Chapter 2

# EU Trade Agreements: What can we expect an EU–India Agreement to cover?

This chapter briefly sketches the history of EU thinking about trade agreements, showing that bilateral and regional arrangements have always had a major role. In the last decade we have seen the EU move outside its region and former colonies to focus on larger developing country and emerging markets. EU–India must be seen as part of this progression. In these agreements, and even more so in agreements with the ACP states, the EU has encouraged considerable asymmetry over the degree and timing of liberalisation. We expect to see this in goods markets with India but probably to a smaller extent than previously. EU rhetoric has also come to stress so-called deep integration – regulatory harmonisations and liberalisations and a focus on services. The latter are particularly significant for India. There are huge potential gains from deep integration for the partners to an agreement if it can be achieved, but the consequences for excluded countries are mixed: in some cases new discrimination could arise but in others excluded countries will benefit from the reforms induced by the bilateral agreement. Moreover, given the histories of the two partners, we do not actually expect a huge amount of deep integration.

## A brief history

As a successful customs union the EEC, and now the EU (as we will refer to what has now become the European Union), has always been ambivalent about the benefits of a purely multilateral approach to trade policy. Especially in recent years the EU has seen the GATT/WTO as representing, in a limited way, an extension on to the global plane of its internal 'rules-based' regime and has pronounced itself committed to this system. But simultaneously, since the 1960s the EU has constructed a spider's web of bilateral and plurilateral trade agreements, mostly with developing countries, that means that it conducts trade with the vast majority of its partners on a preferential non-MFN basis. On the other hand, the small number of partners facing MFN tariffs, including the US, Canada, Australia and Japan, are large, and China receives only rather limited preferences, so that a high share of trade still goes through the non-preferential gateway.

Historically the main preferential agreements were with the African, Caribbean and Pacific (ACP) partner countries and the countries of the Mediterranean region. The 1963 Yaoundé convention which gave preferential market access principally for industrial goods to former French colonies was transformed in 1975 into a sequence of Lomé conventions which broadened preferential access to UK ex-colonies in Africa, but not Asia. Lomé also provided for some commodity price stabilisation. The Lomé system was

replaced in 2000 by the Cotonou convention. Several of the key characteristics of the Contonou regime and also the early Euro–Med agreements were, however, incompatible with the principles of the GATT and in the post 1994 era the WTO required that these rules be respected (Christopher Stevens and Jane Kennan, 2002).

In particular, the agreements were non reciprocal and incomplete. The EU opened its markets to ACP country goods but they did not have to liberalise their imports in the same way. This violated Article XXIV of the GATT. In the case of the early generation of Euromed agreements an attempt was made to square the circle by declaring that the agreements were full free trade areas but that the market opening by the southern partner was to be postponed more or less indefinitely.

In the case of the agreements with the Mediterranean partners, the EU began to address this problem head on in the 1990s and began to sign a series of agreements with Egypt, Morocco, Tunisia et al. which were indeed to be considered full free trade agreements, even though still slightly asymmetrical in timing and having less than full agricultural coverage. For the ACP partners the problems proved harder to deal with. The WTO membership agreed in 2000 to give the non-reciprocal Cotonou agreement a waiver until 2008 after which time the EU was expected to sign agreements that were fully in conformity with the WTO rules, or else to revert to non-discriminatory arrangements, although in this case 'non-discriminatory' means arrangements which do not discriminate between similarly placed developing countries; the deep and far-reaching 'Everything But Arms' (EBA) preferences are limited to least developed countries and hence discriminate in their favour relative to other agreements.

The EU eventually decided to propose ostensibly GATT-compliant Economic Partnership Agreements to the ACP partners. The problems with these do not need rehearsing here but it is worth noting that the current generation of agreements must also abide by the General Agreement on Trade in Services (GATS) Article V if they include any services elements. This provision is broadly similar, although more precisely worded, than the provision in the GATT Article XXIV that requires 'substantially all trade' to be covered.[10]

As well as the ACP and Mediterranean countries, the EU has also extended its neighbourhood policy further into Eastern Europe including countries such as Ukraine among its partners. These are essentially political agreements rather than primarily economic or mercantile ones. At the same time, however, the EU has concluded in the last 10 years a series of agreements that can hardly be described as 'regional' trade agreements, with partners such as Mexico, Chile and South Africa. In some cases these reflected political motives. Patrick Messerlin (2001) has observed that, lacking a fully-fledged foreign policy instrument, the EU is forced to offer trade cooperation as the only form of alliance available to non-members. There were economic motives behind the FTA between EU and Mexico in 1997 but there was also clearly the diplomatic desire for Mexico not to fall totally under US influence. The, as yet stalled, EU-Mercosur talks were probably inspired by similar motives. At the same time some countries such as Chile were driven by what Baldwin (1993) has called the domino effect to seek the same market access to the EU as the most favoured partners were getting (i.e. the same as those partners who received better treatment than the normal MFN tariff provided).

Many economists regret these moves as likely to cause direct economic distortions through trade diversion, and systemic damage to the multilateral system, if only by absorbing scarce negotiating capacity.

The lack of progress in the Doha Round at first prompted the EU to hold back on FTA negotiations. But since 2006 the EU has embarked on an ambitious project to launch FTA talks with trading partners to whom it thinks market access is important for the EU itself, and the EU–India project fits into this series, even though it is reported that the initiative came from New Delhi.

## 'Global Europe'

In 2006 Peter Mandelson launched the 'Global Europe' scheme. Underlying this was the notion that the EU should consider its own offensive interests more clearly, and strive to achieve bilaterally what it could not get at the WTO. The list includes two important elements: the choice of large growing markets as partners and going beyond tariffs reduction as the way to get market access.

The EU's current strategy in trade agreements places great emphasis on 'deep integration' in the sense that it recognises that 'shallow' integration in the form of the removal of trade barriers at borders such as tariffs and quantitative restrictions is inadequate. It sees such agreements as important for Europe's 'competitiveness' (and also probably for its market access and influence on the world trading system).

The 2006 background paper on 'Global Europe' – European Comission (2006) – made it clear that the EU would be seeking to complement the WTO with bilateral trade deals with major partners.

> '**The key economic criteria for new FTA partners should be market potential** (economic size and growth) **and the level of protection against EU export interests** (tariffs and non tariff barriers).'

The text insists that the new generation of FTAs must address services and regulatory issues.

> '**New competitiveness driven FTAs would need to be comprehensive and ambitious in coverage**, aiming at the highest possible degree of trade liberalisation including far-reaching liberalisation of trade in services covering all modes of supply.'

It sets ambitious targets for the new type of FTA:

> '**Future FTAs would also need new ways of addressing non tariff barriers**. The effectiveness of competitiveness-driven FTAs will depend in part on their capacity to tackle non tariff barriers. Our ability to tackle NTBs will differ depending on our trade partners. Regulatory convergence, for example, is more likely to be achieved with neighbourhood partners than others. But these issues must be on the agenda with all our prospective partners. Mutual recognition agreements should be concluded where necessary and useful.'

The last sentence shows a degree of optimism or hubris, even, since the EU has had great

difficulty realising such agreements with the USA, and mutual recognition has been the last element of the internal market to function.

This focus on non tariff measures is known as 'deep integration' and it is to this aspect of the EU's ambitions for its agreement with India that we now turn. As we note, 'deep integration' implies major internal regulatory reform and it has been suggested that this is an aim of the Indian side in approaching the EU. The EU paper claims:

> 'Our potential partners such as India, Korea and ASEAN seek a very high level of ambition as regards investment which goes well beyond the provisions of current EU FTAs.'

The term Deep Integration was first coined by Lawrence (1996). He used it to refer to a process of removing barriers to trade and investment that are *behind the border*, notably regulatory barriers or even mere differences that make it harder to do business across borders than within jurisdictions. The term deep integration should perhaps be subdivided to distinguish the policy dimension, which we refer to as Deep Institutional Integration (DII), from the autonomous market processes that the private sector initiates to make trading easier – Deep Market Integration (DMI). We can also distinguish 'Deep Outcome Integration' (DOI), referring to the intensity of trade, as a way to highlight the fact that the aim of market and private institutions is to actually affect trade flows.

DII refers to any element of an FTA that essentially addresses the barriers to trade caused by regulations that are discriminatory or even just different and hence create problems for traders. It covers a broad range of domestic policies including the following, all of which the EU has sought to include in trade agreements:

- Services regulation
- Investment rules
- Standards and technical barriers including SPS measures (and related regulations and procedure such as testing and certification)
- Competition policy (or its absence if that leads to private barriers to entry)
- In some cases, migration rules
- Intellectual property rules
- Subsidies
- Government procurement

Several fundamental arguments have been advanced for moving beyond shallow integration to DII:

1. When tariffs are low their removal has little effect, whereas if they are high there is a risk of trade diversion; removing regulatory barriers, on the other hand, is thought to be generally trade and welfare enhancing.
2. Where there are, despite the qualifications above, potential gains from Shallow Integration, these can only materialise if NTBs are also removed.

3 Experience of the European Internal Market programme and of the recent CEEC accessions suggests that the biggest effect of regulatory alignment does not so much lie in the improved market access as in the upgrading of standards (using this term loosely) across the whole domestic economy.

4 Evidence also suggests that the productivity enhancing effects of trade occur when fine degrees of specialisation occur, allowing firms to invest in learning by doing in particular product niches or steps in the value chain, and to take part in production systems that facilitate technology transfer. This places a premium on the emergence of private and public arrangements that can reduce transaction costs, enhance certainty and predictability of behaviour, and create markets that are contestable and free of adverse externalities.

The role of an FTA in promoting this deep integration is then to remove unnecessary regulatory obstacles to trade and to create a facilitating environment in which mutually advantageous private contracts and market-led institutional arrangements can flourish.

We have elsewhere tried to schematise the links between trade policy and new types of trade flows, such as the development of 'Smithian' specialisation in niche markets and production chains. We see Smithian specialisation as occurring when firms focus on a particular niche product (e.g. screws of a certain gauge) or one step in the chain of tasks going into a final product. This often involves separating service components from manufacturing. This 'unbundling' relies on markets that are credibly open and where quality can be assured without costly post-delivery inspection. These phenomena may show up in indicators of Intra Industry Trade in goods sectors, but trade in services is harder to measure.

We see a remarkable burgeoning of DMI and consequential trade patterns (DOI) in East Asia with only limited DII. Perhaps most remarkable is the intensity of trade links between China and Taiwan in the absence of any official diplomatic links at all or even regular direct flights![11] This leads to the possible conclusion that DII is unnecessary, although this is likely to depend on the individual circumstances and on the nature of the DMI taking place. Historically, however, a close relationship between DII, DMI and DOI has been observed, for example in the context of the EU.

## EU–India FTA

The EU–India agreement has hardly finished its exploratory phase to date, with no concrete proposals having been made at all. Thus it is impossible to know what it might entail in the end. Some commentators have argued that there is thus little to discuss in a report of this kind. We would argue, however, that, on the contrary, the time to explore policy options is before they are set in stone so that the policy may be influenced. This book is part of this process. We naturally have to proceed by assumption and offer analysis conditional on those assumptions. Even if these assumptions turn out to be factually incorrect, we can still learn a great deal by considering their consequences[12]. Moreover, while a claim to be able to make precise predictions about the nature of a future EU–India FTA

would be fatuous, there are many indicators to guide our assumptions, some of which are public and some private to this research team which has devoted a good deal of time to discussing the possibilities with experts and officials.

General statements of intent are available from the Indian and EU sides in Government of India (2007) and European Commission (2007) and brief progress reports from the press in, for example, *The Hindu* 4 March 2008. (http://www.bilaterals.org/article.php3?id_article=11377), and *Bridges* 5 March 2008 (http://ictsd.net/i/news/bridgesweekly/11087).

One major source is the discussions that took place in the preparation of a joint Sussex/CUTS report to the European Commission entitled 'Qualitative analysis of a potential Free Trade Agreement between the European Union and India' in 2007 – Gasiorek et al. (2007). The report is the major source of the assumptions and discussion of them that follows. Its preparation, however, entailed detailed talks with senior public and private figures on both sides of the FTA, and so, although we have made no direct use of the content of those talks in the current paper, we have supplemented the published analysis with the background it provided. The discussions gave several of us a strong feel for current thinking and, along with our consequent analysis, a good deal of insight into the economic pressures and interests shaping an FTA. Hence, while overall, we wish to make no claims about predicting the content of the EU–India FTA, we are confident that in this publication we are analysing an appropriate and relevant set of issues.

Based on its earlier FTAs, the EU is likely to offer pretty far-reaching liberalisation of access to its non-agricultural markets in terms of border measures, but may well – and possibly to the Indians' relief – not wish to pursue liberalisation in agriculture very far. The Indians on their side seem likely to resist much liberalisation even in industrial products and we can expect to see some asymmetry in terms of both timing and of eventual tariff cuts. Given the size and growth rate of the Indian economy, however, the EU may not accept as much asymmetry as it seems happy to offer the ACP countries. Hence, in what follows we assume a full border liberalisation in goods even though we realise that this is not ultimately likely to materialise. Thus, our estimates of the effects on excluded countries are likely to be exaggerated in this dimension.

Potentially much more significant than tariff cuts is deep integration, which, as we saw above, now figures prominently in the EU's rhetoric. Here we have even less idea what will materialise but it is worth trying to think through some of the incentives and objectives that the partners might bring to the table. We briefly consider five possible components of deep integration. Modalities for dealing with them are sketched in Table I.1 on p. 27.

## Government procurement

The Indian system differs from the provisions of the WTO's plurilateral Agreement on Government Procurement (GPA) mainly with respect to national treatment, transparency, and challenge and review mechanisms. India's biggest problem with any government procurement agreement is with the 'national treatment' requirement. This results from national and state governments using public procurement to direct investment to preferred sectors. There are no price preferences in this procurement at the central government level, only purchase preferences accorded to both SMEs and public sector enterprises. However, price preferences exist for state-level procurement and for purchases made by Indian Railways. There are no provisions in India that require information on winning contracts to be made public nor that each public body, on request, provides information on the reasons for rejection and the characteristics and relative advantages of the successful bidder. India also does not have a formal bid challenge procedure as there is no independent adjudicating authority, and the concerned department generally deals with disputes itself.

Transparency in procurement with respect to tender documentation specifying criteria for awarding contract, disallowing negotiations with the lowest bidder, requiring debriefing of the unsuccessful bidder and the publication of contract awards are issues that could be negotiated in a potential EU–India RTA. Most importantly, clearly defined arbitration, formal appeal or bid challenge procedures are needed. The EU could also negotiate a centralised database with information on government contracts in India, both at the level of the central government and for state-level purchases.

## Investment

The various issues in investment are foreign direct investment (FDI) caps (mostly in services), barriers to effective implementation including transparency and state-level differences and other horizontal regulatory issues affecting investment climate.

Provisions on investment in a possible agreement could provide for transparency and setting up a system of a single window information system for investors of both the economies. Certain problems cannot perhaps be dealt with in an FTA, e.g. issues related to the ownership of land and labour policy in India. Such issues are state subjects and politically controversial. However, issues such as reservation policies for the small scale sector and positive list for India can be dealt with in an investment chapter.

## Trade facilitation

While trading conditions in India have improved, the key issues of concern in trade facilitation in India are transparency, different implementation/enforcement policies, complex procedures for calculating customs duties, delays in customs clearance and inter-state variations in internal transit procedures.

The ambit of trade facilitation is very broad and the facets that could become the subject of a possible RTA include improving port logistics, facilitating inter-state commerce, har-

monisation of standards, encouraging business mobility, setting up trade information and e-business facilities, and fostering administrative transparency and professionalism.

## Standards

There are several sectoral issues in Sanitary and Phyto-Sanitary Measures (SPS) and Technical Barriers to Trade (TBT) related to India but there is a general perception by the EU that the Indian approach lacks transparency and that standards issues (especially SPS), become politicised and that decisions are not always taken on the basis of clear scientific evidence. Further, there have been allegations even from within India that the Indian government has been using standards as non-tariff barriers especially after the abolition of quantitative restrictions in 2001. There are also horizontal factors such as the bureaucracy, corruption and the slow process of decision-making that affect the standards regime in India. The Bureau of Indian Standards (BIS) often appears to be slow and bureaucratic. Some of the sector-specific problems are in autos, bottled/mineral water, primary products, import of plants and animal products, etc. There are problems related to mandatory certification and maximum retail pricing.

There will always be differences in ways of dealing with sectoral and horizontal issues. There should, however, be overall transparency in the process of standards setting, and the scientific basis therein. There should also be transparency/clarity over the existence of standards and the lack of, for example, a single enquiry point. Both sides have argued for forms of mutual recognition but see this differently. The EU finds mutual recognition of certain standards acceptable, but does not favour mutual recognition of conformity of assessment procedures. The Indian side, on the other hand, would like to have mutual recognition of standards and technical regulations coupled with an agreement with regard to conformity assessment. There are at least two ways to conformity assessment. First, two economies could make use of existing labs, certification and inspection bodies in each others' countries. Reportedly, such a process has already been initiated by the EC in India. Second, there could be accreditation of relevant bodies – a more cost effective procedure.

## Services

The services sector is extremely important for the two trading partners and from the perspective of a potential RTA, a substantial coverage of services as in GATS Article V could help deliver improved access to mutual markets and more rapid liberalisation of India's services than can be accomplished unilaterally. The challenge for the RTA is not only to accelerate liberalisation in India's services sectors (which is continuing albeit slowly at times and at a varied pace across sub-sectors), but also to facilitate the implementation of a range of complementary reforms designed to improve the quality of regulation[13].

We explore the possible effects of the EU–India FTA on services in more detail in Part III .

## The prospects for agreements on elements of deep integration

The potential agenda on deep integration is huge and important. If we are realistic about

the EU's and India's track records in pursuing deep integration we have to admit that the prospects of far-reaching reform are quite small. Prior to the current administration, the Indians have tended to be very cautious about regulatory reform and conditions for it to occur are certainly not improving. On the EU side, despite all the talk, very little progress has actually been made towards deep FTAs so far. The EU has surveyed the deep provisions in its own FTAs and found them wanting (Bourgeois, J., Dawar, K. and Evenett, S., 2007). Strong agreements have been signed with the EU's neighbours and with accession candidates but with hardly any other partner.

> 'The current geography of EU FTAs mainly covers our neighbourhood and development objectives well, but our main trade interests less well. The content of these agreements also remains limited: they may deliver on market access commitments but even an advanced agreement like the EU–Chile FTA does not present major progress in areas such as IPR, subsidies, SPS or TBT.'[14]

How does deep integration affect excluded countries, especially in the present context, poorer ones such as the ACP States? If other countries continue to face regulatory barriers which have been selectively removed by the EU for India, trade diversion can occur. A paper by Chen and Mattoo[15] has argued that regional standards harmonisation can harm excluded countries' export prospects in this way. However, there is also a good chance that much deep integration will have fewer adverse effects on excluded countries than tariff reduction.

Often it is possible to make concessions only through reforms that affect all parties on an *erga omnes* basis. Indeed, some forms of market opening of this kind have to be MFN, so a deep FTA between the EU and India will have to open the Indian market to excluded countries. At one extreme, if India agreed to enforce competition policy against barriers to entry for imported products, it could not discriminate in favour of the EU. Moreover, since there has been so little movement in this direction in the past, a deep EU–India FTA could set positive precedents for future Indian liberalisations. In other cases, discrimination is possible, as, for example, if licences to establish or bring in key personnel are granted more liberally to partners than to non-partners. And given the importance of first-mover advantages in many service sectors, an agreement of this kind could significantly favour EU over other suppliers. However, these sectors are not of particular interest to poorer countries and the EU–India agreement seems unlikely to go in for too much explicit hard discrimination against others.

Bearing all this in mind in thinking about the *actual* impact on excluded countries of the prospective EU–India FTA, our tentative hypothesis is that it would be rare that other partners would lose significant market access through leapfrogging by the EU. However, especially among the set of countries which has been led to depend very heavily on the EU – e.g. the ACP states – excluded countries clearly need to be vigilant and might reasonably expect the EU to keep them informed and to offer them advances similar to those offered to India.

**Table I.1. Ways in which Regulatory Barriers could be dealt with in an RTA[16]**

| | Preferential | MFN | National Treatment | Mutual Recognition | Harmonisation |
|---|---|---|---|---|---|
| **Standards: (SPS, TBT)** | MR with some partners. | Agreement that both parties will adopt ISO etc. norms. | Generally required by GATT Art III anyway. | For conformity assessment likely to be preferential. | EU presses for this, but limited value without CA MR. |
| **Investment** | Discrimination possible in industry so long as trade not affected. But de facto hard to apply if third country can buy into the industry. | GATS requirement unless Art V satisfied. | Agree to apply same rules to foreign firms as home. | Most likely to apply for services. | |
| **IPR** | | Must be MFN under TRIPS. Rare case where you have to extend. | Generally required under TRIPS. | Unlikely. | EU & US call for this in some areas. |
| **Trade defence** | EEA removes AD. | Unusual. | n/a | | |
| **Services** | Must satisfy GATS V.<br><br>Preferences hard to apply if third country can buy into firms. | Quite likely; GATS obliges MFN for all sectors even if not scheduled unless exemption taken out in 1994. | Unlike goods only required for scheduled sectors; Preferences possible, but subject to Art V. | Home country regulation.<br><br>Possible, but GATS has rules. | Possible. |
| **Government procurement** | Can be done. | GP not covered by GATT, only GPA. | Possible. | Would apply to approved lists. | |
| **Competition Policy** | Unlikely but could apply to takeover rules. | Most likely – would affect all partners. | Possible to apply to some or all. | Would imply MR of decisions. | Possible. |
| **State aids rules** | Hard to do except for CVDs. | State aid controls would affect all partners. | | | EU seeks to secure: bonus – removal of CVD rules. |

## Notes

10 The EU argues that PTAs which cover 90 per cent of mutual trade are compliant with the GATT Article XXIV requirement that they cover 'substantially all trade', and moreover that this can be translated into 100 per cent coverage in one direction and 80 per cent in the other. None of this has ever been tested via a dispute settlement or ruled upon by the General Council or Committee on Regional Trading Arrangements.

11 X.Li (2008) suggests that RTAs may have played a larger role in promoting East Asian trade (DOI) than is usually supposed.

12 The fact that you do not know exactly what the opposition will do in a football match does not invalidate the process of exploring their and your strengths and weaknesses, developing a strategy and making conditional plans.

13 See World Bank (2004) for more on this.

14 European Commission, (2006).

15 Chen, Maggie Xiaoyang, and Mattoo, Aaditya 2004, 'Regionalism in Standards: Good or Bad for Trade?' Policy Research Working Paper No. 345.

16 See also Hoekman, B. and Winters, L. Alan. (2007)

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