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SSISI Public Policy Brief: *International Trade and Investment Agreements: Fit for Future Purpose*

Effects and Complexities of Deeper Trade and Investment Treaties

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1. INTRODUCTION

This paper provides an overview of the growth and deepening of international trade and investment agreements over time and a selection of some of the areas of complexity and controversy that they sometimes attract.[1] The overview is of the most common elements across agreements rather than delving into any individual agreement in detail. The particular focus is on how agreements have evolved over time and the expansion of deeper and more complex arrangements. Given time restrictions, I cannot go into many individual items, but I will touch on the array of topics that are now frequently included in international trade and investment treaties.

I then give some examples of the existing evidence on the impact free trade and investment agreements have on flows of trade and investment between countries. These aggregate assessments provide generally positive impacts showing increased trade and investment between countries although the magnitude will be shown to vary across the depth of the agreement. The final focus of the paper is to highlight a small selection of the complexities and controversies that have attached themselves to international trade and investment agreements which have led to questions such as the title of this symposium on their fitness for purpose. The examples I will discuss are the importance of standards in these agreements, the complexity of rules of origin requirements and the issue of how disputes get resolved in investment treaties.

2. EVOLUTION OF TRADE AND INVESTMENT AGREEMENTS

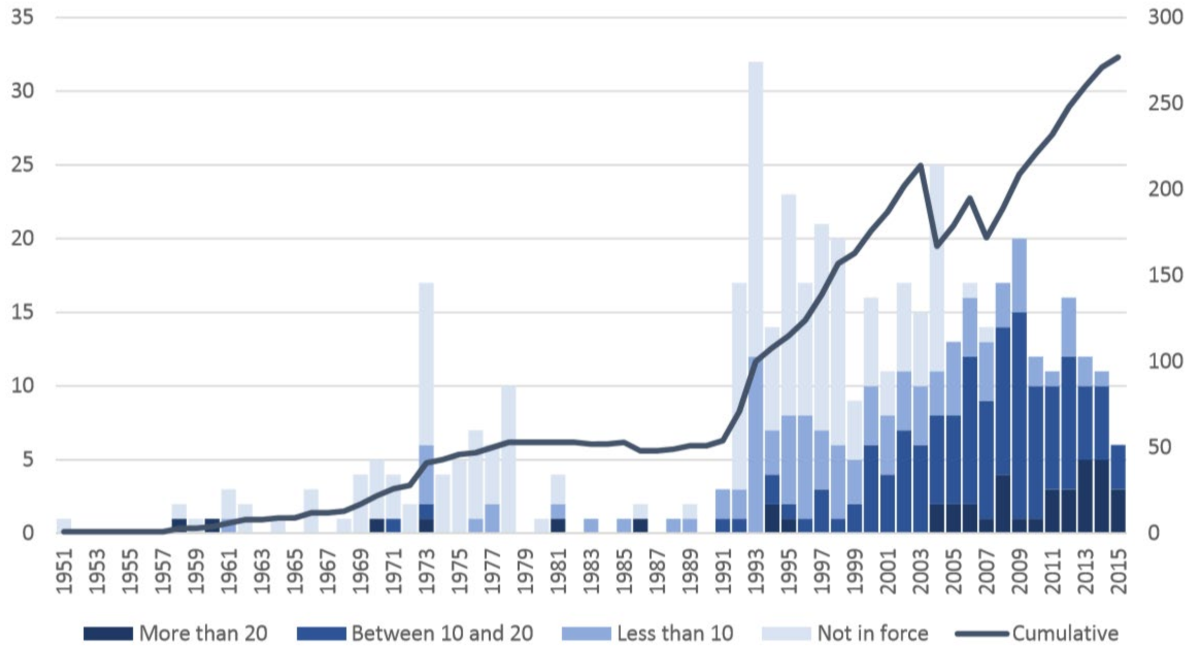
There has been both a dramatic expansion in the number of trade agreements over the last 40 to 50 years and also a considerable change in their contents. Figure 1 shows a graph from Mulabdic, Osnago and Ruta (2017) of the growth in trade agreements over time with the bars representing the number of agreements registered with the World Trade Organisation (WTO) in each year from 1951 to 2015 and the cumulative number (solid line). This shows the gradual increase in the use of trade agreements up to around 1990 followed by a sharp acceleration in the twenty subsequent years, interrupted only by the global financial crisis years.

Traditionally, the agreements were relatively narrowly focused with agreement on tariffs and quotas to the fore. Over time, as international tariff levels declined in general, these moved somewhat to the background. For example, debate on tariff levels played a very minor part in the recently concluded negotiations between the EU and UK while issues relating to standards for example played a much greater role. This is reflected in Figure 1 by the different colours that the bars are divided into which represent the number of areas covered in the agreements. Agreements with more than ten areas covered begin to appear from the early 1990s and account for most agreements signed after 2000. At this stage, agreements with over twenty areas covered become a feature in the later years indicating the much greater depth of more recent agreements.

[1] A small note on terminology: although it is possible to have entirely separate treaties on trade and on investment, in many cases the two are combined. I therefore mainly refer to trade agreements or treaties as a general term that may incorporate investment clauses unless referring to specific elements that relate only to investment agreements.

Although the scope of trade agreements has broadened considerably over time, they still tend to focus largely on goods trade with services only more recently playing a greater role – for example in the CETA treaty between the EU and Canada. One area where tariffs and quotas do remain important is in terms of agricultural products, which countries frequently apply a much greater degree of protection to relative to other sectors. This can be the source of some controversy in agreements being negotiated between developed and less developed countries. Agricultural products may account for a greater share of potential exports and be something of a comparative advantage for poorer countries but is a sector where protection levels typically remain high in richer countries.

Figure 1: Number and depth of trade agreements over time

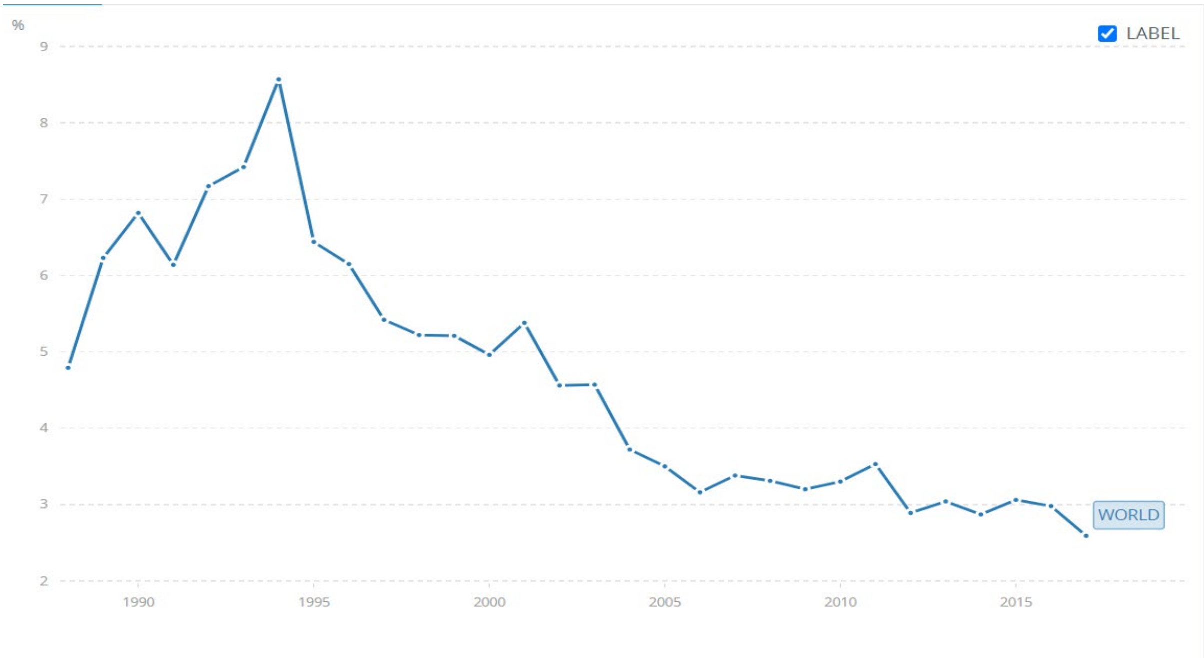


Source: Mulabdic, Osnago and Ruta (2017)

Along with this increase in the number of trade agreements, there has been a corresponding fall in global MFN or Most Favoured Nation tariffs that are charged to all trading partners that there is not a specific trade agreement with. Figure 2 shows that the average MFN tariff across all WTO member countries has fallen steadily for the past thirty years. This forms the backdrop against which the tariff element of trade deals has been superseded by other aspects of the economic relationship as there are less marginal gains to be made from lowering these already low tariffs for many countries.

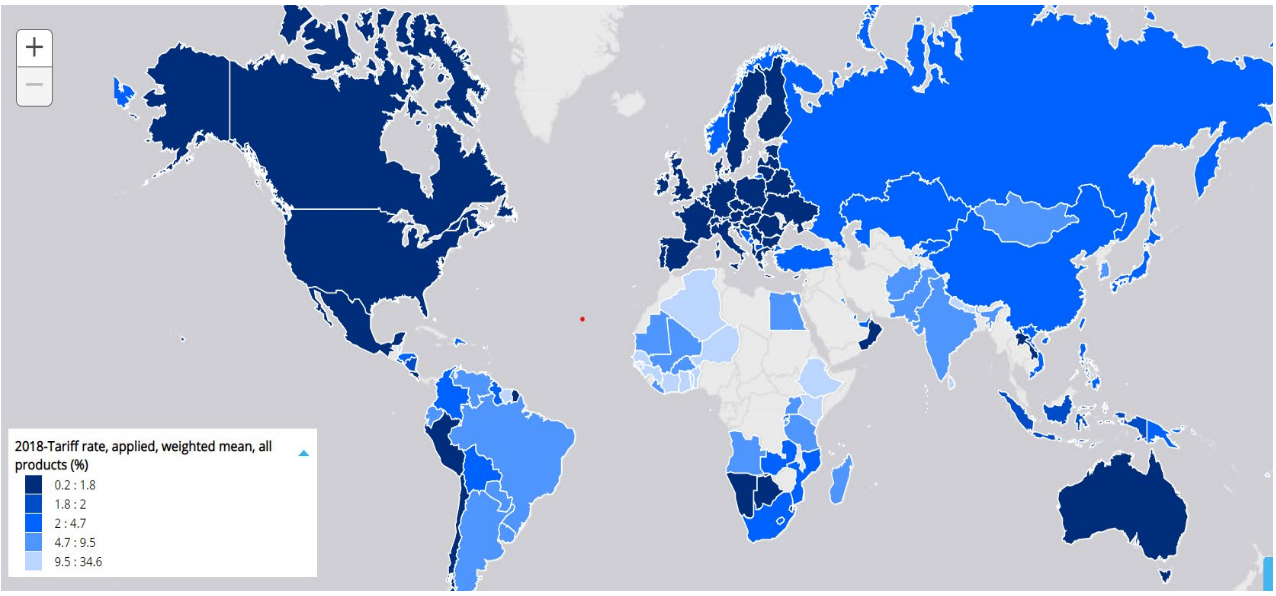
As already mentioned, however, agricultural products remain broadly an exception to this pattern. As a broad generalisation, this can be seen to be reflected in a greater importance of tariffs for poorer countries. The variation in average tariffs across countries is shown in Figure 3 prepared by the World Bank (2021). This shows average tariffs of a trade-weighted basket of goods is under 1.8 per cent in many of the largest trading countries, including the EU, USA, Canada and Australia. Tariffs are higher and a more central tool of trade policy on the other hand for many other countries, typically (but not exclusively) those with lower per capita incomes than the group in the lowest tariff bracket.

Figure 2: Average global MFN tariffs



Source: World Bank (2021)

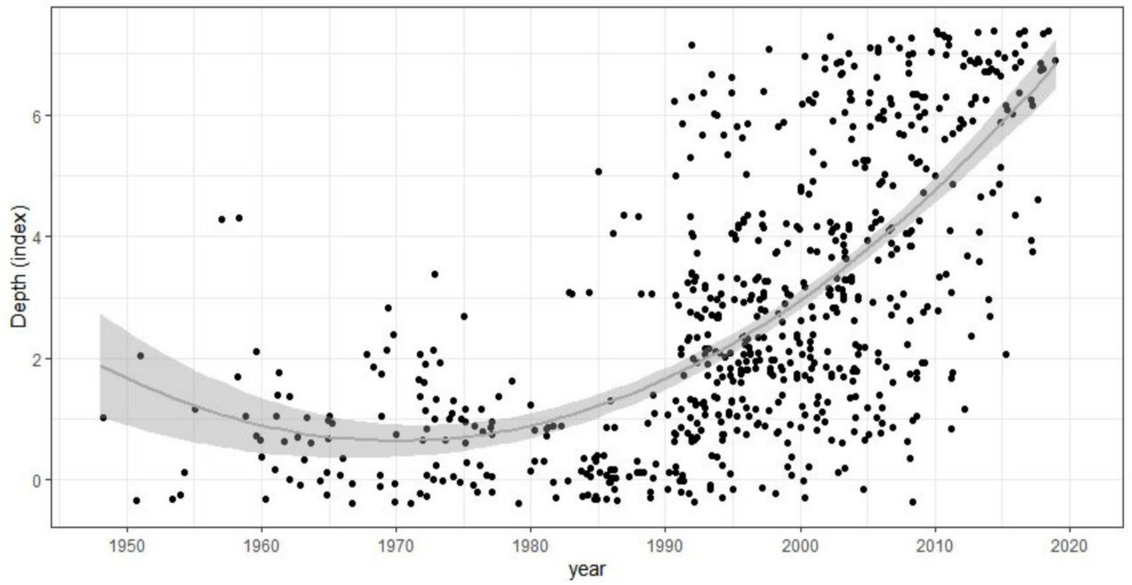
Figure 3: Variation in MFN tariffs across countries



Source: World Bank (2021)

The growth in complexity of trade agreements over time, from being very much about setting tariffs and quotas to covering a whole range of different issues, has already been mentioned. I now turn to look at some of the elements captured by this increased complexity. First, I show in Figure 4 a measure of the depth or complexity of trade agreements which comes from the Design of Trade Agreements (DESTA) research project described in Dür, Baccini and Elsig (2014). This database puts together data for a wide range of international trade agreements with up to 100 detailed measures of the composition of each treaty and the extent of market access allowed under multiple headings. The depth index summarises this information. In a similar pattern to the expansion of the use of trade agreements in Figure 1, there is a very strong increase in the level of complexity and depth of coverage of these trade agreements from 1990 and continuing up through 2020.

Figure 4: Complexity of trade agreements - "depth index" – over time



Source: Design of Trade Agreements (DESTA) database by Dür, Baccini and Elsig (2014).

What makes these more recent trade agreements more complex? Table 1 gives a list of the range of topics that are now being included in trade agreements. Mulabdic, Osnago and Ruta (2017) divide the issues found in agreements into two broad categories: The first of these is WTO+, which are areas traditionally under the general mandate of the WTO that may now be dealt with in more depth than previously. This category includes the traditional themes of customs cooperation and tariffs but also now regularly features clauses on reducing non-tariff barriers to trade such as SPS (sanitary and phytosanitary measures that set rules on plants and foodstuffs) and TBT (or Technical Barriers to Trade relating to standards on manufactured goods). Other topics regularly contained in trade agreements cover interventions or policies that could give one side a competitive advantage, for example they may include measures to limit government subsidies, prevent "dumping" (below cost selling) and protect intellectual property.

In addition to expansion of the traditional headings coming under the mandate of the WTO, more recent trade and agreements have gone further by including a wide range of subject areas that go beyond a narrow focus on trade. Examples of these are shown under the "WTO-X" heading in Table 1. This gives a picture of how modern trade agreements can be extremely comprehensive agreements that feature a whole range of policies and agreements on environment, investment, labour standards and data to pick out just a few. The inclusion of investment on this list points to the overlap between trade and investment treaties which is why this paper refers to both as a single agreement in many instances (although stand-alone investment agreements are also possible).

Table 1: Topic headings in free trade agreements

WTO+	WTO-X	
Tariffs on industrial goods	Anti-corruption	Financial assistance
Tariffs on agricultural goods	Competition policy	Health
Customs administration	Environmental laws	Human rights
Export taxes	IPR	Illegal immigration
SPS measures	Investment measures	Illicit drugs
State trading enterprises	Labour market regulation	Industrial cooperation
TBT measures	Movement of capital	Information society
Countervailing measures	Consumer protection	Mining
Anti-dumping	Data protection	Money laundering
State aid	Agriculture	Nuclear safety
Public procurement	Approximation of legislation	Political dialogue
TRIMS measures	Audio-visual	Public administration
GATS	Civil protection	Regional cooperation
TRIPS	Innovation policies	Research and technology
	Cultural cooperation	SMEs
	Economic policy dialogue	Social matters
	Education and training	Statistics
	Energy	Taxation
		Terrorism
		Visa and asylum

Source: Mulabdic, Osnago and Ruta (2017)

3. **EVIDENCE OF IMPACT OF TRADE AND INVESTMENT AGREEMENTS**

Having given an overview of the expansion and deepening of trade (and investment) treaties over time, this section asks to what extent they actually have an impact on trade and investment flows. Work by Mattoo, Mulabdic and Ruta (2017) examined a whole range of different trade agreements between countries and found that there was a significant positive association between preferential trade agreements and bilateral trade flows. In addition, the size of the effect was larger for deeper agreements.

Taking a similar approach to measuring the impact of investment treaties on flows of foreign direct investment (FDI), Kox and Rojas-Romagosa (2020) found that there was a positive overall impact from an agreement being in place but also that the size of the effect increased with the depth of the agreement. They found that this depth measure varied from a 4.4 per cent increase in FDI from having the most basic, low depth, agreement in place up to a 35 per cent increase in FDI for their highest category of deep agreement. They also benchmark these effects against the highest depth integration of membership of the European Union which is associated with a 135 per cent increase in FDI. On both trade and investment flows, therefore, we find a consistent pattern of benefits from the existence of a bilateral agreement but the size of the effect varying according to the depth of the agreement.

4. LEVELLING THE PLAYING FIELD

With trade and investment agreements increasing both in prevalence and complexity, the remainder of this paper takes a slightly closer look at some examples of areas where this greater depth has featured and some of the complications that can result from greater complexity. The specific examples I will mention are establishing a level playing field, rules of origin and dispute resolution.

One of the most prominent areas of debate that emerged in the negotiations leading up to the EU-UK Trade and Cooperation Agreement in 2020 related to setting and recognition of standards (Baldock et al., 2019). The importance of a “level playing field” as a condition of free movement of goods is motivated by the need to have some common rules in place if markets are to be freely accessible to producers in other countries. The fundamental objective is to prevent one country's producers undercutting the others either by getting government subsidies that artificially lower their cost of production or by cutting costs themselves through lower labour and environmental standards rather than via efficiency improvements.

While this idea of fair competition is simple in principle, establishing commonly recognised standards in practice is far from straightforward. A host of difficulties in negotiations arise from establishing exactly what requirements are needed in order to establish and maintain the levelness the international trade playing field. The standards need to be decided not just for the moment of the agreement's signing but on how they might evolve in the future. As standards evolve over time, in order to future-proof a trade agreement, there must be some linking of local rules to those of partner countries. This can be done in many ways, from commitments not lower standards as a minimum to a closer dynamic alignment relationship of jointly implementing changes to standards. This provides a clear example of one of the main trade-offs that comes with any sort of economic integration: while an agreement will bring market access and the evidence suggests that this will increase trade and investment flows, some reduction in domestic economic control is likely to be the price. This trade-off between economic integration and sovereignty loomed large in the Brexit negotiations of recent years with standards alignment one of the sticking points until close to the final days.

Beyond the specific instance of the EU-UK negotiations, these complexities are reflected broadly in the length of time it takes to conclude trade and investment agreements. Arroyo and Castillo-Ponce (2019) examined 132 trade agreements and found that the average duration of negotiations was 72 months with a range from seven months for the shortest negotiation process to the longest taking close to twelve years. Some of the factors they found that determined the length of the process could be interpreted as reflective of the power dynamic in the negotiations. In particular, they found that deals are typically concluded faster when there are large differences in country size and also when one country is growing much faster than the other. These would increase the likelihood that the smaller, slower growing partner is more willing to accept the playing field terms put forward by the stronger side of the negotiation process.

5. INCREASING COMPLEXITY AND RULES OF ORIGIN

The second area of increasing complexity relate to how goods qualify for preferential tariff rates. The qualification standards are known as "Rules of Origin" and feature in almost all trade agreements. Again there is a relatively simple principle which is to avoid the risk that if one of the partner countries signs a separate preferential trade agreement with a third country, that the third country cannot avoid tariffs by redirecting products through the country they have the free trade deal with. The existence of rules of origin therefore makes a lot of economic sense. However, the details can be incredibly complex with rules varying at a detailed product level for the amount of processing that is required in the countries that have signed the agreement for the good to be accepted for tariff-free trade. Different rules may also apply depending on where inputs were sourced with some trade agreements having different rules if a component comes from a country where both parties to the new agreement have similar trade relationships.

Some of the complexity of determining rules of origin can be seen in specific anomalies in the opening weeks of the operation of the EU-UK trade agreement. For example, much media attention was directed at the treatment of a brand of sweets imported from Germany into the UK and then distributed in Ireland.[2] Despite eventually moving from one EU country to another, this product did not satisfy the rules of origin definitions for zero tariffs. This was because the criteria required that the good must either undergo a certain degree of processing in the country it is being exported from or can travel through a country on the way to its final destination. Goods that move from EU countries into the UK and then have the shipments divided or repackaged for movement back into the EU effectively fall between these two definitions. Because the goods are not simply transiting the UK, they lose their EU origin status. However, because the only "processing" is repackaging or splitting of bulk loads, this is not sufficient to acquire UK status. This leaves such goods as being treated as not from either the UK or EU when they re-enter the EU.

A similar issue regarding qualification for origin arose on goods entering the EU or UK from counties that both have a trade agreement with. Many trade agreements allow inputs to be used from other countries when both of the signatories have a similar agreement with that third country. This allows origin to be cumulated from different inputs rather than all having to come from processing in the final country. However, this allowance for cumulation of inputs across trade agreement partners was not included in the EU-UK agreement. An example of the impact of this was that tariffs would be attached to flour imports from the UK if they used more than a limited percentage of Canadian wheat, even though both the EU and UK have almost identical trade agreements with Canada.[3]

6. INVESTOR-STATE DISPUTE SETTLEMENTS

The final example of complexity (and indeed controversy) that I look at arises in investment agreements and relates to how disputes between investors and the investment destination country get resolved. The most common approach is for investment treaties (and trade treaties that include investment clauses) to set up an Investor-State

[2] Brexit: The disappearance of Percy Pig is a feature, not a bug (irishtimes.com) (26 February 2021)

[3] Bread alert: why Brexit and a bad harvest will force up the price of sliced pan (irishtimes.com) (4 February 2021)

Dispute Settlement (ISDS) mechanism. There are about 3,000 of these ISDS clauses when all of the different investment treaties between different pairs of countries are considered (Abbott, Erixon, and Ferracane, 2014).

At its most basic level, the motivation between clauses is to protect investors from taking their money to another country and then having the government of that country make legal changes that cause them to lose or devalue their investment. This could be by directly expropriating the investment property (perhaps by nationalising the relevant industry or revoking an operating licence after infrastructure was built), preventing them from repatriating their profits or discriminating against the foreign investor in favour of domestic producers for example. A second motivation was to de-politicise disputes that involved private companies as prior to ISDS arrangements, any treaty dispute would be dealt with at a state-to-state diplomatic level.

The standard features of these ISDS clauses are that an investor can bring a claim directly against the host state and the dispute goes to a tribunal for arbitration. The tribunals are set up specifically for each individual dispute and typically both sides are involved in selecting the members of the tribunal (Abbott, Erixon, and Ferracane, 2014).

While the original motivation was largely to protect individual investors from unfair measures by states, the concerns about ISDS today is that the power dynamic has to some extent shifted in the other direction and these clauses can potentially be used by large multinational companies to put pressure on countries in how they draw up regulations that may negatively impact on firm profits. A particularly famous case of this kind was an action taken by the tobacco company Philip Morris against the Australian government. The company was claiming compensation for losses that it would incur as a result of new government legislation requiring plain packaging and prominent health warnings on tobacco products. Although the company did not win their case, the costs to the Australian government of the legal process were substantial.[4]

Although Philip Morris was not successful in the case against plain packaging in Australia, and indeed most cases are won by the government side in ISDS tribunals, concerns remain that the structure of this system allows large companies to influence regulatory decisions being taken by governments or have them face the risk of having to pay compensation for the impact of regulations on company profits. It is important to emphasise that nothing in ISDS arrangements places direct limits on the rights of governments to pass domestic legislation. None of these treaties or clauses can make a state change its laws even if it loses the case. The risk to the state is entirely financial – if the state loses a case, it may have to pay compensation to the investors that are affected by the legal changes. ISDS clauses do not therefore directly prevent a state from changing regulations but they can act as a disincentive if there is a risk that a new regulation may be challenged.

Other concerns on the ISDS process relate to the *ad hoc* nature to the tribunals. As these are set up for each case rather than as a standing court, the outcomes can be inconsistent. There is also limited ability to challenge the findings of the tribunal. This has led resulted in a recent international emphasis on reform of the system, with the United Nations examining potential models of an investment court more in line with the WTO's processes for the resolution of trade disputes (United Nations Commission on International Trade Law, 2018). In the meantime, individual treaties such as the CETA recently agreed by the EU and Canada includes changes to the ISDS model to have a permanently established tribunal rather than a sequence of *ad hoc* panels as disputes occur. While this may not impact the regulatory disincentive concern, it would appear to go some way to improving the consistency and continuity of how disputes are settled.

7. CONCLUSION

With high profile trade and investment treaties recently concluded by the EU with the UK and Canada, this paper gives a high-level overview of the growth and deepening of this class of international treaty over time. The main focus has been on the expansion of topics that now fall under the umbrella of a trade agreement, which now frequently goes well beyond the traditional elements of tariffs and quotas. Several specific examples of complexity and occasionally controversy are then discussed – the common rules to establish a competitive level playing field, rule of origin and the settlement of disputes between investors and states. While I present evidence that deeper agreements help promote trade and investment, the complexity requires the understanding of a range of trade-offs and clear communication to keep such agreements fit for purpose over time.

[4] See Kofman and Williams (2015) for discussion of the case itself. Costs were published later and reported here: Revealed: $39m cost of defending Australia's tobacco plain packaging laws | Tobacco industry | *The Guardian* (2 July 2018)

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DISCUSSION

Ronan Lyons: I have a question in relation to public approval, in particular what the key challenges are in conveying the benefits of trade agreements, given how prominent those agreements are in the public discourse, not least since Brexit.

Suzanne Drisdelle: I agree with some of the points made by speakers in relation to how agreements like CETA have implications not just for larger firms, or those affected by direct tariffs, but other firms, including smaller and online/services firms.

Frances Ruane: I thank all the speakers. I raise the issue of the contrast between the necessity of detail in trade agreements and the challenge for politicians to portray the deals as simple. In particular, I ask whether economists are part of the problem - in that economists often refer to trade as being simple, based on first principles.

Danny McCoy: I raise the issue of intangible assets and the complexity they bring and ask what the difference is, for the general public, between the investor dispute systems of the past and the idea of investment protection courts proposed in some newer trade deals.