BOX 4.1.1 Regulatory convergence in mega-regional trade agreements

TPP aims to promote a common regulatory approach, either through mutual recognition agreements or outright harmonization. Benefits for members and non-members tend to be higher when members choose mutual recognition and rules of origin are not restrictive.

Introduction

Trade policy makers like to think of standards as the seabed rocks that are revealed as the tide of tariffs ebbs. Not surprisingly, the European Union and the United States, with their relatively low tariffs, have decided to address the trade impact of mandatory standards—referred to formally as Technical Barriers to Trade (TBT) and, when they concern food safety and animal and plant health standards, as Sanitary and Phytosanitary (SPS) measures—in the context of the prospective Transatlantic Trade and Investment Partnership (T-TIP). To a more limited extent, the diverse group of countries that has just concluded the Transpacific Partnership (TPP) have also decided to adopt a "common regulatory approach" in certain respects. For the most part, the TPP initiates a cooperative process rather than an obligation of early implementation. Would all countries, within and outside the TPP, benefit from these developments?

Whereas the T-TIP has an ambitious agenda on regulatory convergence, parties to the TPP have settled on a dual approach. First, they have agreed on "transparent, non-discriminatory rules for developing regulations, standards and conformity assessment procedures, while preserving TPP Parties' ability to fulfill legitimate objectives." In this respect, the TPP rules broadly reflect, and in fact, directly incorporate some of the main rules already contained in the WTO, TBT, and SPS agreements. In specific sectors, the Parties have also agreed to promote a more streamlined regulatory approach across the TPP region. The sectors selected for such an approach include cosmetics, medical devices, pharmaceuticals, information and communications technology products, wine and distilled spirits, proprietary formulas for prepackaged foods and food additives, and organic agricultural products. The provisions of the agreement cover labelling requirements for wine, marketing authorizations for pharmaceuticals, medical devices and cosmetics, and encourage mutual recognition of standards for organic products as well as mutual recognition of conformity assessment of telecommunications equipment.

What does regulatory convergence as envisaged in the T-TIP and TPP imply? The voluminous research on preferential trade agreements, with its almost exclusive focus on tariffs and (sometimes) quotas, provides only limited illumination on the implications of agreements on standards. Baldwin (2000) presented a useful analytical framework for the analysis of mutual recognition agreements (MRAs), but assumed identical countries with identical costs of complying with standards. Few previous studies have empirically explored the impact of shared standards on trade (e.g., Swann et al. 1996, Moenius 2004, Shepherd 2007, Reyes 2011, and Orefice et al. 2012).

This box draws on one of the few papers to analyze the implications of preferential agreements on standards (Chen and Mattoo, 2008). It addresses the following questions pertaining to a common regulatory approach:

- How could it be implemented?
- What are its implications?
- What policy choices would ensure that it produces wider gains?

How could a common regulatory approach be implemented?

Based on earlier experience, notably in the European Union, three broad types of agreements are available to deal with technical barriers to trade. The TPP seems to place emphasis primarily on the third type of agreement listed below.

Mutual recognition of existing standards. The simplest, and potentially most powerful, is the mutual recognition of existing standards, whereby a country grants unrestricted access to its market to products that meet any participating country's standards. This was the approach taken in principle by the European Union following the Cassis de Dijon judgment of the European Court of Justice. Mutual Recognition Agreements (MRAs) are, however, not likely to be an option if there is a significant difference in the initial standards of the countries, as became evident in the context of the European Union.

Harmonization of standards. In such cases, a certain degree of harmonization is a precondition for countries to

Note: This box was prepared by Aaditya Mattoo.

BOX 4.1.1 Regulatory convergence in mega-regional trade agreements *(continued)*

allow products of other countries to access their markets. The most important example of such harmonization is the current approach of the European Union where directives from the European Commission set out essential health and safety requirements for most regulated products.

Mutual recognition of conformity assessments of requirements. In many other cases, neither mutual recognition nor harmonization of substantive standards are deemed feasible or desirable. Instead, countries may choose to mutually recognize each other's conformity assessment requirements (e.g., Country A trusts Country B to certify that the products made by Country B conform to Country A's standards). Examples of such initiatives are the intra-EU MRAs on some unharmonized industries and the EU's agreements with a number of other countries. A key element of these agreements is the rule of origin. Previous MRAs between the EU and US and the EU and Canada specify that conformity assessments done in one of the MRA countries, in which products are manufactured or through which they are imported, is accepted throughout the entire agreement region. Other agreements, such as the MRAs the EU has concluded with Australia and New Zealand, impose restrictive rules of origin that require third country products to meet the conformity assessment of each country in the region.

What are the implications of a common regulatory approach?

The implications of a common regulatory approach depend on the chosen approach. A significant upward harmonization of standards can be more detrimental to exporters in non-member countries than mutual recognition of standards that avoids restrictive rules of origin.

Harmonization of standards. Harmonization of product standards implies that firms do not need to create different products for different markets. In the resulting integrated market, firms can reap economies of scale. These benefits accrue not just to firms of participating countries but also to firms in third countries. However, the economic impact of standards harmonization also depends on the level at which the harmonized standard is set. The impact on the firms of a specific country depends on how the costs of meeting the new harmonized level of the standard compare with the benefits from economies of scale in integrated markets. If firms from some countries incur a higher cost in meeting the harmonized standard and reap fewer scale economy benefits in integrated markets than firms from other countries, then the former can suffer a decline in exports to the integrated market when harmonization raises some destination countries' standards.

Available evidence suggests that harmonization within the EU tended toward the high range of initial standards due to pressure from the EU's richer members (see Vogel 1995). For example, in the late 1990s, when the EU decided to harmonize standards for aflatoxins (a group of toxic compounds produced by certain molds), eight member states—including Italy, the Netherlands, and Spain—raised their national standards substantially. This likely caused African exports of cereals, dried fruits, and nuts to Europe to decline by as much as $670 million (Otsuki et al. 2001). Recent research using firm-level data for 42 developing countries also suggests that an increase in the distance between source and destination country standards can have an adverse effect on both firm entry into exporting and export volumes (Fernandes et al. 2015).

Mutual recognition of standards. The economic impact of an MRA depends critically on the choice of rules of origin.

- *Member countries.* An MRA of standards is in effect a downward harmonization of standards since firms are now free to meet the least costly of the initial standards: trade is stimulated not only by market integration but also by the reduced stringency of the standard.

- *Non-member countries.* The implications for imports from third countries differ dramatically with rules of origin. If the firms of non-participating countries are also entitled to access the entire region by conforming to the least costly standard, then they too reap benefits.[16] In contrast, if firms of third countries are denied the benefits of the MRA and must continue to meet the original standard in each market, they will face unchanged absolute conditions but suffer a decline in relative competitiveness—and hence a decline in exports to the region.[17]

[16]The best example of liberal rules of origin is the EU's regime for goods: thanks to the Cassis de Dijon judgment, even the products of a third country, say a Korean medical device, admitted for sale in one EU country are free to circulate in all EU countries.

[17]Restrictive rules of origin have proved problematic for some of the EU's previous recognition agreements, such as those governing professional-services standards. For example, while a Brazilian orange admitted for sale in Portugal can be sold throughout the EU, a Brazilian engineer or accountant licensed in Portugal must fulfill separate licensing requirements to work elsewhere in the EU, forcing non-European services providers to endure costly and inefficient bureaucratic procedures.

BOX 4.1.1 Regulatory convergence in mega-regional trade agreements *(continued)*

Mutual recognition of conformity assessments falls short of an MRA of standards in that it does not lead to full market integration. Nevertheless, the MRA of conformity agreements does remove duplicated testing and certification procedures and lowers the excess costs that firms face in demonstrating compliance of their goods to the standards in each country. Whether the benefits are restricted to member countries or also accrue to non-member countries again depends on the rules of origin. If firms of third countries are denied the benefits of the MRA, they must continue to fulfil conformity assessment requirements in each market and are likely to suffer a decline in competitiveness relative to firms of member countries.

Empirical analysis. In order to test the empirical validity of these propositions, Chen and Mattoo (2008) constructed a dataset that directly identified policy initiatives of different types on standards for manufacturing industries in 42 countries over the period of 1986-2001. These include all OECD countries and 14 developing countries that are the largest exporters of manufactured goods outside the OECD and account for over 80 percent of non-OECD manufactured exports. The policy measures include each harmonization directive and MRA concluded between the countries in the set. They then estimate the significance of the impacts of these measures on bilateral trade across countries and over time, controlling for other influences.

The limited available evidence broadly confirms the intuitive results spelled out above. A common regulatory approach—whether achieved through harmonization or mutual recognition—significantly increases intra-regional trade in affected industries. For trade with non-members, however, the implications of harmonization depend on existing standards in non-member countries and of mutual recognition agreements on the rules of origin.

- *Standards in non-member countries.* With harmonization, exports of excluded *developed* countries to the region also increase, but exports of excluded *developing* countries decline. These asymmetric effects may arise because developing country firms are hurt more by an increase in the stringency of standards in some markets (as a result of harmonization) and benefit less from economies of scale in integrated markets.

- *Restrictive rules of origin.* Mutual recognition with restrictive rules of origin reduces the probability of the relevant good being imported from non-members (even more than in harmonization agreements) and reduces trade volumes. In contrast, mutual recognition with permissive rules of origin boosts the likelihood of trade with non-members and enhances trade volumes (Figure 4.1.1.1).

What policy options could ensure gains from a common regulatory approach?

Multilateral rules on trade have taken a permissive approach to regional agreements on standards. While it is neither feasible nor desirable to restrict the freedom of countries to harmonize or mutually recognize their standards, more could be done to strike a better balance between the interests of integrated and excluded countries.

Even in the absence of international rules, two steps could be taken to avert any adverse consequences for third countries.

- *Favor MRAs, with permissive rules of origin.* T-TIP and TPP members could generally favor mutual recognition over harmonization, as long as regulatory objectives are met, and agree not to impose restrictive rules of origin. Just as producers in the member countries would be able to supply the entire market by fulfilling requirements of any member country, so would producers in third countries.

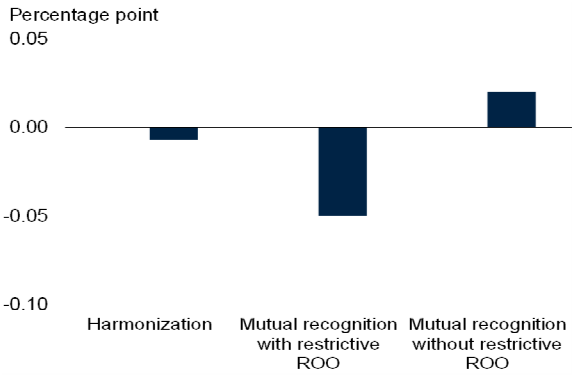
- *Balance non-trade objectives with trade losses from more restrictive standards.* Where members do consider harmonization, they could favor the less stringent of the original standards unless there is credible evidence that these would not meet regulatory objectives. This is akin to a WTO test for departures from established international standards. However, such an approach may be more feasible in the T-TIP context than in the TPP context because of much greater divergence between the standards of TPP member countries.

BOX 4.1.1 Regulatory convergence in mega-regional trade agreements (*continued*)

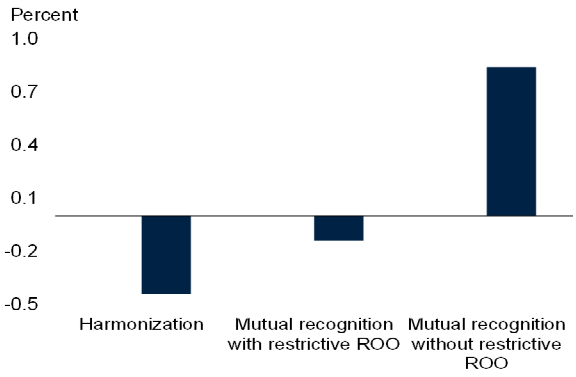
FIGURE 4.1.1.1 Implications of a common regulatory approach

Mutual recognition without restrictive rules of origin promises the greatest benefits to third countries.

A. Impact on the probability of trading with non-members



B. Impact on trade volumes with non-members



Source: Chen and Mattoo (2008).
Notes: ROO = Rules of origin.
A. Bars indicate the percentage point increase in the probability that a good is traded as a result of a common regulatory approach (Chen and Mattoo 2008).
B. Bars indicate the percent increase in average annual trade volume as a result of a common regulatory approach (Chen and Mattoo 2008).