

Mildner, Stormy-Annika; Schmucker, Claudia

**Research Report**

## Trade agreements with side-effects? European Union and United States to negotiate Transatlantic Trade and Investment Partnership

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## Trade Agreement with Side-Effects?

European Union and United States to Negotiate  
Transatlantic Trade and Investment Partnership

*Stormy-Annika Mildner and Claudia Schmucker*

At the G8 summit in Northern Ireland on June 17, the European Union and the United States kicked off the negotiations for a comprehensive Transatlantic Trade and Investment Partnership (TTIP) to reduce tariffs and non-tariff trade barriers. While the expected economic benefits for both sides would be more than welcome in an era of gloomy growth forecasts, a TTIP is not entirely without risks for global trade and the multilateral trading system. The talks could tie up a considerable portion of EU and US negotiating capacity and divert attention from the WTO Doha Round. More broadly, potential trade-diverting effects could function to the detriment of other trading partners. Such side-effects should be avoided. The “high road” of international trade policy must remain the WTO, with bilateral agreements making sense only as a stepping stone to multilateral liberalisation. Alongside the TTIP talks, the Transatlantic Partners should therefore continue to push for a conclusion of the Doha Round. And the TTIP must be designed to be compatible with WTO rules.

A transatlantic free trade area is not a new idea. The project was first proposed in the 1990s, and resurfaced in 2006/2007 under the German EU Presidency. Now talks have finally started. On 11 February 2013 the High Level Working Group on Jobs and Growth of the Transatlantic Economic Council (TEC) recommended a comprehensive agreement to abolish tariffs and above all to dismantle the non-tariff barriers (NTBs) that affect especially industrial goods (approval, technical standards, safety standards) and agricultural products (hygiene and health standards), and customs arrangements. The talks were also to cover

“trade plus” topics including rules for public procurement, investment, intellectual property protection and patents, competition, data protection, and environmental and social safeguards.

On 12 February 2013, US President Barack Obama, EU Commission President José Manuel Barroso and European Council President Herman Van Rompuy declared their intention to begin talks. At the recent G8 summit, the European Union and the United States launched the negotiations; the first round of talks will begin the week of July 8 in Washington, D.C.

A Transatlantic Trade and Investment Partnership would join together the world's two largest economies. The European Union and United States account for 25.8 percent of global goods exports (2011, excluding internal exports within the European Union), 43.7 percent of global service exports (again without EU internal trade) and 39.4 percent of global stocks of foreign direct investment (inward, not including internal EU stocks; all figures here from Eurostat or UN). With respect to its regulatory scope such an agreement would also be one of the world's most comprehensive treaties.

### Why a TTIP?

There are multiple reasons why a TTIP is desirable. Although Transatlantic trade is already strongly liberalised, with average applied tariffs of 4.0 percent (EU) and 3.3 percent (US) on industrial goods and 13.9 percent (EU) and approximately 5 percent (US) on agricultural products (WTO figures), the large volume of bilateral trade means that the growth effects of dismantling remaining barriers should not be underestimated. Moreover, low average tariffs should not obscure the continuing existence of numerous peaks. In the European Union these are found above all in agriculture (up to 205 percent), in the United States on particular industrial products, especially textiles (42 percent), clothing (32 percent), and leather goods and footwear (56 percent). Both sides also impose high tariffs on chemicals, transport equipment and medical goods. Tariffs aside, NTBs represent especially grave obstacles to trade and investment. Technical (regulatory) trade barriers affect above all pharmaceuticals and cosmetics, textiles and clothing, and the automotive sector.

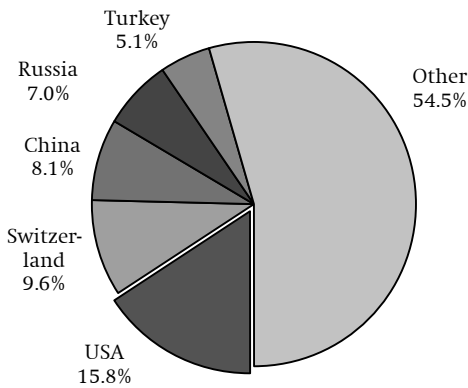
The European Union and the United States would benefit considerably if tariffs in bilateral trade could be abolished and NTBs dismantled. The study *Reducing Transatlantic Barriers to Trade and Investment*, published in March 2013 by the London-based

Centre for Economic Policy Research (CEPR) forecasts the impact of a TTIP on prosperity for various liberalisation scenarios, expressed in terms of change in gross domestic product (GDP). If only tariffs are eliminated ("limited agreement" scenario: abolition of 98 percent of all tariffs), the authors expect an annual growth stimulus of 0.1 percent (€23.8 billion) for the European Union and 0.04 percent (€9.4 billion) for the United States. The "comprehensive/ambitious" scenario is more radical, assuming the abolition of 98 percent of tariffs, 25 percent of NTBs on goods and services and 50 percent of procurement NTBs. Here, the European Union's GDP would rise by 0.48 percent (€119.2 billion) and the United States' by 0.39 percent (€94.9 billion Euro) – a welcome boost for both economies. While the US economy is growing again, forecasts for the coming years are anything but rosy. For the European Union things look even worse. Numerous member-states are likely to slide into recession in 2013, and the debt crisis is anything but over.

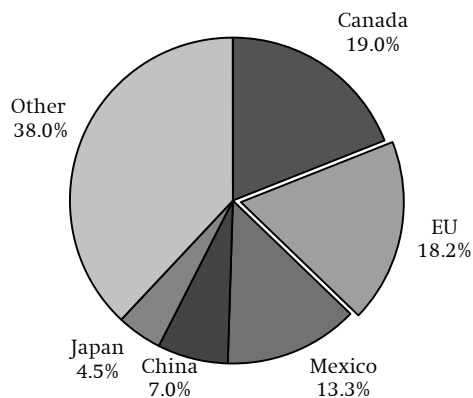
Stronger Transatlantic integration would also improve both partners' competitiveness against emerging economies like China and India. According to the IMF, the EU-27's share of global GDP fell from 34.1 percent in 1980 to 25 percent in 2011. The situation with exports is similar.

In 1980 the European Union accounted for 22.7 percent of global goods exports (current EU-27), by 2011 its share had fallen to 13.9 percent. The United States' shares of global GDP and trade have also fallen steadily. While a TTIP is unlikely to reverse that trend, it could slow it, partly through the economies of scale businesses can achieve through improved access to the partner country's markets and consumers and by reducing costs for businesses trading with or investing in the transatlantic partner. Moreover, by working together the European Union and United States could generate the economic and political strength to set global standards, for example for security of investment or fair competition. The TTIP could conceivably

**Figure 1**  
**Main EU export markets**  
**(goods exports, 2011)**

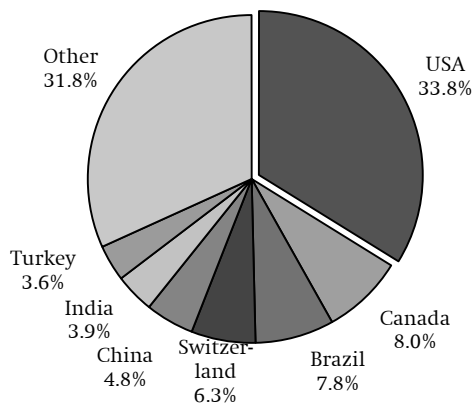


**Main US export markets**  
**(goods exports, 2011)**

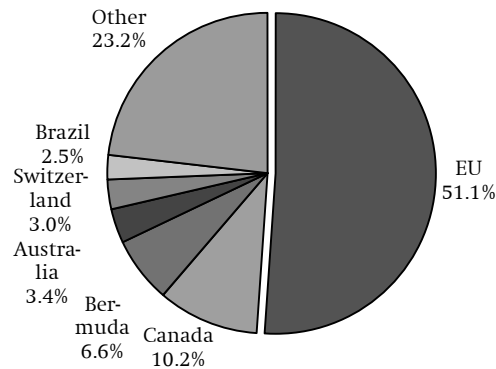


Source: IMF, *Direction of Trade Statistics* (accessed 15 April 2013).

**Figure 2**  
**EU foreign direct investment**  
**(Outflows, 2011)**



**US foreign direct investment**  
**(Outflows, 2011)**



Sources: Bureau of Economic Analysis, *Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data*, [www.bea.gov/international/di1fdibal.htm](http://www.bea.gov/international/di1fdibal.htm); Eurostat (both accessed 15 April 2013).

function as a test bed for new areas of regulation whose complex character has to date precluded their inclusion in negotiations at the multilateral level. Initial testing of new rules in preferential trade agreements (PTAs, such as free trade agreements and customs unions) is not without historical precedent. Examples include the liberalisation of the service sector at the European level and its subsequent inclusion in the GATT Uruguay Round

(1986–1994). Preferential trade agreements like the TTIP can thus also inject momentum into multilateral negotiations.

The European Union has another important reason to seek a TTIP with the United States: the talks on a Trans-Pacific Partnership (TPP). Currently the United States is speaking with Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore and Vietnam about a “high-standard” agreement. Japan, Mexico and Canada have also

signalled interest, with Canada and Mexico already officially invited to join; in 2013 the United States agreed to Japan's participation. If the TPP countries receive preferential access to the US market that would represent a competitive disadvantage for European businesses.

### **Risks Involved**

However, a TTIP is not without risks for global trade and the multilateral trade system. Discrimination against third countries is a central problem of preferential agreements. Selective tariff abolition can eliminate protectionism and distortions between the signatories of such an agreement and create trade-generating and growth-boosting effects. As the economist Jacob Viner demonstrated in the 1950s, the bilateral/plurilateral abolition of trade barriers can increase trade if domestically produced goods and services or imports from third countries are substituted by cheaper (i.e. more efficiently produced) goods and services from the partner country. But frequently such an agreement leads to discrimination against third countries with trade-diverting effects. According to Viner, trade diversion occurs when the dismantling of trade barriers gives goods and services from the partner country a competitive advantage and consequently trade with third countries is diverted to the partner country even if the third country can produce the relevant goods and services more efficiently.

One particular problem of preferential trade agreements is that they contain many different and contradictory rules. This applies above all to the rules of origin in free trade agreements (FTAs), which define which goods are granted preferential treatment. To enjoy preferential market access a particular proportion of the product must be produced in one of the FTA signatory countries. This is intended to prevent non-signatories from profiting from preferential treatment without themselves making concessions. Cumulatively, the multiplicity of

preferential trade agreements has produced a confusion of different rules of origin that tangibly obstruct trade. Small and medium-sized enterprises in particular suffer from high transaction costs. Worries that a TTIP would exacerbate the "spaghetti bowl effect" identified by economist Jagdish Bhagwati in the 1990s are certainly justified.

A study by the German ifo-Institut published in January 2013 argues that countries geographically close to the United States or the European Union, countries with a high volume of trade with either or both of them, and countries with free trade agreements with either or both must expect to lose trade through a TTIP. For the United States this means in the first place Canada and Mexico, primarily through erosion of the preferential access to the US market both enjoy through the North American Free Trade Agreement (NAFTA), but also through trade-diverting effects. Australia, which has a FTA with the United States, is also a loser in both liberalisation scenarios (comprehensive agreement or tariff elimination).

Another problem is that the TTIP talks could tie up a considerable proportion of EU and US negotiating capacity. Both sides are already involved in numerous bilateral and plurilateral negotiations. The European Union is currently negotiating FTAs with Canada, Japan and Mercosur, the United States, as already mentioned, with the TPP countries. Additional Transatlantic talks thus threaten to overstretch both executives and could further diminish interest in a successful conclusion of the Doha Round.

Should the European Union and United States fail to conclude the bilateral talks within a reasonable timeframe they also risk damage to their reputations as capable political actors and their credibility as proponents of open markets. But speedy conclusion will be no easy matter with so many sensitive topics involved. Many European states reject liberalisation of agricultural trade, and France has recently succeeded in excluding cultural services from the talks.

Finally, a TTIP could also have unintended political repercussions. Emerging economies and developing countries could interpret it as an instrument of exclusion or even an attempt to blackmail them into making concessions in the Doha Round. In the worst case this threatens to block the already difficult WTO talks. While such scenarios are certainly plausible, the Transatlantic partners have options for counteracting them.

### **Ensure WTO Compatibility**

Their economic and political weight lends the European Union and United States a special responsibility for the world trade order. Thus, how must the TTIP be designed if it is to benefit rather than harm the multilateral trading system? In the first place it must be compatible with WTO rules and serve as a stepping stone for future global liberalisation regimes. Firstly, the Transatlantic Partnership should liberalise trade and address trade plus issues. Secondly, it should standardise rules in order to simplify the “spaghetti bowl” of competing and contradictory rules. Thirdly, it should be open for new members to avoid exclusion. And fourthly, it should recognise the WTO as the central arbitration instance and avoid undermining its dispute settlement procedure.

### **Comprehensive Liberalisation**

Preferential trade agreements contradict the central WTO principle of most-favoured nation treatment (MFN), because they grant partners benefits that are denied to others. Accordingly, they are permitted only as an intermediate step in the multilateral liberalisation process and subject to rules laid out in GATT Article XXIV (for trade in goods) and GATS Article V (for trade in services).

Paragraphs 4 to 10 of the GATT Article define the conditions under which customs unions and free trade zones may be created. These involve definition of such entities,

duty of notification, treatment of third countries, etc. Paragraphs 8 (a) (i) (customs unions) and 8 (b) (free trade agreements), under which the tariffs for “substantially all the trade” must be dismantled, are especially important. Under paragraph 5 (b), the external duties of countries participating in a free trade zone must not be higher than before conclusion of the agreement. Given that these conditions would also apply to the TTIP, it would be impossible to exclude whole sectors from liberalisation. Removing agriculture from the TTIP talks, as proposed by Renate Künast, leader of the Green Party parliamentary group in the German Bundestag, would thus contradict WTO rules.

GATS Article V defines the conditions for economic integration in the service sector a little more loosely. The Partnership would only need to have “substantial sectoral coverage” rather than covering all sectors. Agreements must also provide for “the absence or elimination of substantially all discrimination ... between or among the parties”. Exceptions are thus permitted, and GATS also provides exemptions for cultural services, but the goal should be for a TTIP to cover at least all services that are in line for liberalisation through the WTO.

But the ambitions of the TTIP should not end with the scope and depth of WTO regulation. Instead it would be desirable for the talks to reach beyond the traditional realm of the WTO and address the aforementioned trade plus issues. New cross-cutting issues like treatment of state-run companies and stronger integration of small and medium-sized enterprises (SMEs) should also be included. With these issues of broader interest a first step could be taken towards global regulation.

### **Harmonised Rules**

As already mentioned, one drawback of the numerous existing preferential agreements is that they create an increasingly complex tangle of rules that tend to hamper rather than ease free trade. Special attention must

be given to rules of origin. The European Union and the United States should ensure that any new rules of origin do not worsen the global regulatory chaos and are compatible with the pre-existing FTAs of both sides. The rules should also be as generous as possible in order to prevent the danger of trade diversion and the associated discrimination against third states. At the same time it would make sense to extend market access and new rules for investment or procurement to other trade partners that are willing in return to liberalise their markets to the same extent.

### **Openness to New Members**

If a preferential agreement is not to harm the multilateral trading order it must be open to third countries. The TTIP is no exception. Initially it will be negotiated solely between the European Union and the United States. But in the long term it would be desirable to expand it to the whole NAFTA region, especially given that the European Union already has a free trade agreement with Mexico and is currently negotiating one with Canada. The more members a preferential agreement comprises, the smaller the trade-diverting effects and the greater the chances of multilateralisation.

### **Uphold WTO Dispute Settlement**

Even after conclusion of the TTIP, the European Union and the United States should conduct their bilateral disputes mainly before the WTO and promptly implement its rulings. It would set a poor example if the Transatlantic partners were to withdraw from the WTO dispute settlement mechanism.

According to the European Commission, the European Union currently has twenty-two complaints against the United States outstanding at the WTO (of a total of fifty-five EU complaints against WTO members). Three of these are in the panel process that begins if the parties fail to agree on a com-

promise in the consultation phase. The three cases concern subsidies on civil aircraft (Boeing), copyright, and American use of anti-dumping duties under the Byrd Amendment. The United States has nine outstanding complaints against the European Union (out of twenty-nine in all). Here too, three conflicts are in the panel process: Airbus, geographical indications, and the widely noted dispute over genetically modified foods.

But not all disputes should be dealt with at WTO level; some should certainly be resolved bilaterally. This applies for example to the sensitive field of consumer protection, where disputes dragging on for decades demonstrate the limits of WTO procedures. Conflicts over issues for which the WTO possesses inadequate rules should be resolved bilaterally. This includes the Airbus/Boeing dispute over illicit subsidies that has been before the WTO for years without any resolution in sight. Such disputes bear considerable potential for conflict and unnecessarily burden the WTO dispute settlement procedure.

### **Strengthen the WTO**

In order for the TTIP talks not to endanger the multilateral trade system it is not enough to ensure compatibility of rule-books. Rather, the European Union and the United States must work for a rapid conclusion of the Doha Round. Even if the negotiating capacities of both sides are likely to be stretched by Transatlantic talks, the Doha Round should remain top priority. Firstly, this is the only way for the European Union and the United States to open up the attractive markets of rapidly growing emerging economies and developing countries. Both have already concluded bilateral free trade agreements with numerous countries in this group, such as South Korea. But the BRICS (Brazil, Russia, India, China and South Africa) are not on the list. The European Union is negotiating with India and Brazil (the latter in the scope of talks with Mercosur) but as yet without

success. The United States currently has no plans for agreements with these countries. Secondly, the long standstill in the Doha Round endangers the credibility of the WTO and could in the medium to long term negatively impact its dispute settlement procedure, on which the European Union and United States depend to deal with the growing number of trade conflicts with emerging economies, especially China.

For almost twelve years the Doha Round has been discussing improved market access for agricultural products, industrial goods, and services, as well as environmental issues, strengthening multilateral rules and improving the integration of developing countries in world trade. It was originally scheduled to conclude in 2005, but every self-imposed deadline since then has been missed. The most recent ministerial conference at the end of 2011 failed to achieve a breakthrough.

The goal of the next ministerial conference, scheduled for December 2013 in Bali, is to pass a minimum package including trade facilitation and certain agricultural aspects that are especially important for developing and least developed countries (LDCs). The European Union and the United States should support such a package even if it promises little benefit for themselves, as this would signal their continuing commitment to the Doha Round and the WTO. The European Union and United States should implement the concessions they made at the Hong Kong ministerial conference in 2005, where they agreed to abolish agricultural export subsidies and open their own markets to products from LDCs. The United States should make concessions especially on cotton.

After adoption of such a minimum package, the next step would be to decide how to proceed with the Doha Round. If it is clear that timely agreement will be impossible it would make sense to end the round provisionally in order to lift the blockade of the WTO. Then new topics that do not presently fall under WTO rules, such as investment, information technology and

possibly further-reaching questions such as resources and energy or strengthening global supply chains, could be tackled first. These topics are becoming increasingly important for industrial countries as well as for emerging economies and developing countries. If the WTO fails to expand its regime to these areas it risks becoming irrelevant. Nor can its dispute settlement procedure hope to effectively resolve new trade conflicts without corresponding rules.

Plurilateral agreements within the WTO should also remain under consideration. Currently the European Union and the United States are engaged in the “Really Good Friends of Services” group of twenty-one WTO members that has been conducting plurilateral negotiations on further liberalisation in the service sector since early 2012. The group also includes emerging economies like Mexico, Chile and South Korea; in 2010 the group accounted for about two thirds of global trade in services. Such a plurilateral agreement would allow signatories to open their markets more widely to one another. But it must be ensured that such agreements respect the WTO principle of most-favoured nation treatment.

A strong WTO is important for the European Union and the United States, especially as China, Brazil and India gain weight in international trade policy. Even if the Transatlantic partners agree a TTIP, the importance of clear global trade rules that are accepted by the emerging economies and enforceable through the WTO will continue to increase. The European Union and the United States should therefore design their agreement to be WTO-compatible and to incentivise the Doha Round, as NAFTA did in the 1990s for the Uruguay Round. A successful TTIP could thus also help achieve a breakthrough in the Doha Round.

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**SWP**  
Stiftung Wissenschaft und Politik  
German Institute for International and Security Affairs

Ludwigkirchplatz 3-4  
10719 Berlin  
Telephone +49 30 880 07-0  
Fax +49 30 880 07-100  
www.swp-berlin.org  
swp@swp-berlin.org

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