-Market access – is limited to nations that have, inter alia, adopted EU competition policy norms and practices. Nations that are heavily dependent on the EU market often adopt EU internal policies, including competition policy, on a ‘voluntary’ basis, locking-in such reforms



in their EU bilaterals.<sup>33</sup> In these cases, it is the usual domino-effect that drives the EU's partners to seek to offset the discrimination implicit in the lower-levels of EU access.<sup>34</sup>

The above-documented spread of NAFTA competition policy provisions in the telecoms sector seems to be driven by two political economy factors. First, during the 1990s, many Latin American nations deregulated and privatised telecoms. Many of these countries may have found North-South RTAs as a particularly useful commitment device or, more weakly, means to signal their intent to get serious about competition in the telecoms sector.<sup>35</sup>

Second, the same decade saw a considerable international consolidation in the telecommunications, utilities, and banking sectors as well as greater openness in Latin America to foreign investors in these and other sectors. Such foreign investors would no doubt like to have seen region-wide rules to discourage anti-competitive conduct by incumbent firms, but in the absence of any progress towards completing the Free Trade Areas of the Americas (FTAA), tough binding rules in a web of bilateral RTAs may well have been the next best alternative. Moreover, since expansion by a subsidiary within Latin America may have been represented successfully as benefiting the subsidiaries' host country, the host government might be induced to demand competition provisions be included in RTAs with other countries. Given one of the key sectors involved – telecommunications – became very concentrated in Latin America in the late 1990s, a small number of foreign investors had plenty at stake.<sup>36</sup> Given similar consolidation has taken place across the globe in the banking, financial services, and utilities sectors (to name a few), greater pressures for measures against the anti-competitive conduct of incumbent firms (that may well be state-backed or state-influenced) will grow. The substantial cross-border corporate consolidation witnessed in recent years blurs the distinction between "us" and "them," creating in this case pressures for the wider application of national treatment in national commercial legislation and associated regulations.

In sum, because non-discrimination is one of the core principles of competition policy that are typically part of RTA competition provisions, the spread proliferation of RTAs has done little to create a Spaghetti Bowl effect. Moreover, the spread of RTAs may well be building blocs towards a multilateral agreement. The dominance of EU norms in the Euro-Med area, and of NAFTA norms in the Western Hemisphere and Pacific has narrowed differences among WTO members' perceptions of the merit of competition-policy disciplines linked to trade agreements. The substantial differences between the European and US norms – differences that have frustrated most attempts at US-EU cooperation on the issue – are likely to make it impossible to agree a highly detailed set of norms at the global level. There is, however, a great deal of commonality in the two models, so some sort of multilateral agreement should not, in principle, involve enormous changes at the national level for a large number of nations.

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<sup>33</sup> EFTA nations (all of whom have adopted EU competition norms) follow a policy of shadowing EU bilaterals so that EFTA-based firms face the same competitive conditions as EU-based firms. This phenomenon, which creates what might be called an RTA union, means that the number of RTAs with EU-like competition policy is doubled almost automatically.

<sup>34</sup> See Baldwin (1997) on the how the domino-effect worked with respect to Single-Market access.

<sup>35</sup> Alternatively, they may have regarded the provisions rather unimportant and so accepted them rather than offer further concessions to induce a trading partner to drop demands for competition provisions.

<sup>36</sup> At the end of the period of consolidation Telefonica (of Spain) and Bell South (of the US) were by far the two largest firms operating in the telecommunication markets of Latin America.

### 3.6. Investment performance requirements

Despite the economic significance that many policymakers attach to foreign direct investment (FDI), three attempts to negotiate wide-ranging international disciplines have ended in failure.<sup>37</sup> Having said this, there are multilateral disciplines on selected investment matters including those related to trade-related investment measures (such as rules on performance requirements contained in the WTO's TRIMs agreement) and in services (as part of the GATS agreement). Many observers agree, however, that most of the innovation in designing international disciplines is taking place in preferential agreements such as Bilateral Investment Treaties (BITs) and RTAs (Sauvé 2006: 327). At the end of 2005, some 2495 BITs had been signed and dozens of FTAs include investment provisions, in particular those FTAs between industrialised and developing countries (UNCTAD 2006, Leshner and Miroudot 2006).

In this case study, we focus mainly on commitments to ban so-called performance requirements on foreign investors – whether those requirements are trade-related or not.<sup>38</sup>

#### Preferential provisions

NAFTA provides good examples of the sort of investment disciplines that can be included in RTAs. Chapter 11 of the NAFTA agreement covers a wide range of matters including the definition of investment, the standards of treatment of investors, expropriation, and consultation and dispute resolution mechanisms (Heindl 2006). In particular, Article 1106 of Chapter 11 contains strict provisions on performance requirements that are often regarded as having gone beyond the measures contained in the TRIMs agreement, not least by offering a more extensive list of prohibited measures than in the latter agreement but also by requiring the abolition of these requirements against any foreign investor, even those from countries not party to the NAFTA (OECD 1996, Wilke 2002).

There is evidence that certain investment provisions are spread across RTAs, in particular NAFTA's investment provisions (Gantz 2004, Gangé and Morin 2006, and Reiter 2004). To explore these matters further we examined how many FTAs contained a clause that was identical to, or very similar, to that found in Article 1106 of NAFTA.

Figure 6 shows the extent of the spread of NAFTA's restrictions on performance requirements in Latin America and beyond. Fourteen countries have effectively agreed to repeal and never apply performance requirements against foreign investors from any jurisdiction. Another country (Uruguay) has agreed to do likewise, but in the context of its very recent BIT with the United States. This reform is effectively multilateralised even though the vehicle for doing so is traditionally associated with preferential treatment and discrimination.

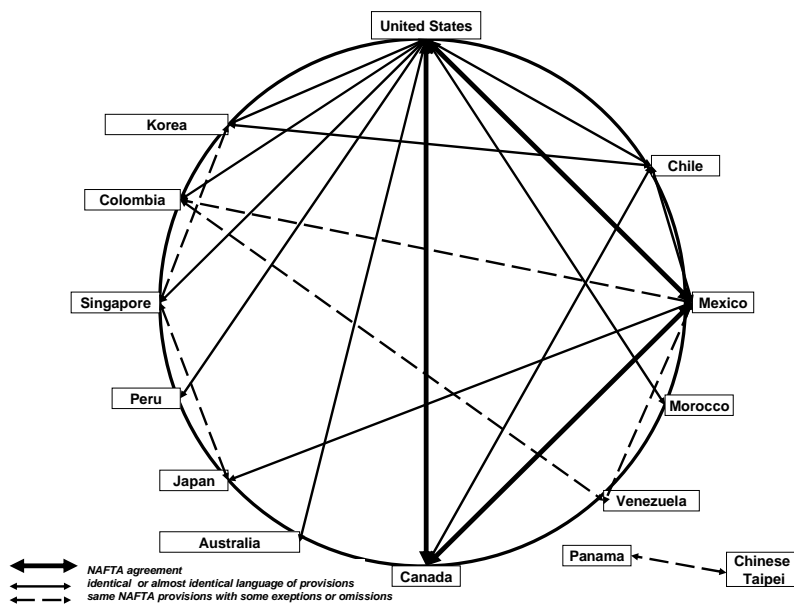
We also checked whether clauses similar to Article 1106 can be found in US and Canadian BITs, which are traditionally associated with including measures on performance requirements that go beyond

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<sup>37</sup> Specifically the inclusion of the proposed investment chapter in the Havana Charter, the collapse of negotiations over a Multilateral Agreement on Investment (MAI) at the OECD in 1998, and the July 2004 decision of WTO members not to negotiate a Multilateral Framework on Investment during the course of the Doha Round of multilateral trade negotiations.

<sup>38</sup> Performance requirements include measures requiring foreign investors to export a given percentage of goods or services, to achieve a given level of domestic content, to accord preferences to goods or services in a specific territory or from a certain group of suppliers, to use or exchange certain amounts of foreign currency, to restrict sales of goods produced or services delivered by the foreign investor, or to require an investor to be an exclusive supplier.

the TRIMs agreement (OECD 2005). A further 36 countries were found to have committed to forgo the application of performance requirements against US or Canadian investors, but are not committed to treat non-party foreign investors similarly. In terms of FDI covered, however, the FDI inflows into countries that have liberalised on a MFN basis was three times as large as that into countries that liberalised on a preferential basis.<sup>39</sup> The fact that in less than 15 years a quarter of worldwide FDI currently flow into countries which operate under the same liberalised regime for performance requirements is striking (see Table 1 and Table 2) and provides a firm basis for the further spread and multilateralisation of rules to ban the use of such requirements on foreign investors.



**Figure 6: Spread of NAFTA performance requirements provisions in FTAs.**

It is noteworthy that few EU member states and no large emerging markets (such as Brazil, India, and China) have agreed to eliminate performance requirements, either unilaterally, bilaterally, or multilaterally. More generally, multilateralisation of a ban of performance requirements on foreign investors is an option for WTO members, although if recent debates are anything to go by a controversial one (Sauvé 2006, Ferrarini 2003).

Like preferential access to goods markets, preferential access to investment locations can introduce differentials to corporate cost structures and so distort FDI flows from the global optimum. Worse still, preferential access offered to foreign investors may trigger a ‘race to the bottom’ when it comes to subsidies and other benefits that have high opportunity costs in developing nations. Not every argument, however, point to welfare-reductions from preferential investment rules. For one, in a second-best world the offer of such preferences by a trading partner may induce a government to eliminate costly

<sup>39</sup> For completeness sake we also check an UNCTAD compendium of national investment regimes to see which countries had eliminated preference requirements on a unilateral basis. The results are reported in the penultimate column of Table Table 1. Two countries were said to have eliminated their performance requirements in totality (those with a "tick" in this column) and three other countries were found to have "generally" liberalised their performance requirement (those with a "G" in this column.)

restrictions and obligations on foreign investors. In sum, then, it is inappropriate to issue a blanket condemnation of the investment provisions in FTAs or BITs.

**Table 1: RTAs and BITs that forgo the use of performance requirements entirely.**

		Country	Performance requirements (PR) eliminated because of				FDI average 2003-2005
			FTA	BIT with US	BIT with Canada	Unilateral	
Countries committed to eliminate PR entirely	1	Australia	√			√	5'855
	2	Canada	√			G	14'323
	3	Chile	√				6'049
	4	Colombia	√				5'022
	5	Japan	√			√	5'638
	6	Korea	√				6'272
	7	Mexico	√				16'971
	8	Morocco	√				2'144
	9	Panama	√	*			820
	10	Peru	√				1'838
	11	Singapore	√				15'093
	12	Chinese Taipei	√				1'325
	13	United States	√			G	91'655
	14	Uruguay		√	*		449
	15	Venezuela	√				2'378
<b>Total:</b>						<b>175'834 (24.1%)</b>	

### Multilateralisation

As far as multilateralisation is concerned, it is important to note that many of the RTAs include MFN clauses which automatically multilateralise the disciplines and thus spread the benefits offered by a trading partner to foreign investors from a given jurisdiction to other jurisdictions. Admittedly, these MFN clauses are not so prevalent that they have eliminated all forms of discrimination; even so they are probably more prevalent than some might appreciate (OECD 2005). Table 1 gives some very concrete examples. Given the multilateralism-via-RTAs effect, it is useful thinking about the political economy driving the spread of investment provisions in RTAs and BITs.

Unbundling – specifically, the creation of complex international supply networks – fundamentally alters the political economy of performance requirements within nations. The emergence of national firms that are internationally competitive in supplying even a single part, component, or in undertaking a step in the production process, will not want to support performance requirements that shield less efficient domestic input suppliers, knowing that the latter raise the costs of supplying from overseas markets from their country and put off foreign investors in the first place. Here, once again "us" fragments and some commercial interests align themselves with "them." This logic has become pervasive in a number of developing countries that recognise investment provisions as a means of promoting the attractiveness of their economies as export centres. Reiter (2004) argues that these considerations drove Mexico, Chile, and to a lesser degree Singapore to include tough disciplines on foreign investment in their myriad of RTAs – a strategy at which they have been quite successful.<sup>40</sup>

<sup>40</sup> Reiter (2004) also reports that Mexico sought to include expansive investment provisions in its FTA with the EC, however for a variety of internal reasons the EC was not able to accede to Mexico's demands in this respect.

**Table 2: RTAs and BITs that forgo the use of performance requirements bilaterally.**

		Country	Performance requirements (PR) eliminated because of				FDI average 2003-2005
			FTA	BIT with US	BIT with Canada	Unilateral	
Countries committed to eliminate PR bilaterally	1	Albania		*		G	257
	2	Argentina		*			3'529
	3	Armenia		*	*		198
	4	Azerbaijan		*			2'840
	5	Bahrain		*			810
	6	Bangladesh		*			501
	7	Bolivia		*			12
	8	Bulgaria		*			2'588
	9	Cameroon		*			6
	10	Costa Rica			*		615
	11	Croatia		*	*		1'697
	12	Czech Republic		*			6'022
	13	Egypt		*			2'590
	14	El Salvador			*		345
	15	Ecuador		*			1'543
	16	Estonia		*			1'607
	17	Georgia		*			430
	18	Grenada		*			58
	19	Honduras		*			281
	20	Jamaica		*			641
	21	Jordan		*			873
	22	Kazakhstan		*			2'648
	23	Kyrgyz		*			89
	24	Latvia		*			541
	25	Lebanon			*		2'444
	26	Moldova		*			152
	27	Mongolia		*			136
	28	Poland		*			8'395
	29	Romania		*	*		5'039
	30	Senegal		*			61
	31	Slovakia		*			1'308
	32	South Africa			*		2'637
	33	Trinidad&Tobago		*			614
	34	Tunisia		*			668
	35	Turkey		*			4'757
	36	Ukraine			*		3'649
						<b>Total 60'582 (8.3%)</b>	

Unbundling is growing in prominence globally, and spreading to a wider range of manufacturing and service sectors. As a result, export performance and inward investment are increasingly tied. In East Asia, for example, the rapid rise of regional trade in parts and components was closely associated with the rise in regional investment in manufacturing (Ando and Kimura 2005). Just as this unbundling and competition for unbundling encouraged a 'race to the bottom' on MFN tariff cutting, it likewise encouraged nations in the region to commit to certain liberal investment policies, such as forgoing the right to performance criteria. While these commitments have typically been made in the context of

RTAs and BITs, the logic of making such commitments is not primarily bilateral – it is to improve the attractiveness of the nation as a location for FDI. On the other side, outsourcing firms clearly prefer a larger diversified pool of potential investment locations where there are few, if any, conditions imposed on their operations. In short, there may well be an interest on the part of both home and host countries in multilateralising the investment provisions in their network of RTAs and BITs. The WTO should consider using its power as fair broker and convenor of negotiations to facilitate this sort of multilateralisation, more precisely, plurilateralisation of investment provision.

#### 4. LESSONS FROM THE CASE STUDIES

The case studies provide useful perspectives on the factors propelling the spread of common RTA provisions and towards multilateralisation, the precise circumstances differ from policy instrument to policy instrument. This section gathers the lessons and examines how the process of multilateralisation is similar to or differs from the case of tariffs. Table 3 identifies key characteristics of tariffs and the six policy areas covered by the case studies. The comparison of these characteristics underlies the observations that follow.

The first observation concerns the departure from non-discrimination at the border (MFN) and inside the border (national treatment). In the case of tariffs, RTAs are the principal point of departure from MFN. RTAs are an important source of discrimination for government procurement and investment measures however in both cases other international agreements have introduced important elements of discrimination too. In contrast, the principal sources of discrimination in trade remedies and competition law are unilateral, that is, the discrimination follows from the acts of a single national government. In the former, these are acts of commission (for example, the imposition of antidumping duties). In the latter, it could be sins of commission (e.g. explicitly discriminatory national competition laws) or sins of omission (e.g. the absence of rules against anti-competitive conduct by firms that sustain discriminatory practices.) The purpose of making these distinctions is to point out that RTAs are not always the source of discrimination and, as we have seen, in some cases certain RTA clauses can be the antidote to discrimination and the spread of those clauses may contribute to the restoration of a non-discriminatory multilateral norm (such as desisting from the discriminatory application of national competition law.)

The second observation is that in the case of some of the policy instruments considered here there is no role played by rules of origin that is comparable to the case of the preferential liberalisation of tariffs (as explained in Section 2). Rules of origin are, of course, conditions that must be met before a firm can enjoy the preferential benefits contained in a trade agreement. In the case of some instruments, governments may not want to differentiate between foreign suppliers (in which case they offer MFN) or they may find it too costly and cumbersome to discriminate between foreign firms. A national government, for example, may take on obligations in a RTA to introduce and enforce a pro-competitive regulatory regime for the financial services sector. That government may then decide that it is too costly to maintain two regulatory regimes (one for firms that hail from the RTA parties and another for other firms), and in this case the benefits of the new regulatory regime are effectively multilateralised. Our case study of service sector provisions in RTAs pointed to research which had identified similar outcomes in other circumstances. The underlying and perhaps more fundamental point being made here is that trade agreements can contain both commitments on market access and on rules and that, while rules of origin can in principle be applied to both, in fact they are not applied uniformly.

The fact that rules of origin do not create Spaghetti Bowl effects for some of the policy instruments considered in our case studies does not mean there are no triggers for multilateralising the RTA provisions associated with those instruments. Our third observation from Table 3 is that there are a number of triggers or factors conducive to multilateralisation. Unbundling of production across national borders, in particular across regions, has probably contributed to the spread of certain RTA provisions on trade remedies and on performance requirements for foreign investors. Other prevalent changes in corporate strategy observed in the last 10 to 15 years have been important too, such as cross-border consolidation. Moreover, multilateralisation has probably been facilitated long-standing domino-effects, at least in the area of government procurement practices which to date still is not subject to a comprehensive WTO agreement.

The fourth observation is that the measure which "tames the tangle" – the vehicle for multilateralisation, so to speak – differs markedly across the policy instruments. In some cases, the measures needed are entrenched in RTAs and so long as they are observed then the discrimination in question is eliminated. For example, a commitment not to apply performance requirements on foreign investors on a MFN basis can be entrenched in a RTA. Once implemented, any prior discrimination of this form will have been eliminated. In other cases, however, a legal measure must be complemented by some factors. Requirements on parties to create joint committees and to notify trading partners and to consult with them before imposing trade remedies do not on their own prevent nations from discriminating against foreign suppliers on this basis. Discrimination is only avoided if sufficient pressure is brought to bear by trading partners on a RTA party considering imposing a trade remedy (or there is the expectation that sufficient pressure will be brought to bear after notification). Pressure may not always be successful in every case, pointing to a potential weakness of this particular vehicle for multilateralisation. A lesson for policymaking here is that a broad view ought to be taken of the different possible vehicles of multilateralisation. An implication for analysts is that we need to learn a lot more about how different vehicles work, how well they work, and how to make them work better.

The fifth observation is that the current existence of a comprehensive set of multilateral rules for a policy instrument may well reveal something about the political economy forces that are likely to influence any trajectory towards multilateralisation. Case in point is the GATS insistence on 'leaky ROOs' and the fact that most GATS+ RTAs have adopted this, even many of the South-South RTAs that are not bound by GATS disciplines. At the moment the extent of agreement between WTO members on the ultimate goal of multilateral disciplines in trade in goods is probably greater than it is in the area of trade remedies. This may change and the evolving international reorganisation of production, which has been emphasised throughout this paper, could well be an important factor in this regard. Whatever the future, though, there are probably good political economy reasons that account for the present set of multilateral rules and these ought not to be overlooked when assessing the potential for multilateralisation of a particular policy instrument.

**Table 3: Multilateralising Regionalism: Tariffs and Behind The Border Measures Compared.**

	Tariffs	Trade remedies	Government procurement	Investment performance requirements	Competition law	Services	TBTs
Principal source of observed bilateral discrimination	Discriminatory tariffs, protectionist ROOs, Bilateral ROCs	Discriminatory tariffs (AD, CVD and safeguards)	Preferential access to bidding on government contracts	Preferential application of performance criteria	Rare (e.g. CARICOM merger rules)	Preferential market access	Mutual recognition; norms & testing
Agreements creating discrimination	RTAs	National implementation, Article VI	RTAs, national practices, WTO GPA	BITs, RTAs	RTAs (rarely)	RTAs, MRAs (qualifications)	RTAs, MRAs (testing)
ROOs create Spaghetti Bowl	Yes	No	Yes for goods, Slight for services ('leaky ROOs')	No	No	Slight ('leaky ROOs')	No.
Political economy trigger for multilateralisation.	Unbundling	Unbundling	Dominoes and accession of new WTO members to WTO GPA	Unbundling	Cross border M&A, and consolidation (e.g. telecoms)	Unbundling (mode 3) & RTB unilateralism & struggle for hub status.	Unbundling
In practice, how is discrimination tamed?	Common ROOs, diagonal ROCs, zero MFN tariffs	Joint Committee clauses and diplomatic pressure	Expanding WTO GPA (strong), 3rd party MFN clauses (weaker), leaky ROOs in services.	MFN commitments in RTAs (e.g. NAFTA 1106)	Formal competition law implemented without nationality bias	Leaky ROOs, 3 <sup>rd</sup> party MFN, application of 'concessions' on an MFN basis	Lack of ROOs on MRAs, harmonisation to international standards
Severity of Spaghetti Bowl	Severe	Slight	High in RTAs Modest in GPA	Slight	Slight	Modest	Modest
Existing comprehensive multilateral WTO rules?	Yes (GATT)	Yes (GATT & GATS)	No	Partial (TRIMs & GATS)	No	GATS	TBT Agreement



The last observation is that the "end point" of multilateralisation is easier to discern than others. This may not just be a matter of differences of view among interested parties. In some cases there is still disagreement among dispassionate experts about what the globally optimal set of multilateral rules are for an organisation like the WTO whose members' circumstances are extremely diverse. Having said that, there may be some existing policy measures (such as multiple, costly rules of origin) for which it is almost inconceivable that there is a justification, and multilateralisation of measures to improve matters in these respects is desirable. Still, there is a role here for further normative analysis.

The analysis of multilateralising regionalism and consideration of its policy implications is still at an early stage. We would argue that the key dimensions of the multilateralising regionalism are now clearer, not least the vehicles for multilateralisation and the factors influencing this process. We turn next to the near and longer-term implications of this analysis for possible WTO initiatives.

## 5. CONCLUDING REMARKS

The proliferation of RTAs has had a varied impact on non-tariff barriers (NTBs), creating Spaghetti Bowls for some types of NTBs but not others. Moreover the scope for multilateralising the RTA commitments is likewise diverse. This section first sets out a framework for organising our thinking about various outcomes and prospects for multilateralisation; it then proposes a number of areas where WTO engagement might help "tame the tangle" and help ensure that commitments in future RTAs are better woven into the fabric of the multilateral trading system.

### 5.1. An organising framework

The two key concepts are "intentional versus incidental protection" and "the level of self-balancing".

#### **Intentional versus incidental protection**

Some policy measures are explicitly intended to make foreign firms less competitive, i.e. to protect domestic producers. Tariffs and anti-foreign procurement rules are the classic examples. This is what we call 'intentional protection'. Other policy measures are explicitly intended to achieve regulatory goals such as guarding the health and safety of consumers. Given the realities of special-interest politics, such regulation is often implemented in ways that protect domestic firms. This is what we call 'incidental protection'; it is not accidental – powerful vested interests are likely to have promoted the protectionist content – but it is incidental in that the protection is not the stated goal.

This distinction goes a long way to understanding the types of NTBs where RTAs have created a Spaghetti Bowl.

- Intentional-protection instruments come equipped with features that make geographic discrimination easy; rules of origin are the classic example.

It is not surprising that powerful vested interests use these features to create important differences among RTAs. When this occurs in many nations, the world gets the Spaghetti Bowl effect.

- Incidental-protection instruments may or may not come with features that ease geographic discrimination.

It is relatively easy to design a safety regulation that favours domestic products against all foreign products. Take the example of elevators. In absence of anything more subtle, the regulation could name

the domestic elevator company's unique selling advantage in its safety regulation, thus shutting out all competitors. It is much harder to design a regulation that meets the safety goals and favours the domestic products against imports from third-parties but not against those from the RTA partner. Moreover, the greater is the number RTA partners, the more difficult it is to generate the desired incidental protection. In short, incidental-protection instruments are much easier to use on an MFN basis than they are on a geographically discriminatory basis. For this reason, RTAs tend not to produce Spaghetti Bowl effects for incidental-protection instruments.

We can use this distinction to understand why – according to our judgments in Table 3 – the explosion of RTAs has created a Spaghetti Bowl only in some areas. Perhaps the most interesting example concerns procurement. In our judgement, RTAs have created a Spaghetti Bowl when it comes to the government procurement of goods but not with respect to government procurement of services. Standard rules of origin apply to the goods that governments buy, so the vested-interest process creates a Spaghetti Bowl. As discussed in Section 3.2, intangibility rules-out this tactic when it comes to government purchases of services. It is difficult or impossible to determine how much of the value-added of a loan made by a Canadian bank is actually added inside Canada.<sup>41</sup> Preferential agreements on government procurement therefore use a simple rule of origin based on where the seller of the service is established. If the preferences are high enough, third-party firms would use this 'leaky' ROO to profit from the preferences by establishing a judicial identity in one of the RTA partners. A really distortionary Spaghetti Bowl cannot emerge.

RTAs have not created much of a Spaghetti Bowl effect in remedies, competition policy, or TBTs since the protectionist content of these instruments is incidental to their main policy goal and, in most cases, the instruments lack features that make nation-specific discrimination feasible. One systematic, anti-Spaghetti-Bowl factor is the difficulty of ascertaining the nationality of a modern corporation.

### **The level of self-balancing**

The concept of self-balancing is best explained with an example. Unilateral tariff cuts may not be politically optimal even when the same cut is politically optimal on a reciprocal basis. Under reciprocity, domestic exporters who want better foreign market access must counterbalance the political resistance of import competing firms who oppose domestic tariff cuts. In this example, the domestic policy reform – e.g. tariff cutting – is self-balancing only when reciprocity realigns the array of political economy forces inside each nation.

This concept can help us think about which multilateralisation initiatives are not entirely unthinkable. For instance, ASEANs are implementing a regional free trade agreement and thus cutting tariffs on each others' imports. Most the ASEANs, however, multilateralise their preferential tariffs by lowering their applied MFN rates in tandem with their preferential rates. Obviously, they could have maintained geographical tariff discrimination via ROOs but they chose not too. In this case, the unilateral tariff cut on third-party imports is self-balancing within each nations. That is, the pro-and anti-protection forces inside each nation are such that government finds it politically optimal to unilaterally extend the preferential tariffs to third-nations.<sup>42</sup> A similar example occurs in some BITs where nations have made MFN commitments in agreements that only involve bilateral reciprocity (see Table 1). Again it must be that this unilateral third-party liberalisation was self-balancing within the nations themselves.

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<sup>41</sup> The same problem plagues value-added taxation of services.

<sup>42</sup> The basic idea is that unilateral tariff cuts are a means of competing for FDI and the ASEANs are engaged in race-to-the-bottom tariff cuts; see Baldwin (2006c) for details.

As our discussion of the six case studies makes clear, there are surprisingly many instruments where the liberalisation comes in the form of bilateral RTA commitments but is implemented on a non-discriminatory basis. For example, some nations have used GATS+ RTAs to lock-in service-sector liberalisation that is intended to enhance their competitiveness, e.g. by lowering the cost and improving the quality of distribution and communication services. Since the balance of political interest favours improved competitiveness, the government finds it optimal to give access to the best service providers in the world; the bilateral market access ‘concession’ is extended – unconditionally – to third parties.

Self-balancing can also occur at the bilateral level. An example is the third-party MFN clauses in bilateral RTAs some GATS+ RTAs, and procurement agreements. These commit the parties to granting to each other any ‘concession’ made in future RTAs. Here we see that although unilaterally extending the additional concessions is not politically optimal yet – i.e. such a reform is not self-balancing within each nation – the nations find it politically optimal to commit to exchanging third-party concessions in the future. In essence, the level at which a reform is ‘self-balancing’ determines whether the reform will be undertaken unilaterally (internal self-balancing), bilaterally (bilaterally self-balancing), or pluri- or multi-laterally. EU and US agriculture reform are good examples of things that are only self-balancing at the global level.

**Club-of-clubs.** For the purposes of this paper, the interest in the self-balancing notion lies in its ability to help us analyse whether the NTB provisions in RTAs could be multilateralised. In particular, it suggests that some form of reciprocity is a key element in making such initiatives viable. This in turn suggests that multilateralising initiatives might make use of the ‘flexible integration’ or club-of-clubs concept. Note that the EU has formally used the ‘clubs within the club’ approach (the clubs are called Closer Cooperations, or Enhanced Cooperations) to address the tension between deeper integration and member diversity since its 1997 Amsterdam Treaty.<sup>43</sup> The driving force behind the EU’s admission of the club-of-clubs concept was the fact that sub-groups of members, frustrated with the slow progress of integration in some areas, decided to proceed on their own (e.g. the Schengen Accord). The EU faced the choice between continuing as an innocent bystander and having no influence, or engaging, and bringing some order to the process. The WTO now faces a similar choice.

#### Why in RTAs but not in the DDA?

The self-balancing concept helps organise thinking about why many nations – especially developing nations – are willing to make commitments on NTBs in the context of RTAs – especially North-South RTAs – when they refused to engage in negotiations on such matters at the WTO level. According to this thinking, when developing nations negotiate in the multilateral setting, there is very little reciprocity – in part due to the general presumption of special and differential treatment in MTNs and in part due to the inability of small importers to affect the overall package much. This means that there is very little self-balancing. An example helps illustrate the point.

Consider a developing government that is contemplating locking-in a commitment to apply national treatment in a particular type of traded service. Consider the politics of doing this in a reciprocal RTA with a developed country versus doing it in the DDA. If the developed-nation partner is very interested in such service-sector market access, the service-sector reform may be balanced with preferential market access in say, clothing exports. More specifically, the reciprocity in the RTA shifts the array of political forces within the developing nation towards reform. The RTA’s reciprocity allows the

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<sup>43</sup> For more on the concept and its limitations and alternatives, see CEPR (1995) and the recent discussion of how flexible integration might be applied to the WTO in Lawrence (2006).

developing nation government to line up domestic exporters to counter the protectionist pressures from domestic service providers. Since there is very little direct reciprocity in the DDA for many developing nations, the reforms that are politically optimal in an RTA may not be politically optimal in the DDA.<sup>44</sup> Some scholars call this the free-riding phenomenon but the term is too blunt to capture the way in which the level of the agreement affects array of political economy forces inside the participating nations.<sup>45</sup> The free riding is not done by the governments; it is done by the pro-trade forces inside each nation who feel that they will not profit from bringing pro-reform pressure on their own government. This distinction is crucial when thinking about the level and nature of multilateralisation initiatives. It also suggests that some form of mandatory GPA-like reciprocity will often play a role.

## 5.2. Examples of possible multilateralisation initiatives

What sort of multilateralisation initiatives are suggested by our analysis?

**Tariff multilateralisation.** The case for multilateralising tariff preferences was made in Section 2. In terms of our framework, the ITA and PECS became a self-balancing arrangement when the unbundling of manufacturing and offshoring to ‘spoke’ economies created enough politically influential winners in each nation to counter the politically influential losers in each nation. Since unbundling and offshoring are proceeding apace and the range of goods and service sectors affected is spreading, it would seem that future PECS-like, or ITA-like initiatives might be self-balancing. The notion of self-balancing suggests that some form of strong reciprocity is necessary. Such reciprocity was obviously a part of PECS – nations were either in PECS and thus benefiting from the taming of the tangle and changing their policies to make it happen, or they were outside. This reciprocity meant, for example, that the Turkish government could harness the political influence of domestic exporters to counter the resistance of domestic import-competing firms that stood to lose from the elimination of idiosyncratic ROOs and bilateral cumulation. The reciprocity in the ITA came from the requirement that at least 80% of the world’s production be covered – a stipulation that meant that the deal would die if exporters in all the major producing nations did not counter-balance the protectionist pressures in their own nations.

Given the massive, two-way trade in components in East Asia, the relative harmonious state of ROOs and the very low level of applied tariffs, it would seem that a WTO initiative to implement a PECS-like taming of the tangle in East Asia would have some chance of success. If the initiative also resulted in a WTO binding of the zero applied MFN tariffs, the initiative would be a big contribution to making regionalism more multilateral-friendly.

**Procurement.** NTBs related to government procurement of goods are not subject to anywhere near the Spaghetti Bowl problems facing preferential tariffs, so the gains from a multilateralising initiative are likely to be lower. There are, however, indications to suggest that such an initiative could be self-balancing at the regional or global level. First, some RTAs that address procurement include hard or soft version of third-party MFN, which, as discussed in Section 3.4, can be thought of as a form of automatic multilateraliser. This suggests that nations are already sensitivity to the dangers of a Spaghetti Bowl problem emerging. Averting such problems with bilateral third-party MFN clauses, however, is obviously inferior to a plurilateral commitment to a similar clause. The WTO’s GPA provides an example. GPA members must extend ‘most preferred access’ to each other. This automatically avoids a

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<sup>44</sup> Roy, Marchetti and Lim (2006) document the fact that developing nations’ GATS offers in the DDA are frequently less forward leaning than the commitments they have made in their service RTAs.

<sup>45</sup> In academic economic journals, it is often called the ‘terms of trade externality’.

Spaghetti Bowl inside the GPA club. GPA enlargement would be the neatest solution from a logical point of view, but given the current accession rules, it would be very difficult in practice (entrants have to negotiate an exchange of concessions with each incumbent). Short of this, more modest regional arrangements might also help. For example an initiative to multilateralise the third-nation MFN clauses depicted in Figure 2 and Figure 3 might provide a starting point; this would establish a second GPA-like club with more modest commitments. The WTO might also consider hard-law or soft-law rules that encourage/require nations to include third-nation MFN in RTAs that provide preferential procurement access.

**Services.** As in procurement, the Spaghetti Bowl aspects of GATS+ RTAs are fairly modest. One of the reasons is that these RTAs include automatic multilateralisers such as third-nation MFN and leaky ROOs. While the leaky ROOs are already required by the GATS for developed nations, the fact that most developing nations have adopted them suggests that there is willingness to commitment to more discipline than currently exists in the GATS. Of course, developing countries already have the ability to do this unilaterally by declaring themselves developed nation in the WTO, but this is not a self-balancing reform. What might be closer to self-balancing would be a GPA-like ‘club’ that would commit the members – developed and developing alike – to using this sort of liberal, or leaky ROO in all the current and future GATS+ RTAs; other disciplines and rules might also be considered for inclusion in this GATS+ club. The self-balancing aspect of would stem from the signal that this commitment would send to current and future investors. Membership the GATS+ club would show that the members were unswervingly devoted to making sure that investors would always have access to the most competitive services.

**TBTs.** Most of the RTA liberalisation in TBTs is limited to bilateral testing-MRAs in specific sectors. The list of covered sectors, however, is not too dissimilar among nations; it consists largely of sectors where large firms are engaged two-way trade so that the MRAs are self-balancing at the bilateral level. As noted in the text, these testing-MRAs do not impose rules of origin. This fortunate outcome, however, is a matter of convenience not WTO discipline. One initiative would be to turn the de facto into de jure by amending the TBT Agreement to include disciplines on rules of origin. A less ambitious but more easily self-balancing initiative would be to merge the set of bilateral MRAs into a plurilateral MRA club. Given the absence of ROOs, the practical effect of this would come mainly in the form of administrative simplicity and transparency. More generally, getting the WTO more closely engaged with this TBT liberalisation would reduce the chance that future developments would remain multilateral-friendly.

**Remedies.** Substantial reform of antidumping and countervailing duties is an enormously difficult endeavour since it is not self-balancing. The pattern of remedy usage and the pattern of trade in the products most affected make a self-balancing agreement in remedies difficult, even at the multilateral level. Trade-offs between remedies reform and concessions in other areas seem to be necessary. Short of this level ambition, however, the RTA provisions that have been adopted on remedies – e.g., notification and consultations provisions – suggest that something less ambition might be done. We argued that the remedy-commitments in RTAs were driven by unbundling and regional offshoring. Even if such a thing were infeasible at the WTO level, it might be self-balancing in GPA-like clubs in regions with dense international supply networks.

**Investment.** The more than 2,500 bilateral investment treaties in force cover virtually all important foreign direct investment flows. Given the similarities of these agreements – at least in terms of the set of BITs centred on the major FDI providers – the US, EU and Japan – it would seem that this area was ripe for a multilateralisation initiative. To avoid the pitfalls encountered by earlier attempts to establish

multilateral disciplines, the multilateralisation initiatives might start with regional, GPA-like agreements that would begin with the ‘lowest common denominator’ of the BITs concerned. The gain from such multilateralisation initiatives would be modest in terms of liberalisation, but perhaps more important in terms of administrative simplicity and transparency and engagement of the WTO. Given that trade and investment are increasingly tied – the developments in East Asia being the prime example – getting the WTO into this policy area may be important to ensuring that future developments would remain multilateral-friendly. It would also tend to reduce the hegemonic influence of the large investing nations.

**Competition policy.** This is one area where RTAs have substantially advanced the removal of potential and actual protection. There are, however, a number of well-known barriers to agreeing disciplines at the WTO level. In absence of progress on this issue, one idea would be to attempt a clubs approach that commitment all club members to the core principles of good competition policy. As with the GATS+ club suggested above, membership would be a signal of good governance and thus one step toward improving the investment climate in member nations.

#### Final Caveat

As the old saying goes, “the difference between theory and practice is different in practice than it is in theory.” The ideas in this paper will plainly need practitioners’ input to bring them closer to practical proposals. We hope, however, that the paper has at least stimulated thinking on ways of getting the WTO more pro-actively engaged in making sure that the broad range of regional liberalisation initiatives remain as multilateral-friendly as possible.

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## APPENDIX A: THE SIMPLE ECONOMICS OF ROOS AND THEIR MULTILATERALISATION

This appendix sets out the basic economic effects of rules of origin. While ROOs can provide protection in many complex ways, we focus on the simple case that is most relevant to our analysis.<sup>46</sup>

Some rules of origin may have no effect at all. Take for example a ROO that requires at least 50% of a product's value is added in the partner nation. If this criterion was met even before the PTA, the ROO has no effect at all. If, by contrast, the value added was less than 50% prior to the PTA, firms in the partner nation must either switch to using more expensive components bought from PTA-based suppliers, or to continue paying the MFN tariff. In either case, the ROO acts like protection. The second case is trivial since it is just as if the product was excluded from the PTA, so the level of protection continues to be the MFN tariff. The interesting case is where the ROO leads partner-based firms to switch to more expensive intermediate inputs. This can be thought of as a situation where the policy has raised the costs of domestic firms' rivals.<sup>47</sup>

### 5.3. Price and quantity effects of ROOs

The situation is depicted in Figure 7. Here we assume the EU imports the good, say shirts, from two nations, Poland and China. Initially the EU imposes the MFN tariff  $T$  on both, so the resulting import supply curve ( $MS^{MFN}$ ) intersects the EU's import demand curve ( $MD$ ) at the price marked  $P^{MFN}$ . As usual, we construct the  $MS^{MFN}$  curve by horizontally adding the Chinese and Polish export supply curves shifted up by the MFN tariff.<sup>48</sup> If an FTA is signed between Poland and the EU without cost-raising ROOs, the tariff only applies to China. The MS curve is now the horizontal sum of  $XS^{C(MFN)}$  and  $XS^P$ , so the MS curve facing the EU shifts to out to  $MS'_{no\ ROO}$ . The equilibrium price inside the EU would be  $P'_{no\ ROO}$ . This is also the price that Polish exporters see; Chinese exporters, however, see this new price less the tariff. We take this FTA-with-no-ROO as the base case for our analysis of the impact of restrictive ROOs.

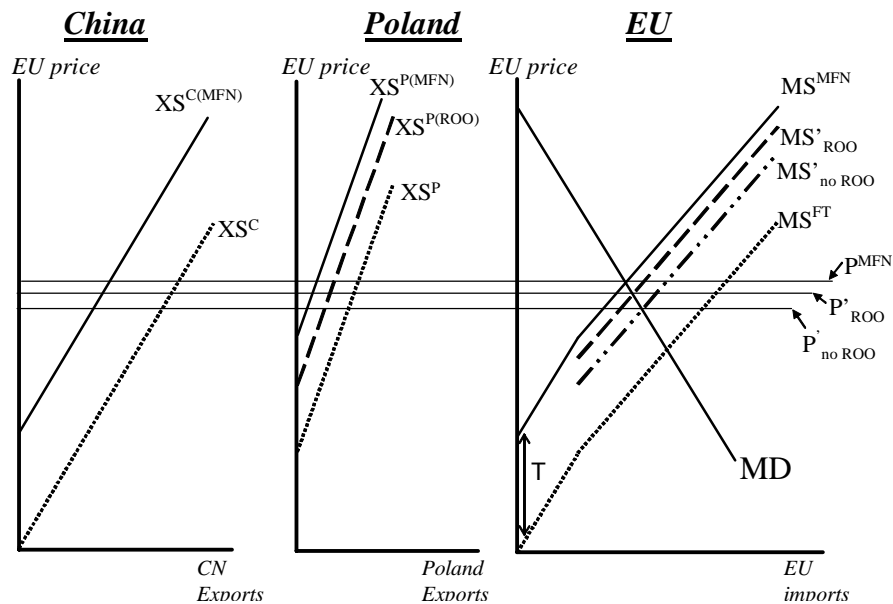
Consider the impact of signing an FTA with stringent ROOs for shirts imported from Poland. To be concrete, suppose the ROO requires Polish shirt makers to buy cloth from within the EU rather than buying the cheapest cloth on the world market. The key point is that this ROO acts as a frictional (i.e. cost-raising) trade barrier against Polish shirt exports. As mentioned, the Polish shirt makers always have the option of paying the MFN tariff so the cost-raising impact of the frictional barrier cannot exceed the tariff; here we assume that is the case.

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<sup>46</sup> See Krishna (2005) and Krishna and Krueger (1995) for more in depth analysis.

<sup>47</sup> Of course, partner-firms can always pay the MFN tariff, so the cost rise cannot exceed the MFN tariff.

<sup>48</sup> For simplicity, we assume that the EU is the only importer.



**Figure 7: Effects of ROOs on prices and imports**

To work out the equilibrium price with the an ROO-laden FTA, we note that the EU's import supply is now the horizontal sum of  $XS^{C(MFN)}$  and  $XS^{P(ROO)}$ , where  $XS^{P(ROO)}$  is Poland's export supply curve shifted up by the tariff-equivalent of the friction barrier (i.e. the per-unit, cost-raising impact of the ROO). As usual, the equilibrium prices inside the EU are given by the intersection of the MS and MD curves and this is  $P'_{ROO}$ . The price exporters received is given by  $P'_{ROO}$  minus the appropriate barrier (the tariff for China and the tariff-equivalent of the ROO for Poland).

#### 5.4. Impact of ROOs on welfare and producer surplus

The net welfare effect of the FTA with and without the ROO follows directly from well known reasoning. The FTA yields an expansion of imports that is associated with a positive trade volume effect for the EU and an ambiguous terms-of-trade effect (Chinese imports get cheaper while Polish imports get dearer). As per Viner's Ambiguity, overall the EU welfare impact is ambiguous with or without the rules of origin. See Box 2 for details.

The impact on Poland is positive in either case since it sees a positive trade volume effect (it sells more) and a terms-of-trade improvement with or without the ROO. The Polish gain is larger without the restrictive ROO. China unambiguously loses for the reverse reasons but loses less with the restrictive ROO in place.

More interesting – from the political economy point of view – is the impact on producer surplus in Poland and the EU. This is shown in Figure 8. The diagram reproduces the various equilibrium prices derived in Figure 7 (not to scale, but the ordering is correct). The impact on producer surplus in the EU is shown in the left panel. The initial price  $P^{MFN}$  falls to  $P'_{ROO}$  if the FTA includes the restrictive ROO and it falls more (to  $P'_{no ROO}$ ) if it does not. Thus EU producer surplus falls in any event, but it falls by

less if the restrictive ROO is in place. Clearly this protectionist outcome is the goal of most of the unusual rules of origin imposed by the signers of FTA.

Polish producer surplus rises with or without the ROO since we are working with the case where the ROO is actually used. The producer surplus gain with the ROO is area 'b' since the price received rises from  $P^{MFN}-T$  to the EU's new internal price  $P'_{ROO}$  minus the extra per-unit cost imposed by the ROO – what we call  $C_{ROO}$  in the diagram. If the FTA is signed without the ROO, then the gain to Poland-based shirt producers is the area 'a+b' since the received price rises from  $P^{MFN}-T$  to the EU's new internal price  $P'_{no ROO}$ .

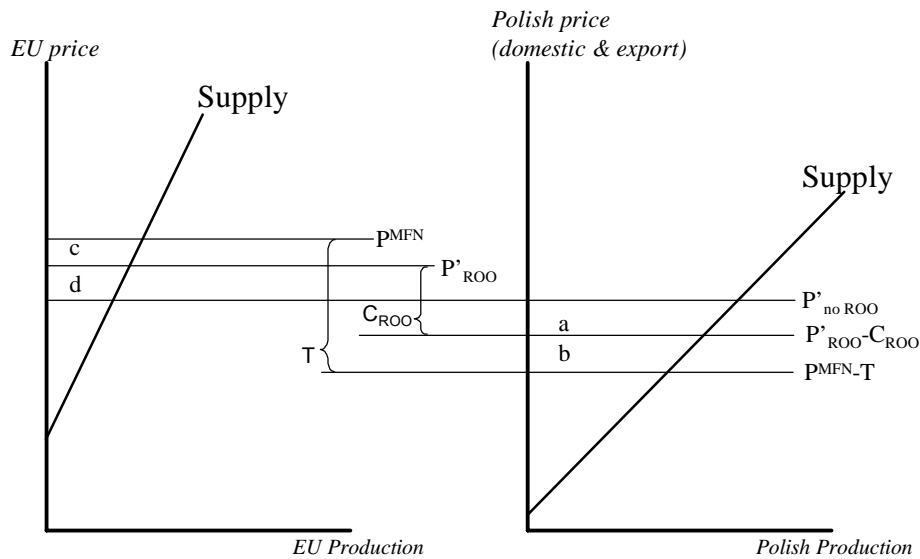


Figure 8: Effects of ROOs on producer surplus

To summarise, the ROOs mitigate the gains of Polish exporting firms and the losses of EU import-competing firms. Polish firms gain from the FTA even with the ROOs but gain more without them while EU import competing firm lose from the FTA but lose less with the ROO.

### 5.5. Intermediate goods producers

We have not yet considered the fate of the cloth-makers in our example. The pattern of world trade in cloth before the FTA would be governed by the usual considerations of trade with MFN tariffs. For example, suppose that China is the low-cost producer of cloth, but the EU has a high MFN tariff so some EU cloth makers can stay in business. Furthermore, suppose that Poland has a low tariff on cloth so as to make its shirt-makers more competitive on the world market. From this situation, consider the impact of an EU-Poland FTA with the ROO on cloth. Assuming that the gap between EU and Chinese prices is not too great, Polish shirt makers will switch from buying Chinese cloth to buying EU cloth. As usual, this shift in demand will raise the price faced by EU cloth makers, so the ROO will benefit the EU cloth industry as well as helping to protect the EU shirt industry from the liberalising impact of the FTA. Polish cloth makers may also gain from the ROO-induced shift in demand away from China.

The key political-economy point is that ROOs tend to align the interests of the whole EU industry – both final goods and intermediate goods producers. It may also make some Polish firms (cloth makers) into fans of the ROOs. Extending the logic, it is easy to see that if a stringent ROO is imposed on an intermediate input, the downstream industry will have an additional incentive to request ROOs on the downstream goods.<sup>49</sup>

### 5.6. Impact of multilateralising an FTA zone

As discussed above, one way to multilateralising a collection of FTAs is to: 1) harmonise rules of origin, and 2) allow diagonal cumulation. Both changes tend to lower costs for firms exporting within the FTA. The harmonisation of rules of origin across many FTAs reduces the number of different ROOs that a single exporter must deal with. This clearly lowers firms' costs in many ways that would depend upon particular circumstances. The cumulation lowers cost by allowing exporters to buy their parts, components and materials from the lowest cost source in the cumulation zone.

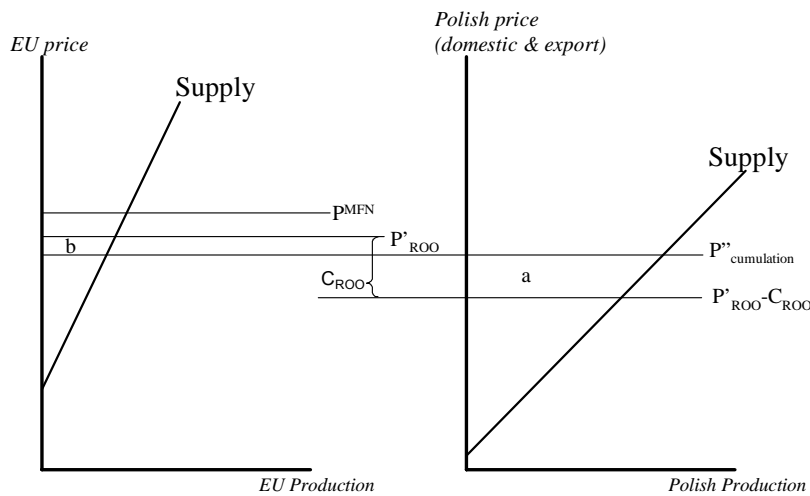


Figure 9: Economic and political economic impact of multilateralisation

<sup>49</sup> The upstream ROO in Home raises the cost of downstream firms in Home; other things equal, this cost disadvantage would give an extra edge to the downstream firms in Partner. To offset this extra edge, Home downstream firms may push for a ROO that 'levels the playing field', i.e. requires the Partner downstream firms to use equally expensive inputs.

We study the economics and political economics of these cost lowering effects using Figure 9. The overall welfare effect of this liberalisation tends to be positive, especially if the multilateralised FTAs cover most the imports.<sup>50</sup>

### Producer surplus effects

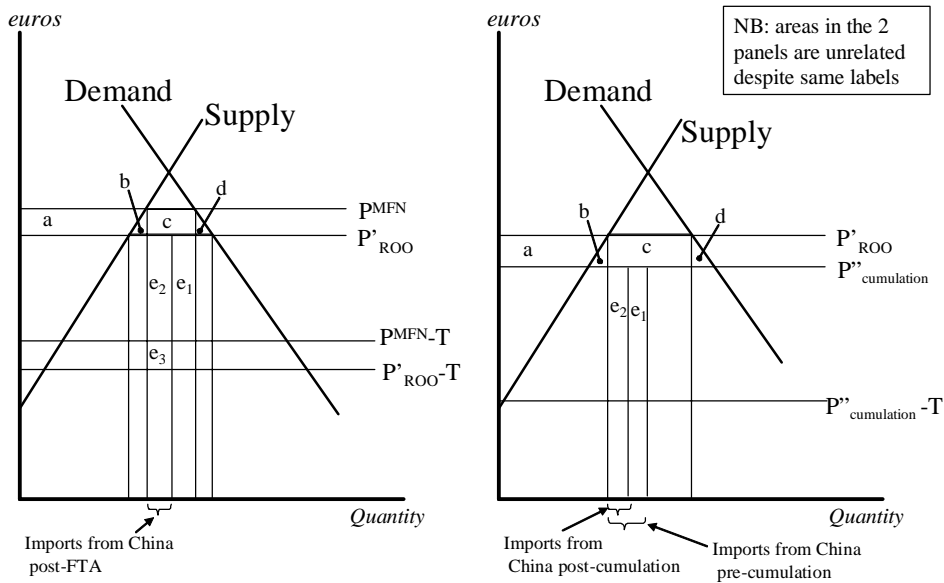
The key issue, however, is the political economy of the reform as driven by the changes in producer surplus in the EU and Poland. The cost-lowering aspects of the reform will drive down prices in the EU from  $P'_{ROO}$  to a lower level marked as  $P''_{cumulation}$  in the diagram. This will raise producer surplus in Poland by area 'a' and lower it in the EU by 'b'.

Importantly, the area 'a' expands as the initial level of *exports* from Poland to the EU rises; the area 'b' falls as the initial level of *production* in the EU falls. This makes it clear why shifting comparative advantage may make multilateralisation politically easier. As EU shirt production falls due to the natural pressures of evolving comparative advantage, EU opposition to multilateralisation falls. Moreover, as the exports within the FTA zone increase, the gain from the reform rises. In the limit, when EU production is extinguished by, say, competition from China, there will be no EU import-competing firms left to object.

Moreover, if the firms that used to be import-competing firms in the EU shift production to Poland in order to remain competitive then the political economy of 'taming the tangle' becomes lopsided. The production shifting both lowers the EU pain, area 'b', and it raises the gain to the EU firms now located in Poland (area 'a'). This has been dubbed the 'spaghetti bowls as building blocs' effect in Baldwin (2006a, p.1).

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<sup>50</sup> As is well known by now, Viner's ambiguity does not apply to pure frictional barriers. The deep reason is that with a frictional barrier the importing nation's internal price is also the price it actually pays for imports. A liberalisation that lowers this price will result in a positive trade volume effect (imports expand) and a positive terms-of-trade effect (the nation pays less for its imports). The same point can be made using textbook-terms by noting that there is no tariff-revenue loss to offset consumer gains. When third-nation imports pay the tariff, as in our example, we get a confounding impact on the terms of trade when EU importers switch from buying third-nation imports (which are cheap from the nation's perspective) to more expensive suppliers within the cumulation zone. However, if third nation imports are small, the maximum loss is small.



**Figure 10: Importing nation's ambiguous welfare effects of an FTA with rules of origin**

Box 2: Welfare effect of an FTA with ROOs and cumulation

Explicit analysis of the impact of an FTA with ROOs on the importing nation's welfare is straightforward; the discussion is organised around Figure 10. As in the text, the FTA with ROO lowers the domestic price from  $P^{\text{MFN}}$  to  $P^{\text{ROO}}$ . The impact on private welfare is the gain to consumers ( $a+b+c+d$ ) less the loss to producers ( $a$ ). Tariff revenue before the FTA was  $c+e_1+e_2$ , while after it is only  $e_2+e_3$ . Thus the net welfare effect for the importing is  $b+d+e_3-e_1$ . The analysis for an FTA with no ROO is similar.

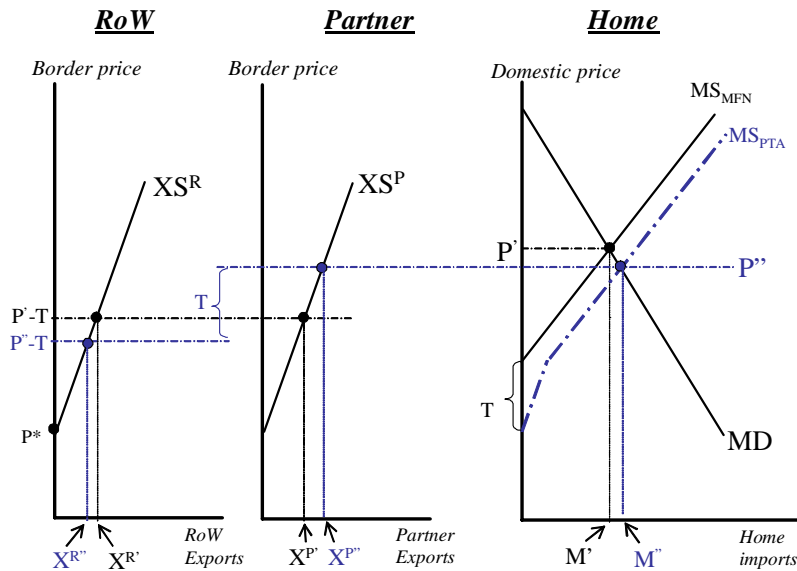
It is intuitive to break this down into the trade volume gain,  $b+d$ , and the conflicting terms of trade effect ( $e_3-e_1$ ). There is a terms of trade gain with respect to third-nation imports (their border price is driven down to  $P^{\text{ROO}-T}$ ); this corresponds to the area  $e_3$ . There is also a terms of trade loss with respect to imports from the FTA partner,  $e_1$ ; their border price rises from  $P^{\text{MFN}-T}$  to  $P^{\text{ROO}}$ .

As mentioned in the text, cumulation has ambiguous welfare effects that stem from negative terms of trade effects on third-nation imports. The right panel shows the analysis. The cumulation's cost-lower effect on intra-FTA trade pushes down the price in the EU from  $P^{\text{ROO}}$  to  $P^{\text{cumulation}}$ . This results in a net gain to the sum of producer and consumer surplus of  $b+c+d$ . However, the additional competition in the EU market reduces Chinese exports (the price Chinese firms received is reduced by the fall in the EU internal price since these firms continue to pay the tariff) as shown in the diagram. This reduction reduces EU tariff revenue by  $T$  times the reduced imports, i.e. area  $e_1$  in the diagram. If third-nation imports were initially very large, then  $e_1$  can be very large and the overall impact may be negative. Yet since the tariff loss is limited to the initial level of the tariff revenue (and this is linked to the initial level of third-nation imports), the possibility of a welfare loss disappears as the initial level of third-nation imports becomes vanishingly small.

**APPENDIX B: BASIC ECONOMICS OF PREFERENTIAL TBT LIBERALISATION**

The proliferation of bilateral and plurilateral agreements can be thought of as creating a spaghetti bowl syndrome in TBTs. The extent to which this is true and the extent to which it is a problem cannot be understood without reference to the basic economics of TBT liberalisation.

Standards and regulations can influence economic activity and industry structure in ways too numerous to count. The World Bank, for instance, conducted a large, multi-year project studying the impact of standards on trade.<sup>51</sup> To focus on essentials, however, we abstract from many details and model TBTs as frictional barriers, i.e. barriers that raise the marginal cost of selling a good internationally.<sup>52</sup> The impact of such frictional barriers is similar to that of a tariff except no tariff revenue or other form of rent is generated. The gap between the price of the good inside the importing nation and the exporting nation is burnt up by costly activities that are required to satisfy the TBT.



**Figure 11: Effects of MRAs on prices and imports**

To keep things simple, consider a three nation world with TBT liberalisation between two (labelled Home and Partner); the third nation (RoW) remain outside the arrangement. We start by assuming that all three nations impose TBTs that have a specific-tariff equivalent of  $T$ . The specific policy change to

<sup>51</sup> For the results, see <http://www.worldbank.org/trade/standards>.

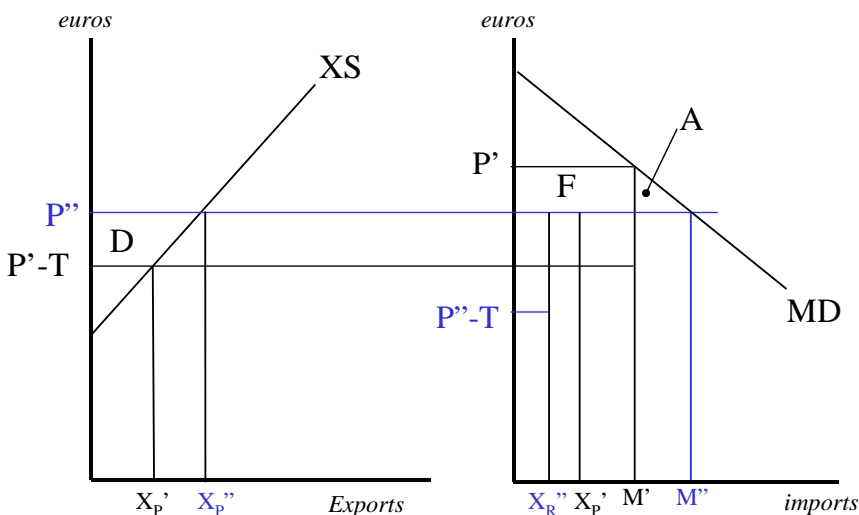
<sup>52</sup> In certain industries, the impact of TBTs is radically more complex. In industries with network externalities, like mobile telephones, standards can be manipulated to throw up barriers against non-local firms. In industries with patent races, like pharmaceuticals, a regulation that merely delays the introduction of foreign goods can radically alter the market outcome in favour of home firms. In industries with learning curves, product standards that apply to only a fraction of the market – government or military purchases, for example – can have large effects on the market equilibrium. Modelling TBTs in such “sexy” industries will certainly be the focus of much future work, but in this paper we focus on mundane industries where TBTs act by raising the costs of foreign firms more than the costs of local firms.

be studied is a lowering of  $T$  to zero on all trade between Home and Partner with no change in the barriers on RoW–Home or Partner–RoW trade.

The price and quantity effects of the preferential liberalization are very similar to those discussed of a tariff liberalisation. The only change concerns the border price. With frictional barriers the domestic price is the border price for the importing nation, so the liberalization lowers Home’s border price. At the same time, the exporter that benefits from the liberalization receives a higher price for its exports, so the exporter’s border price rises. The point is made concretely with Figure 7.

Start from the situation where the TBT is applied to both Partner and RoW imports (i.e. when the equilibrium price is  $P'$ ), the preferential liberalisation shifts Home’s import supply curve ( $MS$ ) to  $MS_{PTA}$  from  $MS_{MFN}$ . The internal Home price falls to  $P''$  and this also becomes the price in Partner. The price that RoW exporters receive (net of the cost of the TBT) falls to  $P''-T$ . Partner exports expand and those of RoW contract, although the former contract less than the latter expand so over Home imports rise.

The welfare implications of this are shown in Figure 12.



**Figure 12: Viner’s Ambiguity Vanishes: Welfare Effects of Preferential TBT Liberalization**

As with preferential tariff cutting, the liberalisation creates a positive trade volume effect for home equal to area  $A$ . However since the price that Home actually pays for its imports from Partner and RoW is Home’s internal price (as opposed to the external price as in the case of tariff protection), the liberalisation lead to an unambiguous terms of trade gain. Home gets its imports – both from RoW and Partner – for less, namely  $P''$  instead of  $P'$ . This gain corresponds to the area  $F$  in diagram. Thus although the discriminatory application of the TBT leads to supply switching from RoW to Partner, this ‘trade diversion’ has no welfare consequences for Home.

Notice that, as usual, Partner unambiguously gains from the preferences since it enjoys a positive trade volume effect (its exports expand) and terms-of-trade effect. Thus in the market under study, the FTA partners unambiguously gain. Notice that Viner’s ambiguity has disappeared.

RoW unambiguously loses for the usual reasons. The heightened competition in Home’s market induces RoW firms to sell less and charge a lower net price.