BIS | Department for Business Innovation & Skills

REGULATORY COOPERATION

Trade and Investment Analytical Papers
Topic 17 of 18

DFID Department for International Development

Contents

Summary

Evidence shows that non-tariff obstacles are often a bigger impediment to trade than import tariffs, in particular in the case of developing countries. On the other hand, these obstacles often stem from domestic regulations, which are enacted primarily to achieve valid domestic goals. Therefore, unlike tariffs they cannot be removed simply.

Economists agree that regulatory measures are necessary to increase welfare by correcting market distortions, internalising externalities or addressing inequalities. However, they are often created with only domestic considerations in mind. As a result, their impacts on foreign suppliers are often unaccounted for. Furthermore, complexity and inherent differences in the international patterns of regulation generate additional costs for participation of trade. Reducing these constraints on trade would generate economic benefits and help boost economic growth. There is therefore clear justification for countries to reduce obstacles to trade stemming from disproportionate or discriminatory regulations. These can normally be addressed under WTO rules, but countries can also seek to reduce "behind the border" obstacles to trade by greater international regulatory cooperation.

The Single Market is probably the most powerful example of international cooperation in this field, with mechanisms ranging from mutual recognition to harmonisation of rules and standards.

Experience shows that between large economies (or between regional blocs), harmonisation proves difficult as both parties have usually already developed a complex set of advanced standards and regulations. When large trading partners seek a reduction in their bilateral regulatory barriers to trade, mutual recognition of existing standards is therefore an easier and better way forward. However, whenever possible, rather than developing competing and often incompatible regional standards, using global standards represents the best avenue.

Aim

This paper examines the issue of regulatory cooperation as a tool to promote international trade and identifies the main challenges facing UK policymakers.

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1. Regulations are necessary but may raise important obstacles to trade

Regulatory measures pursue legitimate public policy objectives. They are intended to increase the welfare of consumers and citizens by correcting market distortions, internalising externalities, or addressing inequalities. However, regulations are often prepared with purely domestic considerations in mind, without sufficient account being taken of their impact on foreign suppliers and thereby also on own industries competitiveness, as they rely on access to intermediate input, or of the availability of less trade restrictive solutions.

In developing countries, this is often the lack of regulations or their inadequate implementation that reduces or suppresses international trade. This is for instance the case when property rights are not properly protected. This issue of the absence of rules is outside the scope of this paper, rather our focus is on the additional cross-border trade costs of existing regulations, over and above domestic compliance costs. These trade costs may be due to provisions that discriminate de jure or de facto against foreign producers or which apply disproportionate requirements. Such unlawful provisions can normally be addressed under WTO rules.

Even lawful, proportionate, and non-discriminatory regulation can increase trade costs for foreign producers, simply because of inherent differences in the international and inter-industry patterns of regulations which, in their turn, result from differences in initial regulatory approach, levels of income, consumer preferences, risk perceptions and the pace of pro-market oriented reforms. However, as companies increasingly become part of global supply chains, differences in regulation between trading partners requires suppliers to adapt their products to the regulatory requirements of each export market. This increases the cost of participation in the global economy (e.g. familiarisation costs, maintenance of two different product specifications within a same production chain) and reduces the competitiveness of local companies.

In addition regulatory measures like other non-tariff measures (NTM) can have wider economic effects by enabling market segmentation. A distinction can be made between vertical and horizontal market segmentation resulting from NTMs. Vertical segmentation occurs when a NTM leads to quality differences between varieties of the same product (e.g. emissions levels in cars). This is beneficial for consumers as it enables them to choose the quality level they prefer and to increase their utility (e.g. ISO quality standards, food safety standards). Horizontal segmentation normally occurs when a national or sub-national government adapts a standard / specification of a local firm as its norm, which differs from international competitors. This type of segmentation has no benefits for consumers and just enables suppliers to practise price-discrimination between markets.

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2. Reducing regulatory barriers may generate significant economic benefits

Recent economic evidence has shown that in most cases NTMs, including regulatory measures, are a bigger obstacle to trade than import tariffs. For instance, Copenhagen Economics (2010) suggests that EU exports to Japan could increase by 23 percent or €14 billion if tariffs were abolished but up to 50 percent or €29 billion if the cost of NTMs in Japan were reduced to the fullest possible extent.

According to Nicoletti and Scarpetta (2003) , if Germany, France or Italy were to align regulation in non-manufacturing industries with US standards their investment rate would increase between 30% to 50%. Overall, reforms that reduce competitionrestraining regulations, cut tariff barriers and ease restrictions on foreign direct investment to “best practice” levels in the OECD area could lead to gains in GDP per capita of up to 2 to 3 percent in the European Union.

Ecorys (2009) asserts that a reduction by 50% of the NTM divergence between the EU and the US could boost EU GDP by €122 billion annually (0.7% above the baseline scenario). That would yield €41 billion annual gains for the US economy corresponding to 0.3% additional GDP.

3. Regulatory cooperation as a tool for barriers to trade reduction

Unlike tariffs, regulations that result in obstacles to trade cannot be removed simply as they often pursue domestic legitimate goals. Therefore, the best avenue is regulatory cooperation which can help reduce the unnecessary obstacles to trade that domestic regulations may create.

The OECD definition for “regulatory cooperation” is the range of institutional and procedural frameworks within which national governments, sub-national governments, and the wider public can work together to build more integrated systems for rule making and implementation, subject to the constraints of democratic values such as accountability, openness, and sovereignty.

Regulatory cooperation can include a number of different tools, ranging from the informal, such as basic information sharing to the more formal, which include mutual recognition agreements and complete harmonisation of regulatory frameworks. They can occur unilaterally, whereby one country acts to bring its regulatory approaches more in line with others (during the transition process of East European countries for instance), bilaterally (between two countries), regionally (e.g. the EU) or multilaterally (international agreements such as UNECE regulations for motor vehicles).

Trade costs of regulatory measures can be reduced by full harmonisation of standards and regulatory convergence between trading partners. Harmonisation and convergence may best work for smaller economies that may benefit substantially from strong economies of scale when accessing the market of a large trading partner. Countries in EU’s neighbourhood often chose for instance to implement EU technical standards in order to facilitate access for their companies to the European Single Market.

Between large or more advanced economies (or between regional blocs), harmonisation might prove difficult as both parties have usually already developed a complex set of advanced standards and regulations. When large trading partners seek a reduction in their bilateral regulatory barriers to trade, mutual recognition of existing standards may be an easier and better way forward. However, whenever possible, rather than developing competing and often incompatible regional standards, using global standards represents the best avenue.

When harmonisation and mutual recognition of standards are not an option, mutual recognition of conformity assessment procedures and simplifications of procedures may help reduce costs incurred in international trade. The EU and the US have signed such agreement providing for mutual recognition of conformity assessment activities covering medical devices, electromagnetic compatibility, electric safety, recreational craft and pharmaceutical good manufacturing practices.

Enhancing regulatory cooperation is however always challenging. First, NTMs are harder to quantify; that makes negotiations less transparent. Second, NTM reductions often entail domestic reforms and hence touch upon issues that are not normally negotiated within a bilateral trade framework. It requires therefore strong political will and administrative creativity to come to an agreement on meaningful NTM reductions. Third, NTM reduction implemented by the countries in a context of a trade agreement may benefit third countries, therefore the incentive for the latter to free-ride may be high. Fourth, like all economic reforms, a change in regulation creates winners and losers adding to the difficulties in achieving an outcome which will be beneficial overall. Finally, to be meaningful an initiative to reduce NTMs at a global level needs to involve an ever growing number of countries with diverging regulatory systems and traditions.

The Single Market is the ultimate example of regulatory cooperation

Harmonisation of rules is a key element of the single market programme for promoting the free circulation of goods, capital, people and services within the EU. It contributes to business' competitiveness by eliminating the costly fragmentation of the internal market stemming from different national rules.

For instance, EU legislation harmonising technical regulations was introduced in the higher-risk product sectors in order to minimise risks and ensure legal certainty across Member States. Trade in the 'non-harmonised' sectors relies on the 'mutual recognition' principle, under which products legally manufactured or marketed in one Member State should be able to move freely throughout the EU.

Nowadays, half the trade in goods across the EU is covered by harmonized legislation. Economic evidence shows that EU countries trade nowadays twice as much with each other as they would do in the absence of the Single Market. At the same time, greater trade integration in Europe is not to the detriment of external trade partners. Evidence shows that the latter also benefit from greater access to EU's market as internal barriers to trade decrease.

The success of creating a high degree of regulatory cooperation within the EU, has the consequence that the EU can find it more challenging to negotiate regulatory cooperation with third parties, as the acquis cannot easily be changed. Therefore, negotiating regulatory cooperation with third parties tends to be more successful and achievable when focusing on future areas of regulation

Despite its achievements, the Single Market is not yet complete. For instance, the ongoing implementation of the Services Directive shows that Member States still retain nearly 3,000 regulatory requirements specifically for professional and business services. That includes requirements for shareholding, specific legal forms, tariffs and restrictions on multidisciplinary activities.

Recent BIS evidence shows that the complete withdrawal of the remaining barriers to trade inside the European Union would trigger very strong positive benefits for all its members. When considering the level of anti-competitive discrimination existing across Europe, current UK trade with the rest of the EU runs 45% below potential. It means that the complete removal of these obstacles to trade would translate into a step change of 7% additional income per capita in the UK (14% at EU level), corresponding to £4,300 a year per British household.

Other regulatory cooperation initiatives

High Level EU-US Regulatory Cooperation Forum of the Transatlantic Economic Council

Regulatory barriers have long been recognised as the most significant impediment to trade and investment between the EU and the USA. In May 1998, the EU and the US launched the Transatlantic Economic Partnership (TEP). The TEP Action Plan called for action to address technical barriers to trade in goods, including improving the dialogue between EU and US regulators.

The 2005 EU-US Summit launched an Initiative to Enhance Transatlantic Economic Integration and Growth with EU-US regulatory cooperation as one of its priorities. A High Level EU-US Regulatory Cooperation Forum was set up to focus on key regulatory issues and to facilitate the sharing of experience and best practice. The aim of the forum was "to build effective mechanisms to promote better quality regulation, minimize unnecessary regulatory divergences to facilitate transatlantic trade and investment and increase consumer confidence in the transatlantic market". The Forum intends to provide a unique platform to bring together senior American and European regulators to exchange views on cross-cutting regulatory issues. The Forum helps to identify prospective areas for EU-US regulatory cooperation, and facilitates early warning about possible divergent regulatory approaches.

The work of the Forum contributes to achieving the objectives of the Transatlantic Economic Council, the high-level political body established in 2007 to promote economic integration between the EU and the US.

International regulatory cooperation in the financial sector

As the recent financial crisis illustrated, financial events in one country have the potential to affect many others and thus there is undoubtedly an important role for international cooperation and coordination in financial regulation.

Well devised international financial regulatory standards can help to encourage all nations to maintain effective domestic regulatory systems. Coordinated international supervisory arrangements can help ensure that every large, internationally active financial institution is effectively supervised.

With this view, the Financial Stability Board's Standing Committee on Standards Implementation launched an initiative in 2010 to encourage the adherence of all countries and jurisdictions to international financial standards, including by identifying non-cooperative jurisdictions and assisting them to improve their adherence.
In December 2010, the Basel Committee issued the Basel III rules text, which presents the details of global regulatory standards on bank capital adequacy and liquidity agreed by the Governors and Heads of Supervision, and endorsed by the G20 Leaders at their November Seoul summit.

UK-US regulatory cooperation on the financial services sector

In 2006, the Financial Services Authority (FSA) signed a Memorandum of Understanding (MoU) with the United States' Securities and Exchange Commission (SEC) to strengthen cooperation in oversight and supervision of global firms. The arrangement supports the exchange of supervisory information when undertaking consolidated supervision of major UK and US firms.

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URN 12/533