

## **The UK Trade Policy Observatory (UKTPO) University of Sussex – Written evidence (PBS0021)**

This evidence is in answer to question 9 in the Terms of Reference for the House of Lords EU Services Sub-Committee inquiry into the future UK-EU relationship on professional and business services.

### **About UKTPO**

The UK Trade Policy Observatory (UKTPO), a partnership between the University of Sussex and Chatham House, is an independent expert group that initiates, comments on and analyses trade policy proposals for the UK and trains British policy-makers, negotiators and other interested parties through tailored training packages.

The UKTPO is committed to engaging with a wide variety of stakeholders to ensure that the UK's international trading environment is reconstructed in a manner that benefits all in Britain and is fair to Britain, the EU and the world. The University of Sussex has the largest collection of academic expertise on the world trading system in the UK, with specialists on trade policy, trade law and trade politics and European law and economy. The team includes experts in economics, international relations and law.

### **What lessons, if any, can be learnt from the EU's existing trade agreements with other third countries including services, or negotiations on trade in services?**

1. As discussed in Morita-Jaeger and Winters (2018), trade agreements tend to improve market access commitments beyond those bound in the WTO's General Agreement on Trade in Services (GATS), but they do not typically lead to much actual liberalisation of services trade. Rather, the greatest virtue of FTAs is that they lock in policies which are closer to those already applied. However, because regulators often prefer to reserve some policy space should they wish to change their policies in the future, FTAs often fail to lock in commitments that reflect the actual applied policies in partner countries. The benefits to businesses therefore arise mainly from a reduction in the uncertainty around the market conditions that domestic businesses could face when exporting services to the partner country.
2. One of the reasons why liberalising services trade is so difficult is because services trade is all about regulations. Unlike goods, which can be inspected before entry into a country, consumers must purchase a service before they know its quality, and key features of that quality arise from conditions in the country of production over which the importing country has no jurisdiction. To avert market failures associated with this asymmetric information, services sectors are highly dependent on domestic regulatory authorities.
3. For this reason, and in contrast to tariffs and quotas in goods trade where decisions can be made centrally at the relevant trade department,

services negotiations require many actors to be involved in the domestic decision-making. In the case of the EU this is made even more complicated by the fact that many of the relevant regulations 'belong' to national governments rather than EU bodies, and within national governments to pseudo-independent regulatory bodies. This dispersion of responsibility across various national and sub-national regulatory bodies makes services negotiations with the EU very complex.

4. Further, by their very nature, regulatory authorities tend to be conservative and risk averse; their job does not include increasing international trade. Thus, they tend to have strong preferences for retaining existing applied trade regimes, which they understand. This means that actual change to applied policies in services sectors is rare.
5. These observations apply to the extent of liberalisation, but are much more important for the harmonisation of regulation between trading partners. Even if countries' regulations are of equal restrictiveness, differences between them inhibit international trade. Nordas and Rouzet (2017) write, for example, "*Bilateral differences in regulation are also found to curtail services trade over and above the impact of the trade liberalisation level. At the margin, regulatory differences have a larger effect on trade flows the [lower the average level of trade restrictiveness].*"
6. Finally, the regulations that inhibit services trade go beyond what is typically dealt with effectively in a standard trade agreement (market access and national treatment commitments), to areas such as transparency of qualification requirements and procedures, technical standards and licensing requirements; measures which restrict competition; and domestic regulations that are more burdensome than necessary (although considered as legitimate in terms of market failures). These have to also be tackled to achieve substantial services liberalisation, and while modern trade agreements often touch on some of these issues, they rarely achieve much of substance.
7. It is the triumph of the European Single Market that, while far from complete, it has taken far more steps towards reducing services trade barriers between countries, and harmonising (or mutually recognising) the remainder, than any other international agreement. But, of course, that illustrates exactly the trade-off between sovereignty and efficiency that no 'regular' trade agreement can come close to replicating.

### **Most Favoured Nation clauses in EU trade agreements**

8. The above outlines why it is difficult, in general, to achieve actual liberalisation of services trade in trade agreements. In the context of a UK-EU trade agreement, a more technical detail, the so-called Most Favoured Nation (MFN) clause contained in several of the EU's existing

trade agreements could make it even more difficult.

9. MFN clauses included in trade agreements act as safeguards to ensure that preferences granted in one trade agreement are not eroded by one of the parties subsequently granting better treatment to another country in a future trade agreement. In such cases, the MFN clauses stipulate that any further preferences granted in a future trade agreement must also be extended to the parties of the original agreement. That is, they ensure that the parties of the original agreement do not lose out if one of the parties were to give better access to another country in the future.
10. As outlined in Magntorn (2018), many of the EU's agreements have some form of MFN clause, but the type of MFN clause discussed above is only seen in the EU's more recent trade agreements, which have comprehensive chapters on services trade. The EU's agreements with Canada, South Korea and Japan all contain such MFN clauses, as do the EU's recently signed FTA with Vietnam and the Economic Partnership Agreement (EPA) with CARIFORUM.
11. Table 1 summarises the scope of the relevant MFN clauses in these agreements. Subject to a number of sectoral exceptions, all agreements apart from EU-Vietnam have MFN clauses covering cross-border trade in services (modes 1 and 2) and in all of the listed agreements MFN clauses apply to the right of establishment (mode 3). EU-Canada and EU-Japan further extend the MFN clauses to the chapters on temporary entry and stay of natural persons (mode 4). The CARIFORUM agreement also includes a general MFN clause applying to custom duties on goods, and EU-Japan, EU-Mexico and EU-South Korea all apply MFN to the limited sections of goods trade that they do not completely liberalise.

**Table 1: Coverage of MFN clauses**

Partner	Mode 1+2	Mode 3	Mode 4	Goods	Other
Canada	Y Article 9.5	Y Article 8.7	Article 10.6 incorporates MFN from Art. 9.5	N	
South Korea	Y Article 7.8	Y Article 7.14	N	(see other)	Article 5 in Annex 2-C provides MFN treatment with respect to internal taxes and emission regulations on motor vehicles and parts.
CARIFORUM	Y Article 79	Y Article 70	N	Y Article 19	The MFN clauses are asymmetric, applying less stringently to the CARIFORUM parties
Japan	Y Article 8.17	Y Article 8.9	Article 8.24 incorporates MFN from Art. 8.17 and 8.9	(see other)	Article 2.8.4 applies to certain goods where the tariff reduction is incomplete/phased in. MFN may apply if the parties grant quicker or larger tariff reductions to a third party.
Vietnam*	N	Y Article 8.6	N	(see other)	Article 2.11.3 states that any duties, taxes, or other charges imposed on the exportation of goods to the other party can be reviewed if better treatment is granted to another third country pursuant to a preferential trade agreement.

\* This agreement has been signed but is not yet in force.

All of the listed agreements cover modes 1 and 2 in a combined chapter on Cross-Border Services Trade.

**Mode 1:** Cross-border supply; where services are supplied from one country to another without either consumer or supplier moving physical location.

**Mode 2:** Consumption by a resident abroad; e.g. tourism, or international students.

**Mode 3:** Commercial presence; where foreign companies set up subsidiaries or branches to sell services locally.

**Mode 4:** Presence of natural persons; where a natural person resident in one country travels to a different country to provide a service.

Source: Magntorn (2018)

12. There are specific conditions under which the MFN clauses discussed above no longer apply. First, most of the agreements exclude commitments made in existing trade agreements. Second, almost all exclude future agreements which create an 'internal market' in services and investment. Third, agreements that abolish, in substance, all barriers to establishment and/or require the approximation of legislation are also excluded from the scope of MFN. Finally, all of the agreements discussed

above contain exceptions for measures providing for recognition of qualification, licences and prudential measures.<sup>1</sup>

13. In addition to these broad exemptions, the EU makes a number of sector specific exceptions to limit the scope of the MFN clauses in some areas. Table 2 gives the degree to which MFN clauses apply to EU's services commitments for businesses services in the EU-Canada free trade agreement (CETA). A score of 100 indicates that the MFN clause applies fully (i.e. that the EU has not made any specific limitations to the MFN clauses in that sector). This shows that the EU makes barely any exceptions to MFN, meaning that the MFN clauses apply fully to these business services sectors unless the UK-EU FTA satisfies one of the broad exceptions outlined above.

**Table 2: MFN clauses in CETA**

<b>Description</b>	<b>Coverage of MFN</b>
Leasing or rental services without operator	96
Research and development services	100
Legal, accounting, auditing and book-keeping services	99
Taxation services	100
Market research, management and consulting and related services	100
Architectural, engineering and other technical services	97
Business services n.e.c.	98

*Note: A score of 100 means that the MFN clause applies fully to the relevant sector.*

*Source: Magntorn and Winters (2018).*

14. The UK's position is complicated because on the one hand, it is seeking a relatively 'standard' free trade agreement with the EU, similar to CETA. Such FTAs rarely mandate deep enough levels of integration and alignment to satisfy the broad exceptions to MFN outlined above (e.g. agreements creating an internal market, requiring the approximation of legislation or granting the right of establishment). On the other hand, the UK seeks some ambitious commitments on services, in some areas wanting to go further than any of the EU's previous FTAs. This is precisely the type of situation in which the MFN clauses will bite. If the EU granted the UK significantly better access to its services markets than it has done in any of its previous FTAs, the EU would need to extend that same treatment to Canada, South Korea, all CARIFORUM countries, Japan and Vietnam 'for free'. Even if these countries may not be large enough to make such concessions to the UK impossible, they will surely be an additional discouragement to doing so, on top of not wanting to undermine the consensus within the EU that was developed to support the

---

<sup>1</sup> The wording of this exception differs slightly in CETA compared to the other agreements. See Magntorn (2018) for details.

previous FTAs.

15. The same applies if, for example, the UK tries to negotiate better treatment in its new trade agreement with Japan compared to what Japan has previously granted to the EU. Given the MFN clauses in the EU-Japan agreement, Japan would need to extend that same treatment also to the EU, an economy six times larger than the UK. In cases such as these, the MFN clauses could be a considerable constraint on the concessions Japan is willing to offer the UK.
16. Finally, MFN clauses typically apply to both market access provisions and national treatment commitments. However, their impact is likely to be greater for market access commitments than for national treatment offers. This is because national treatment measures distinguish only between domestic and foreign suppliers but not between the latter – they apply equally to all imports for all partners. This means that if a trade agreement results in a more liberal national treatment rule, that change is automatically extended to suppliers from countries other than the negotiating partner. That is, MFN treatment arises automatically and therefore, to the extent that services trade is restricted by national treatment issues, MFN clauses barely affect the incentives for liberalisation. But since it cannot be guaranteed that a party will never be able to grant a benefit to one country but not to another, MFN clauses offer some comfort

## References

Magntorn, J., (2018), "Most Favoured Nation clauses in EU trade agreements: one more hurdle for UK negotiators", UKTPO Briefing Paper 25

<https://blogs.sussex.ac.uk/uktpo/publications/most-favoured-nation-clauses-in-eu-trade-agreements-one-more-hurdle-for-uk-negotiators/>

Magntorn, J., and Winters, L.A., (2018), "Can CETA-Plus Solve the UK's Services Problem?", UKTPO Briefing Paper 18

<https://blogs.sussex.ac.uk/uktpo/publications/can-ceta-plus-solve-the-uks-services-problem/>

Morita-Jaeger, M., and Winters, L.A., (2018), "The UK's future services trade deals with non-EU countries: A reality check", UKTPO Briefing Paper 24

<https://blogs.sussex.ac.uk/uktpo/publications/the-uks-future-services-trade-deals-with-non-eu-countries-a-reality-check/>

Nordås, H.K., and Rouzet, D., (2017) "The impact of services trade restrictiveness on trade flows." *The World Economy* 40.6 (2017): 1155-1183.