Potential Impacts of a EU-US Free Trade Agreement on the Swiss Economy and External Economic Relations

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Colophon

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Summary

Background and mandate: In the wake of the recent financial crisis, in 2013 the European Union and the United States launched a joint, ambitious effort to boost their respective economies through a comprehensive trade and investment agreement. Known as the Transatlantic Trade and Investment Partnership Agreement (T-TIP), the negotiations process that has followed, and that indeed is still on going, is supposed to bring about tariff-free trade in goods, reduction of non-tariff barriers for goods and services, and liberalization of public procurement markets.

While tariff reductions are relatively straightforward, the main ambition with T-TIP actually relates to greater coherence and convergence of regulatory standards. The goal of regulatory convergence (and better cross-recognition of standards) is the most innovative and ambitious aspect of this venture. This goal requires enhanced cooperation in rule making, and so is not as straightforward as tariff elimination. Indeed, there is growing recognition that a successful T-TIP agreement would combine immediate liberalization in some areas with institutional mechanisms set up to allow progressive, long run liberalization in others. Such an institutional mechanism might have strong implications for a broader set of countries that are also grappling with regulatory barriers to trade and investment.
The planned agreement actually amounts to a set of trade agreements. While formally bilateral, it entails the 50 States in the US and 28 Members of the EU. It needs to take into account particularities of a great number of different partners and thus on substance amounts to a new type of mini-lateral agreement. Given its economic and political weight, as well as its mini-lateral character, the T-TIP is of substantial importance for the rest of the world, including Switzerland, which is not a member of the EU and operating her own external economic relations.

Because the T-TIP has potentially strong effects on third countries such as Switzerland, the present report integrates the findings from two studies mandated by the Swiss State Secretariat for Economic Affairs in September 2013 and undertaken by the World Trade Institute, University of Bern. The report summarized here presents the findings of those studies. The mandate for those studies called for analysis of the impact of T-TIP on Switzerland, and the implications of a parallel agreement between EFTA and the US. The focus of the integrated report is therefore on the implications of T-TIP for Switzerland. Except for the option of an EFTA - US Free Trade Agreement, it does not entail the examination of further policy options.

Methodological Approach: By its nature, a potential T-TIP agreement would imply immediate liberalization of some measures and progressive changes to regulatory mechanisms to address others. This means the prospects and shape of a likely T-TIP agreement, at this point in time, are difficult to assess. It furthermore means the Swiss place in such a framework is also difficult to assess. For this reason, this study takes a multi-pronged and multi-disciplinary approach. This methods used here include the following:

- Economic modelling of T-TIP scenarios with a computational model of the world economy (known as a CGE model), backstopped with market focused (partial equilibrium) modelling.
- Statistical analysis of procurement markets, FDI, and services trade
- Comparative analysis of the legal texts of existing agreements that might serve as templates for the T-TIP in critical areas

At the same time, we also examine alternative scenarios in terms of the outcome of T-TIP as it relates to Switzerland. These scenarios are made explicit in the scenario analysis under the CGE-based economic modelling. They are also implicit in the comparative legal analysis, where we need to keep in mind that the shape of the legal texts defining the agreement, and how these relate to Switzerland, also hinge on likely outcomes as spelled out in our scenarios.

The scenarios covered in this report cover both tariffs and non-tariff barriers (NTBs). It should be stressed that in contrast to reducing tariffs, the removal of NTBs is not as straightforward. There are many different reasons and sources for NTBs. Some are unintentional barriers while others reflect deliberate public policy. As such, for many NTBs, removing them is not possible because, for example, they require constitutional changes, unrealistic legislative changes, or unrealistic technical changes. Removing NTBs may also be difficult politically, for example because there is a lack of sufficient economic benefit to support the effort; because the set of regulations is too broad; or because consumer preferences or language preclude a change. In recognition of these difficulties, we follow recent studies by focusing on the set of possible NTB reductions (known as "actionable" NTBs) given that many will remain in place. Of those NTBs that can feasibly be reduced, we focus on different levels of ambition for NTB reduction.

Our formal scenarios are summarized in the table below. The scenarios range from a relatively shallow tariffs only agreement between the EU and US at one extreme to a deep agreement covering tariffs and NTBs and including a parallel EFTA-US agreement at the other. Between these we consider different coverage of the core T-TIP agreement, and different options for a parallel EFTA-US agreement. These scenarios do not mean that we believe one of these is particularly likely of preferred. Rather we simply need to use such a mapping to frame the questions, both empirical and legal, covered in the report.

1. *Tariffs only agreement*: Under this set of scenarios, we assume full elimination of industrial tariffs, and partial liberalization (50% reduction) of tariff barriers for agricultural products. Here we also examine what happens if there is an EFTA-US agreement in parallel with the core EU-US agreement on tariffs.

2. *Tariffs and modest NTB liberalization* (shallow NTB agreement): Under this scenario, we assume that 20 percent of actionable NTBs (those that can be reduced) actually are. This means a 20 percent reduction in trade costs associated with actionable NTBs. We also assume that these NTB reductions are discriminatory. Hence US liberalization would only benefit EU firms, and vice-versa. Again, we also examine what happens if there is an EFTA-US agreement in parallel with the core EU-US agreement on tariffs and NTBs.

3. *Tariffs and ambitious NTB liberalization* (a deep NTB agreement): Under this scenario, we assume that 50 percent of actionable NTBs (those that can be reduced) actually are. We also assume that not all of these NTB reductions are discriminatory. This reflects what are called "regulatory spillovers." Basically, with a deep agreement on NTBs, we assume that third countries also benefit to a limited extent, in terms of some improvement in market access. The logic is that, with deep regulatory reform, at least some of the changes are likely to affect all players, and not just the EU and US firms. For example, where the US recognizes EU standards, firms in other countries might then find it easier to meet US standards themselves. In addition, in the Swiss case, through the MRA CH-EU, Switzerland is already streamlining/harmonizing its technical regulations with the EU's. Therefore Switzerland

might be expected to actually benefit more from such any realized MFN spillovers than other third countries.   Again, we also examine what happens if there is an EFTA-US agreement in parallel with the core EU-US agreement on tariffs and NTBs.

Possible Scenarios for T-TIP and Switzerland

	1. Tariffs only		2. Tariffs and Modest NTB agreement (A shallow NTB agreement)			3. Tariffs and Ambitious NTBs (A deep NTB agreement)		
	1.1 EU-US Agree-ment	1.2 EU-US and EFTA-US Agree-ment	2.1 EU-US Agree-ment	2.2 EU-US and EU-EFTA Agree-ment	2.3 EU-US and EU-EFTA Agree-ment (not tariffs)	3.1 EU-US Agree-ment	3.2 EU-US and EU-EFTA Agree-ment	3.3 EU-US and EU-EFTA Agree-ment (not tariffs)
EU-US agreement on tariffs	X	X	X	X	X	X	X	X
EFTA-US agreement on tariffs		X		X			X	
EU-US modest agreement on NTBs			X	X	X			
EFTA-US modest agreement NTBs				X	X			
EU-US deep agreement on NTBs						X	X	X
EFTA-US deep agreement NTBs							X	X
3rd country Spillovers from NTB reductions						X	X	X

<u>Findings from Economic Modelling</u>:

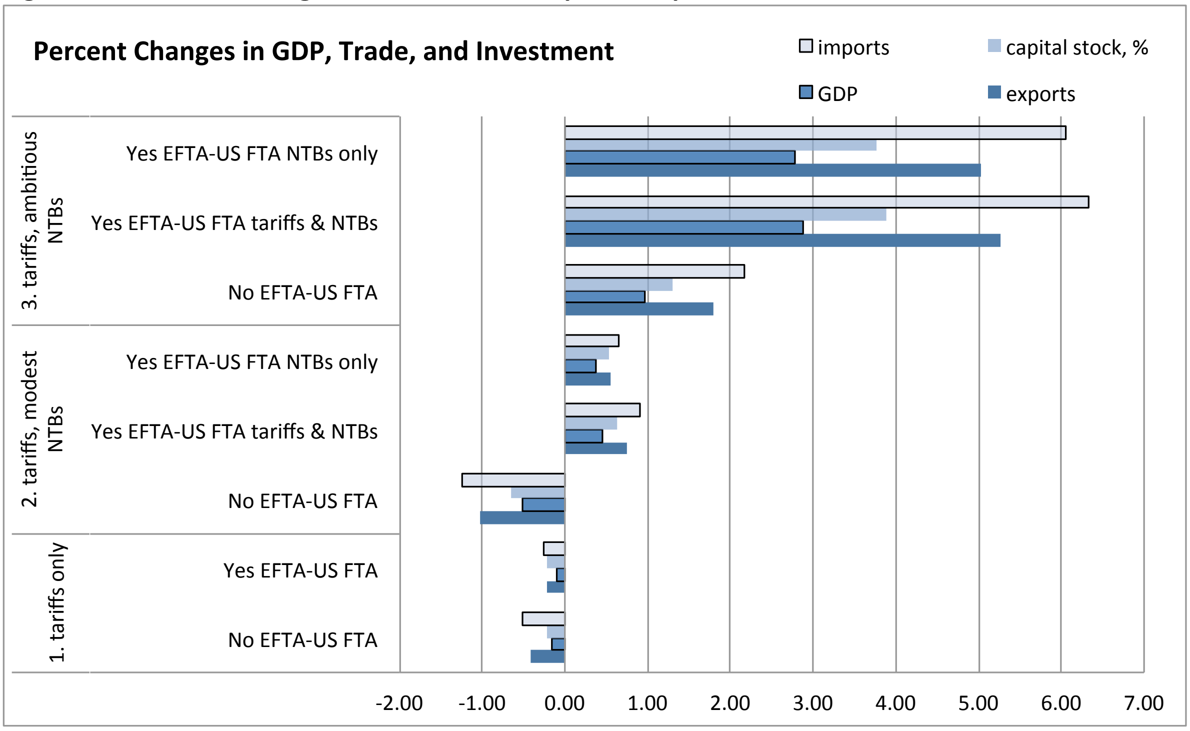
- A discriminatory and shallow EU-US agreement may be damaging to the Swiss economy.
- A deep agreement featuring convergence in EU-US regulatory standards should benefit the Swiss economy.
- Active Swiss involvement would benefit the Swiss economy (through flanking EFTA-US agreements).
- Different sectors will be affected differently

Our assessment of the possible impact of a T-TIP agreement on Swiss production and exports involves a set of computer modelling experiments, based on the scenario table above and ranging from a passive Swiss response to T-TIP, up through negotiating a parallel agreement with the US.

Macroeconomic estimates are summarized in the Figure S-1 below, where in progression from Scenario 1.1 to Scenario 3.3, we move from Switzerland outside a tariff only agreement to a parallel EFTA-US agreement covering both tariffs and NTBs (including procurement markets). We should stress again (as covered in the report) that the deeper integration scenarios include regulatory spillovers. These therefore help to offset the trade diversion impact of T-TIP in the deep agreement scenario, at a macroeconomic level. In general shallow and preferential agreements that exclude Swiss participation harm the Swiss economy, with GDP changes ranging from -.17 (Scenario 1.1) to -.0.51 percent (Scenario 2.1). If there is a parallel set of EFTA-US agreements, the effects then range from basically nothing noticeable (-0.09 percent in Scenario 1.2) to +0.46 percent (Scenario 2.2 with a parallel EFTA-US agreement on tariffs and NTBs). When we move to deeper agreements (Scenarios 3) spillovers mean that Switzerland benefits even as a passive agent. As discussed in the body of the main report, spillover effects are quite important in driving the overall impact on Switzerland under the scenarios assuming a deep agreement. Here we estimate a GDP gain of roughly 0.96 percent from the T-TIP agreement itself, as Swiss firms benefit from greater regulatory coherence between the EU and US markets. With a deep core T-TIP and a flanking set of EFTA-US agreements, Swiss gains are as much as 2.87 percent of GDP (Scenario 3.2). Under this scenario we also see growth in investment in Switzerland (1.43 percent) and greater trade (5.27 growth in exports). In all cases, a parallel set of agreements involving EFTA more than compensate for investment diversion (falling investment) when Switzerland is an outside agent.

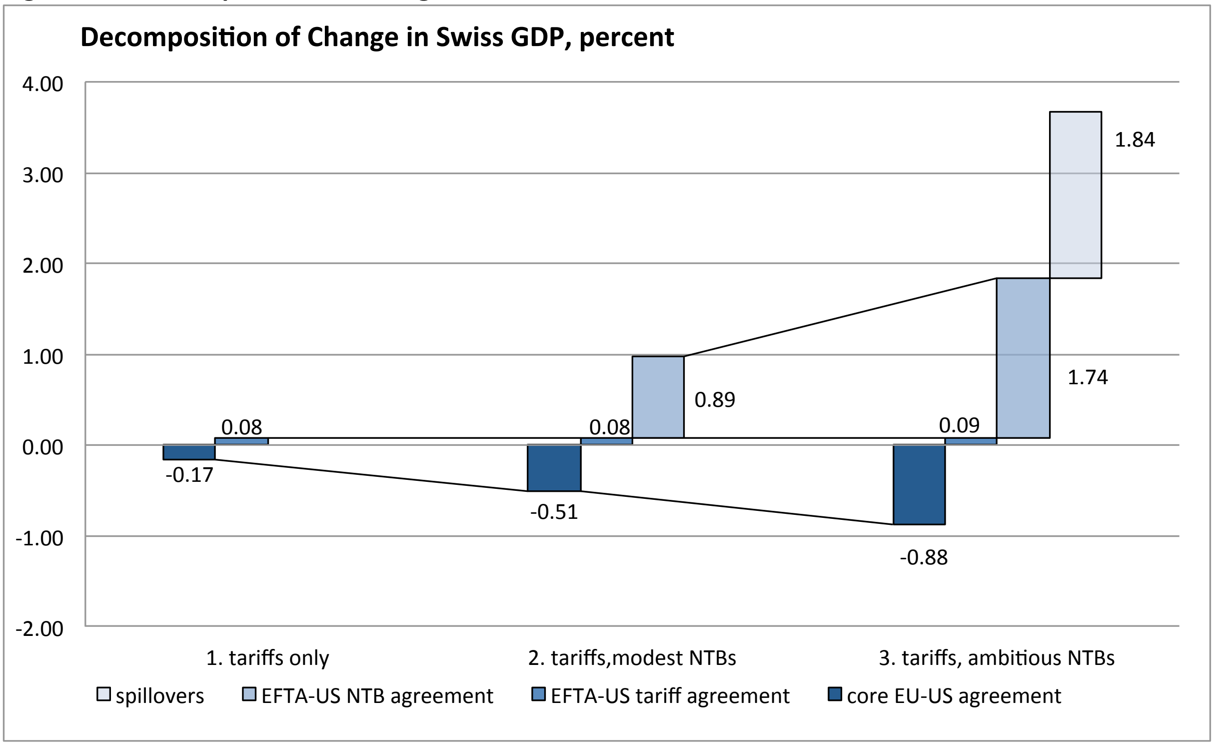
Based on the estimates in the main report and summarized in the figures below, the form that mutual recognition of standards might take under T-TIP is very important. With some NTB harmonization (and so effectively a reduction for third countries) between the EU and US, benefits can be expected for third countries (like Switzerland). This is one possible negotiation path. Alternatively if the solution for negotiated recognition of differences in regulatory systems is to establish some sort of deliberately discriminatory country of origin based mutual recognition mechanism for conformity assessments under divergent national regulations, third country exporters (including Switzerland) would then be worse off. We have illustrated the importance of spillovers in Figure S-2, where we have broken down estimated changes in Swiss GDP into the drivers of those changes. What we find is that regulatory convergence spillovers are central to the overall estimated impact of TTIP on Switzerland. Without this MFN element added to what is otherwise a preferential exercise, the impact on Switzerland is quite different. This finding illustrates the importance both of the core EU-US agreement (potentially quite negative), the benefits of a flanking agreement such as an EFTA-US agreement (potentially quite positive) and also the further benefits of regulatory streamlining (substantial gains from spillovers) as long as the EU and US do not pursue a deliberately discriminatory solution to these challenges.

Figure S-1: Percent Changes in Swiss Trade, Imports, Capital Stock, and GDP



Source: CGE model estimates in this study.

Figure S-2: Decomposition of changes in GDP

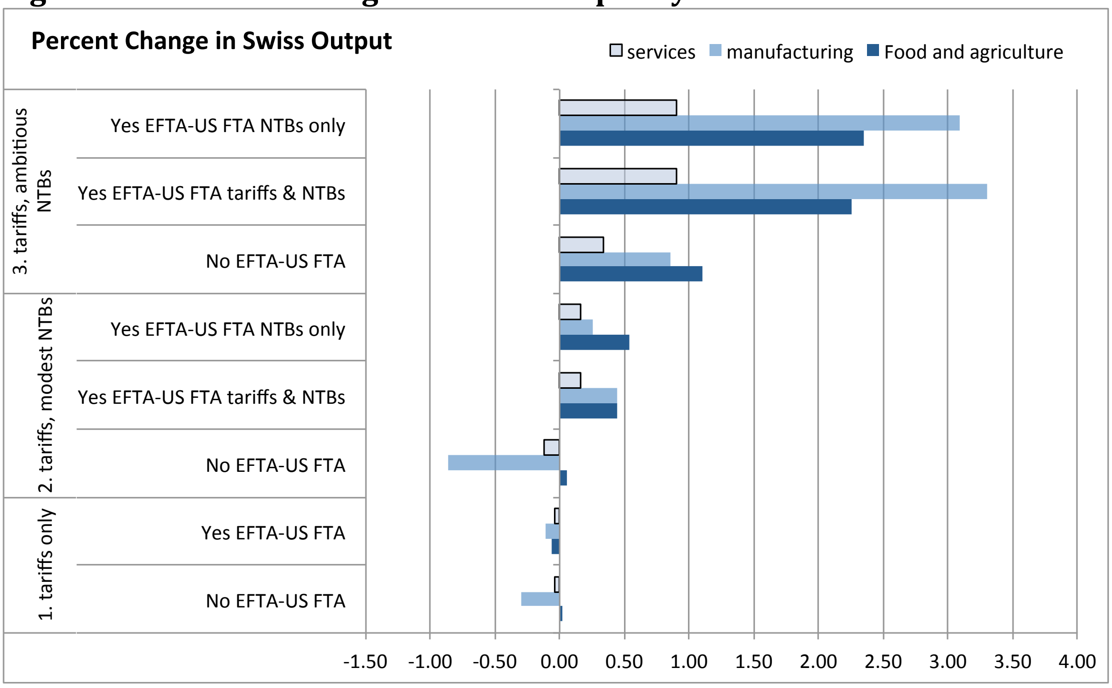


Source: CGE model estimates in this study.

It must be stressed that estimated spillovers are highly speculative, even more so than standard trade policy modelling. One reason is that, unlike old-style FTAs, the TTIP negotiations are different in that they offer scope for reducing unintended barriers in a way that might lead to standards adoption by third countries. The extent to which third countries then adopt a standard adopted by both the US and the EU, accounting together for a major share of world production and trade, is not something anticipated with old-style FTAs. Neither is the potential for effectively simplifying conditions for third country access to the US and EU markets. As such, apart from the single market process in the EU itself, we have little basis for gauging how large these effects might potentially be. It is clear from the analysis in the report, however, that the issue is central to the likely economic impact.

Sector effects vary across sectors, and depend heavily on the depth and width of the agreement, and whether there is a parallel EFTA-US initiative. This is illustrated in Figure S-3 below. Because both the US and the EU are highly protective of processed foods (including meat and dairy, but other foods as well) the Swiss processed foods industry is actually a potential net winner from T-TIP. Furthermore, turning to manufacturing, a combination of a parallel EFTA-US initiative together with spillover benefits from regulatory convergence could be quite beneficial to Swiss industry. However, like the overall impact on Swiss GDP, the impact on manufacturing again depends strongly on whether the EU-US agreement is purely bilateral, the depth of such an agreement, and whether or not it proves strictly discriminatory. These issues are examined in more detail in the report. Finally, in services fewer changes in market access policies are anticipated, and as such the effects are smaller than for goods. This is also examined in the report.

Figure S-3: Percent Changes in Swiss Output by sectors



Source: CGE model estimates in this study.

Findings from Legal Analysis:

- Past agreements suggest that progress in services is likely to be modest.
- A deep EU-US agreement may mean major changes in the competitiveness of Swiss firms in the EU market.
- The emphasis on standards and mutual recognition for service providers will place Swiss competitors under greater pressure mainly in the US while relations with the EU may be accommodated with the existing mutual recognition agreement (MRA).

Assessing the potential implications of services trade liberalization and mutual recognition in services related activities under a future T-TIP is difficult at this stage: as main parameters are not yet available, it does not go beyond guessing. A comparison of commitments in the EU Korean and the US Korean Agreement with US and EU GATS levels shows that levels of additional commitments made in services have generally been modest. At the same time, the actual pattern of trade in services in Europe, and the impact of FDI related regulatory barriers, points to scope for potentially large changes in the competitive structure of European service markets vis-à-vis US firms. These changes are likely to be adverse for Swiss services firms, who will lose competitive advantage relative to US firms in European markets.

The comparative findings on preferential market access in services induce a note of caution. Governments have been reluctant to grant extensive liberalization in preferential agreements going much beyond the levels of GATS. It begs the question whether this will be fundamentally different in EU-US relations. There are fundamental objections on the part of the US to include financial services, and reservations were made on the part of the EU to include cultural services. At the same time, there is a considerable potential that US companies will achieve competitive advantages in EU markets due to the fact that Switzerland still does not have a PTA in Services with the EU. We therefore conclude that independently of T-TIP, Switzerland's competitive position in services vis-à-vis the US in the European Market hinges on free movement and services trade with the EU. A T-TIP agreement will in any case provide a competitive advantage vis-à-vis Switzerland for the EU in the US market.

The strong emphasis on non-tariff barriers in T-TIP, addressing behind the border issues, indicates that better standards recognition and acceptance of testing and admission will be an important feature facilitating transatlantic trade. The same holds true, particularly for the US market, for cross-recognition of the diplomas and certificates of service suppliers. While Switzerland can build upon both its MRA and its agreement on the free movement of persons with the EU, a similar instrument in trade relations with the US has been missing.

Procurement markets:

- Swiss suppliers are major players in EU procurement, and so T-TIP may erode their position in these markets, especially in services.
- The WTO may offer an opportunity to rebalance access conditions for procurement.

Our analysis on the likely impact of potential government procurement liberalization in the TTIP on Swiss suppliers and service providers includes both qualitative and quantitative assessments. Our qualitative analysis discusses the potential areas and issues of interest that are likely to form a part of the negotiations. These include inter alia liberalization of sub-federal procurement including parity in contestable thresholds, and coverage of procurement undertaken by utilities.
Our quantitative assessment identifies sectors important from a market access perspective

for EU and US suppliers and service providers in each other's procurement markets. These include other commercial services, transport services, chemicals-rubber-plastics, food-beverages-tobacco, transport equipment, electronic equipment, machinery and equipment, motor vehicles and parts and metal products. Our analysis suggests that Swiss suppliers and service providers are also significant players in these sectors in both markets. Successful coverage of these sectors in the TTIP would therefore enhance market access on either side that may have adverse implications for Switzerland. However, any adverse effects for Swiss suppliers and service providers are more likely in the services sectors, which are not only more differentiated but where public demand as a share of output is comparatively larger in both the EU and the US than is the case for goods.
We also consider procurement liberalization in the recently negotiated Canada-EU CETA as a benchmark in our analysis and conclude that reciprocal liberalization of sub-federal procurement in the TTIP may lead to greater challenges for Swiss suppliers and service providers in EU and US markets.

<u>Foreign investment and intellectual property</u>:

- Swiss firms should benefit from IPR aspects of T-TIP.
- Swiss service MNEs may lose competitive position in Europe under T-TIP, based on current trade and investment patterns.
- Swiss MNEs may benefit substantially in the US market, through spillovers and through Swiss subsidiaries in the EU.

Through the WTO, Switzerland is entitled to Most-Favoured Nation (MFN) treatment independently of existing levels of protection in the TRIPS Agreement. Any improvement achieved under T-TIP in the field of IPRs will be subject to Article 4 of the TRIPS Agreement. This means that if levels of protection and enforcement increase in EU-US relations, Switzerland and other Members of the WTO are entitled to obtain treatment no less favourable. This is an important source for spillovers that would enhance Swiss interests. Overall, Switzerland is therefore likely to benefit from spillover effects of advancements of IPR protection in the T-TIP.

Our analysis of FDI data (econometric modelling) suggests that the incentive for Swiss MNEs to relocate operations to the European market needs to be taken into consideration. With a head office in the EU, Swiss companies could get unrestricted access to the European market, the full advantages of market access of the T-TIP in the US market, and still have market access to the Swiss market secured through the close trade relations between the EU and Switzerland. Especially when the procedural benefits in Investor-State arbitration in the T-TIP turn out to be substantial, such incentives may be further reinforced. As in the case of direct services trade, we find scope for erosion on the competitive position of Swiss firms operating in the EU following from reduction in barriers that impact on the foreign presence of firms in Europe.