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Research Report

Prospects for regulatory convergence under TTIP

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PROSPECTS FOR REGULATORY CONVERGENCE UNDER TTIP

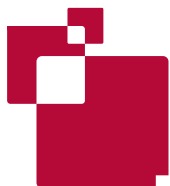
SUPARNA KARMAKAR

Highlights

- An ambitious, comprehensive and high-standard trade and investment agreement between the European Union and the United States is feasible, but a key concern is whether the transatlantic trade partners will succeed in creating a meaningful agreement within the tight timeline of the Transatlantic Trade and Investment Partnership (TTIP) negotiations. The target of a ratified pact before a new European Commission takes office in November 2014 is an objective that is likely to conflict with the level of ambition on the substance.
- Regulatory congruence would require the unilateral and unconditional recognition by the TTIP partners of each other's standards, procedures and conformity assessment tests. The way forward is to create a 'living' (or progressive commitment) agreement on regulatory cooperation with a horizontal template for coherence and conformity assessment and a detailed monitoring mechanism, with implementation starting immediately for a few selected sectors.
- Regulatory harmonisation under TTIP may not lead to emerging markets automatically upgrading to the higher TTIP standards. Domestic priorities and the high demand from a rising price-sensitive group of consumers will likely result in a dual regulatory regime in emerging markets in the medium-term.

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PROSPECTS FOR REGULATORY CONVERGENCE UNDER TTIP

SUPARNA KARMAKAR, OCTOBER 2013

1. Negotiations due to take place during this week in Brussels were cancelled because of the US government shutdown that lasted from 1-16 October.

2. Joseph Francois, Miriam Manchin, Hanna Norberg, Olga Pindyuk and Patrick Tomberger (2013) *Reducing transatlantic barriers to trade and investment: an economic assessment*, Centre for Economic Policy Research.

3. Statistics taken from DG Trade website.

4. ECORYS (2009), *Non-tariff measures in EU-US trade and investment – an economic analysis*, ECORYS Nederland.

5. The TTIP is expected to generate new momentum for multilateral liberalisation and provide a boost to trade and economic growth in the EU and the US. It will also reinforce the global influence of the two parties as international standard- and rule-setters. This directly reflects the unease in the industrialised world about the turbo-charged rise of the developing economies in the last decade, and the fear that the global order is no longer dictated by the west, which is seeing an erosion of its ability to stand up to an increasingly powerful China with the latter's growing economic heft; the present turbulence in the emerging markets is not likely to change the trend.

6. Ulrika Lomas (2013) 'Second Round Of TTIP Talks To Get Underway', *Tax-News.com*, 4 October.

7. The US Federal Railroad Administration confirms that its railroad safety advisory committee, Amtrak, the federal government's passenger rail operator and

THE EU-US TRANSATLANTIC TRADE AND INVESTMENT PARTNERSHIP (TTIP) NEGOTIATIONS are aimed at concluding an ambitious, comprehensive, and high-standard regional trade and investment agreement that offers significant benefits in terms of promoting international competitiveness, jobs, and growth in the partner countries. TTIP would seek to liberalise, as much as possible, trade and investment between the two blocs in the 20 areas that the agreement is expected to cover. The negotiations started in February 2013 and the negotiating parties completed a first round of talks in Washington in early July. The second round of negotiations was scheduled to be held in Brussels in the second week of October¹.

A CEPR study² estimated that an ambitious and comprehensive agreement could bring significant economic gains for the EU as a whole (approx. US\$88.7 to \$155.1 billion a year until 2027, depending on the level of ambition of the negotiated agreement) and the US (US\$64.4 to \$123.5 billion a year), while also increasing global income by almost US\$130 billion annually as a result of increased bilateral trade. If an ambitious and comprehensive agreement that reduces behind-the-border impediments to trade and investment is concluded, it is likely to increase the annual GDP of both parties by 0.5 to 3.5 percent, depending on the degree of integration. Together, the US and the EU already account for almost half of global GDP and a third of world trade; each day, goods and services worth US\$2.7 billion are traded bilaterally³. The stock of shared direct investment adds up to more than US\$3.6 trillion.

KEY CHALLENGES AND CONCERNS

As much as 80 percent of the total potential gains from the TTIP would come from cutting costs that arise from administrative procedures and divergent regulations (so-called non-tariff barriers or NTBs), as well as from liberalising trade in services

and public procurement. Although tariffs between the US and the EU are already low (on average 4 percent), the cost of dealing with unnecessary bureaucracy can add a tariff-equivalent of 10-20 percent to the price of goods⁴, which (although usually borne by the consumer) affects the competitiveness of domestic producers and exporters in highly cost-sensitive modern global value chains. ECORYS estimates that eliminating even half of the NTBs caused by regulatory divergence could increase transatlantic GDP by half a percent, or US\$150 billion. But tackling the NTBs is not easy. The two trade partners have been discussing regulatory harmonisation in key traded products/sectors for nearly two decades, since the adoption of the Transatlantic Declaration in 1990. Furthermore, as most of the gains are expected to emerge from eliminating bilateral regulatory and beyond-the-border barriers (the impact of which on increased trade flows is both difficult to measure and attribute), the inability to reduce the NTBs implies that a large part of the projected trade gains may remain unrealised.

Reducing the remaining tariffs will be harder than imagined: the reason why high tariffs on sugar, textiles and garments, steel, and trucks have existed for so long is because of powerful vested interests that are loathe to relinquish their advantages; tackling these interests would require a political appetite to challenge key constituencies in a time of weak economic prospects. Finally, the TTIP negotiations are not all encompassing; they will not cover agricultural subsidies, subsidies to aircraft manufacturers, or movement of temporary workers. Nor will they comprehensively cover IP rules and financial sector regulation. Therefore, notwithstanding the different studies that have outlined the economic and strategic benefits of TTIP, the debate on the feasibility of a deep trade agreement and even its desirability is still open.

More critically, the TTIP has rather ambitious nego-

tiation targets, aiming for a ratified pact before a new European Commission takes office in November 2014, an objective that is likely to conflict with the level of ambition on the substance. In the run up to the second round of TTIP negotiations, negotiators on both sides seemed committed to press for an ambitious outcome on a number of key issues and seek provisions that will make the EU and US regulatory systems more compatible and help shape global rules on trade⁵ without watering down the existing set of rules and regulations. Current negotiations and roadmaps aim to establish the “*common foundations for an ambitious and transformative TTIP*”, and it is hoped that a commonly agreed outline of the regulatory and rules component of the TTIP will be ready by early 2014⁶. Since the European Parliament is involved in trade negotiations, the May 2014 election can be considered as another deadline.

Concluding a reasonably ambitious deal in the next six months thus may be difficult to achieve as it would require arriving at a mutually accepted modality for implementing transatlantic regulatory cooperation and coherence. Transatlantic efforts to recognise each other's regulations have been a work-in-progress since 1990, some notable recent achievements being: (1) Mutual Recognition of Certificates of Conformity for Marine Equipment (2004), (2) Regulation of Civil Aviation Aircraft (2011), (3) Common Understanding on Regulatory Principles and Best Practices (2011), (4) Partnership on Organic Trade (2012), (5) Trusted Trader Program (2012), (6) EU waiver on exports of Active Pharmaceutical Ingredients (APIs) from the US (2013), (7) US acceptance of EU commuter and high-speed trains safety rules (2013)⁷. A Transatlantic Economic Council (TEC) set up in 2007 has the mandate to guide work on economic convergence and harmonise regulations on: cloud computing, e-vehicles, e-health, e-mobility, energy efficiency, ICT trade principles, innovation action partnership, nanotechnology, small and medium enterprise best practices, etc.

However, despite the growing exchange of information and the increasing mutual trust and cooperation between transatlantic regulators on standards-related issues, the experience in important sectors such as automotive safety and emissions standards indicates that the long-delayed, much-needed standardisation is not easy to achieve⁸. Dialogues with the goals of reducing NTBs have continued at varying levels of alacrity and with different structures, frameworks and roadmaps, but binding agreements have generally been indefinitely postponed, as a review of the official statements from US-EU summits and high-level meetings reveals⁹. The review indicates that the recent upward swing may not be enough to achieve meaningful mutual recognition agreements (MRAs) in the short TTIP timeline. Credible progress within the deadline thus calls for an acknowledgement that key differences exist between the two regulatory regimes, with critical implications for the modality choice for achieving regulatory coherence. Recent experience at the US-led Trans-Pacific Partnership (TPP) negotiations has also clearly shown the unease of US business sectors over the possible sacrifice of ambition in the interests of a timely conclusion of a trade agreement¹⁰.

The remainder of this note presents an assessment of the most viable modality for achieving transatlantic regulatory cooperation under the TTIP and the third-country impact of such convergence, in particular on large emerging markets like China. This is based on ongoing work at Bruegel¹¹, and has benefitted from a July 2013 Bruegel Workshop¹² on *The Transatlantic Trade and Investment Partnership (TTIP): Towards regulatory convergence?*

FINDING A WAY THROUGH THE REGULATORY MAZE – WHAT CAN BE EXPECTED TO BE ACHIEVED BY END-2014?

Past research undertaken by Bruegel shows that FTAs concluded by the EU and US tend to entrench the regulatory philosophy and practice of their

others are working on safety design standards that would allow multiple units to operate in the US. “*There is broad consensus on the path forward*,” it says [Robert Wright (2013) ‘US commuters: Land of the freeway starts to steer clear of the car’, *Financial Times*, 27 May.

8. Current EU/US auto NTBs are equivalent to an *ad valorem* tariff of 26.8 percent (Ecorys, 2009; see footnote 4), the elimination of which would require FTA negotiators to recognise among other things both economies’ standards in car-safety tests, ie US and EU accepting vehicles that adhere to the ECE standard and America’s FMVSS regulations.

9. John F. Morrall (2011) ‘Determining Compatible Regulatory Regimes between the U.S. and the EU’, US Chamber of Commerce White Paper, Annex C describes the slow progress of past efforts.

10. Tom Donohue, the head of the US Chamber of Commerce, has said he was concerned that in the rush to get a deal done before the end of the year the US might give up too much ground on key intellectual property and investment provisions: “... *this is going to be a great deal when it gets done. Let’s just not rush it.*” Source: Donnan, Shawn (2013) ‘US business groups warn against compromises in Pacific Rim trade talks’, *Financial Times*, 26 September.

11. A Bruegel Policy Contribution on this subject is forthcoming.

12. The workshop was conducted under Chatham House rules; consequently this Policy Contribution will not directly attribute the views expressed.

‘Despite the growing exchange of information and the increasing cooperation between transatlantic regulators on standards-related issues, experience in important sectors indicates that the long-delayed, much-needed standardisation is not easy to achieve.’

respective trade hubs because these practices are exported to the partners¹³, in effect dividing the world into a *de-facto* dual regulatory zone. For example, in the case of automotive safety standards, because the US is not a signatory to the international 1958 United Nations Economic Commission for Europe (UNECE) agreement, UNECE regulations do not apply in the US. The US developed its own standards in parallel, the Federal Motor Vehicle Safety Standards (FMVSS), while in the EU, the commercialisation of vehicles is based on a type-approval system that relies more and more on UNECE regulations partially replacing EU legislation. These differences in regulatory environments give rise to many costly measures that hamper trade for EU firms exporting to the US, and vice versa, and in turn for the rest of the countries in their individual hubs. The potential overall gains from regulatory congruence in TTIP from harmonised practices between the two trade partners are significant¹⁴.

An ambitious WTO-plus chapter on Sanitary and Phyto Sanitary (SPS) and Technical Barriers to Trade (TBT) measures, monitorable disciplines on regulatory coherence and transparency, and regulatory compatibility in specific, mutually agreed goods and services sectors will turbo-charge regulatory cooperation and enhance the two trade partners' competitiveness relative to other emerging market competitors, in particular China. However, the problem lies in identifying the mutually acceptable binding modality of such cooperation and coherence. Industry (and consumers) are keen to see regulatory standardisation and mutual recognition in key traded sectors, not from deregulation and the lowering of standards, but through the elimination of wasteful and inefficient rules – both existing and future – by sensibly recognising each other's standards and procedural streamlining where possible, but never at any cost to safety. In the contentious auto sector for example, there is an industry-led call for mutual recognition, which would ostensibly be some kind of reciprocity agreement under which the US and EU would accept vehicles built to either standard¹⁵.

In light of the past interaction between the EU and US, and drawing on Europe's internal market experiences, it is clear that dramatic change in legislation (which would be entailed in case of harmonisation or convergence of existing regulations) on either shore of the Atlantic is not feasible. However, meeting the rather over-ambitious timeline and the scope of negotiations is possible if the partners agree to recognise unilaterally and unconditionally the other's standards, procedures and conformity assessment tests; there is strong evidence that US and EU product safety regulation is likely to be deemed 'compatible'¹⁶. European Commission negotiators agree that although the two sides have different but similar safety requirements when it comes to lights, door locks, brakes, steering, seats, seatbelts and electric windows, many of these could be formally recognised as providing the same level of safety¹⁷. But attaining it calls for a regulatory cooperation agreement that goes further than statements of 'intentions' and outlines 'best practice objectives'.

What is needed is a 'living' (as in progressive and not a one-time commitment) agreement on regulatory cooperation with a horizontal (cross-sectoral) template for coherence and conformity assessment and a detailed monitoring mechanism, with implementation started immediately for a few selected sectors. An agreement to avoid further fragmentation will require cooperation when setting new rules, by motivating regulators to cooperate at an early stage as well as throughout the life-cycle of a regulation. The Ecorys (2009) study finds that 75 percent of total potential TTIP benefits (combined cost reductions for the EU and US by reducing divergence and partially aligning regulatory regimes) are in four sectors: motor vehicles (31 percent); chemicals, cosmetics, and pharmaceuticals (19 percent); food and beverages (14 percent) and electrical machinery, including medical devices (11 percent). Evidence also indicates that regulatory regimes and sectors that have the potential to provide the highest level of benefits and cost savings are likely to be

13. Henrik Horn, Petros C. Mavroidis and Andre Sapir (2009) 'Beyond the WTO? An anatomy of EU and US preferential trade agreements', *Blueprint 7*, Bruegel.

14. The estimated increase in the US-EU bilateral auto trade associated with the elimination of tariffs and NTBs alone accounts for more than one third of total estimated increase in bilateral trade flows associated with a successful TTIP negotiation. Source: Francois et al (2013), see footnote 2.

15. Derek Kreindler (2013) 'Ford Calls For Harmonized US-EU Vehicle Standards, Will Help Niche Vehicles', <http://www.thetruthaboutcars.com/2013/03/ford-calls-for-harmonized-us-eu-standards/>, 7 March.

16. Based on 20 case studies and 3,000 observations of risk-reducing regulatory decisions in the US and EU, it is concluded that overall risk stringency is about the same, with several of the case studies showing divergence explained by protectionism and local rent seeking. See Jonathan B. Wiener, Michael D. Rogers, James K. Hammitt and Peter H. Sand (eds) (2010) *The Reality of Precaution: Comparing Risk Regulation in the United States and Europe*, RFF Press.

17. This also calls for easier rules of origin in MRAs. Excessively constraining rules of origin have proved problematic for some of the EU's previous recognition agreements.

'What is needed is a "living" agreement on regulatory cooperation with a horizontal (cross-sectoral) template for coherence and conformity assessment and a detailed monitoring mechanism, with implementation started immediately for a few selected sectors.'

regulatory regimes in the product safety area. Having corresponding regulatory agencies in both regions undertake Transatlantic Regulatory Impact Assessments (TARIA) on significant existing and pending product safety regulations in these sectors, will further help in attaining regulatory coherence¹⁸.

As for a viable model of arriving at regulatory coherence, lessons from the EU single market suggest enshrining the need for hard legal oversight and unconditional mutual recognition. Discerning ex-ante the optimality of a regulation would be a complex and perhaps impossible task. Experience from the Australia-New Zealand FTA and the European Union Services Directive's mutual recognition exercises clearly show that unconditional mutual recognition works best in integrating markets with developed standards and consumer expectations/cultural preferences, and that recognition must precede harmonisation efforts. Implementing regulatory coherence in a meaningful way in the near future thus calls for mutual recognition and equivalence that sets clear goals to overcome the (largely known and well documented) differences; the key steps to follow are setting (1) clear equivalence principles, (2) an enforcement mechanism, and (3) transparency of processes. In particular, transparency should be its guiding principle, with strong public oversight and involvement of industry and consumers. Without such legitimacy, it would be hard to guarantee that the application of standards would converge.

Clearly, creating a usable regulatory cooperation template with horizontal elements that can be tested immediately in selected sectors, is where the transatlantic political capital needs to be invested during the next few months; generating early momentum is necessary. To meet the targeted TTIP timeline, without sacrificing the ambition of scope, the regulatory cooperation agreement needs to be 'living' and to have 'unconditional mutual recognition' as a key pillar of setting equivalence principles. The fact that there is a healthy fear of Chinese standards thwarting future market access prospects and 'full political support' across the Atlantic, makes the regulatory cooperation prospects under TTIP brighter than in the past. In the case of TTIP, past

preparedness is waiting to be translated into a clear and implementable roadmap.

IMPACT ON THIRD COUNTRY MARKETS – CONVERGENCE IN EMERGING MARKET PRODUCT STANDARDS

An important concern is whether regulatory harmonisation under the TTIP will positively influence standard setting in large emerging markets. Assuming that the TTIP (and TPP) implements deep liberalisation and achieves regulatory coherence in the near future, a consequential restructuring and/or fragmentation of global supply chains remains a real threat for the large emerging markets, in particular China and India. These economies may then react in the following ways. First, they could adopt and upgrade to these new rules, regulations and industrial standards, even at some financial and political cost, in order to reduce the business costs of serving a world market. China took this approach when it adopted and pre-committed to stricter WTO disciplines during its accession process, which helped it to become the world's most competitive economy. Indian exporters treat these costs as fixed before making the decision to export to industrialised country markets, often simultaneously meeting both the US- and EU-led standards' compliance requirements (that are much higher than domestic standards) in order to avoid rejection of consignments. Chinese and Indian experience of the past decade has shown that pragmatically accepting and adapting to new realities bears fruit.

Second, they could selectively refute the rules and production standards, based on domestic interests and the perceived market for their products in the new global economic architecture in which developing countries and their domestic markets account for almost 40 percent of global economic activity at current US\$ levels, and more than 50 percent at US\$, PPP¹⁹. By 2050, it is estimated that six of world's seven largest economies will be outside the OECD group. A more likely possibility is that emerging markets might operate on a sui generis dual regulatory regime in the medium term in key areas such as product standards and intellectual property (IP). Taking the example of the TTIP negotiations, even if the EU and US manage to harmonise and upgrade

18. Morral (2011), see footnote 9.

19. WTO (2013) *World Trade Report: Factors Shaping the Future of World Trade*, Geneva.

transatlantic regulatory regimes as a defence against export competition from the rising Asian emerging economies, especially China, it is uncertain that they will be able to entice them into adopting those rules simply out of fear of exclusion.

The compelling reason for these economies to not unilaterally upgrade to the higher standards and rules, albeit harmonised, arises from the medium-term demand structure and purchasing power of the mass consumer in these economies. In 2011 the per capita GDP of Brazil was US\$12,594, South Africa US\$8,070, China US\$5,445 and India US\$1,489, while the average per capita GDP in OECD countries was US\$41,225, with the US per capita GDP being US\$48,112²⁰. The demand pattern is thus necessarily different. Middle-class demand growth is also expected to be higher in the emerging markets in the next few decades. In such a situation, given that the effective demand from the price-sensitive large emerging middle-class is likely to remain high at home and in similar developing countries that they can easily

serve, a mass domestic upgrading to the costlier, 'higher' regulatory standards, albeit desirable, might not seem optimal to Chinese and Indian policymakers. A more likely medium-term outcome is the possibility of the creation of a dual regulatory regime in emerging markets, with the export-oriented firms in these economies adopting the higher standards, while a large part of the remaining producers servicing the domestic market continue to use the old, less rigorous standards and IP regimes; this will further fragment regulatory regimes across the world. If the emerging market domestic consumer group is significantly large (although difficult to quantify, this share is likely to remain around two-thirds of the total population in China and India for the next decade according to various estimates), the incentive for emerging economy governments to upgrade/sign up to more rigorous regulatory standards will diminish, at least until the majority of domestic consumers can afford to pay the quality-premium on the higher-standard discretionary products and services.

20. Despite the high growth rates of emerging markets, the real wage and purchasing power gap is expected to continue in the medium term, and this coupled with the forecasted exponential growth in the lower-middle classes would in turn reshape the global businesses. See Homi Kharas [2010] 'The Emerging Middle Class in Developing Countries', *Working Paper No 285*, OECD Development Centre.