Which Free Trade Agreement in South Eastern Europe?

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Technical Report

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in association with

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PREFACE

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For simplicitly, the recommendations listed below assume that there will be one regional FTA (as shown in the attached note, the same results can be achieved by a regional set of bilateral FTAs, but at higher costs and greater uncertainty). They focus on five countries (Albania, Bosnia-Herzegovina, Croatia, Macedonia and FR Yugoslavia), but they can be easily extended to other participants of the Stability Pact. If the existing FTAs are kept in force, their provisions should be made similar to the provisions of the regional FTA (through the evolutionary clause). Last but not least, the following recommendations assume that all the countries of the region will be WTO members -- in other words, that the WTO will be, and will stay as, the anchor of the trade policy of the countries of the region.

These recommendations intend to provide a road map for the coming decade. Although they may be introduced and implemented progressively according to a precise time schedule, it is important that they are conceived at the beginning of the process -- in order to create the "Big Bang" effect so necessary for a rapid economic reconstruction of the region.The recommendations are explained and presented in detail in the attached note, in the same order.

RECOMMENDATIONS ON THE PROVISIONS OF THE FTA TEXT

The recommendations follow the sequence of provisions adopted in the majority of the texts of the existing FTA.

Objectives

1. All the FTA essential outcomes should be reached at dates specified in the Treaty, with an "acceleration" clause at the disposal of the Signatories.

2. The FTA should, in principle, cover all the agricultural and industrial goods ("substantially all the trade"). Transitory exceptions should be explicitly listed in annexes.

Free movement of goods

3. As already done in the existing FTAs, the FTA should include standstill provisions in all the domains to be liberalized.

4. If a progressive liberalisation of trade barriers is felt necessary, it should be imposed as much as possible uniformly on all the goods (one should avoid different time schedules for products covered by the liberalisation process).

5. The FTA should induce Signatories to converge to the EC *acquis communautaire* in technical standards in manufacturing and agriculture (as is enforced by the Member state of their choice) or to technical standards already adopted by another WTO member of their choice and already subjected to some kind of international mutual recognition.

6. The FTA should not include a special safeguard provision in agriculture. Alternatively, it should subject its use to a time period specified in the Treaty: for instance, "x" (say 3) years after the inclusion of the farm good into the intra-FTA tariff regime, the use of such a provision should be prohibited.

7. The FTA does not need to include a specific provision refering to the national agricultural policy (as many current FTAs do) since other provisions of the Treaty could cope with all the aspects of such a policy. If a reference to farm policy is felt necessary, it should clearly state that such a

policy will be carefully designed for decoupling farm production and trade issues from farm income issues.

Services, investment, public procurement and TRIPs

8. The FTA should state the principle of liberalisation in services, to be complemented by two types of specific provisions. First, the FTA should focus on telecommunications, by includingthe core principles (in particular, the so-called "reference paper") of WTO liberalisation in this service, and by laying down the foundation of a joint and independent Regulatory Authority for regional telecommunications. Second, the FTA should specify a "built-in agenda" listing services to be liberalized (with specified dates and the possibility of an accelerating clause).

9. The FTA should prepare the ground for domestic liberalisation in investment, by a joint commitment to follow the core principles of the two OECD Codes on capital movements and invisibles.

10. Taking into account the importance of reconstruction, the FTA should include the core provisions of the WTO Plurilateral Agreement on public procurement with, in an Annex, an agreed short list of public bodies to abide by these provisions for a specified range of public bids.

11. In the context of the enforcement of the WTO TRIPs Agreement, the FTA should urge the Signatories to enable their independent competition authorities to deal with TRIPs-related provisions in a competition-friendly way.

Common provisions

12. The FTA should specify that each Signatory will have at most three tariff schedules: the preferential schedule between themselves, the preferential one with the European Community, and the MFN schedule. The FTA should contain a provision urging the Signatories to make these three schedules as close as possible to each other (see recommendation 21).

13. The application of rules of origin should be waived for goods for which the difference between the MFN (highest) and lowest preferential tariff rates is less than specified percentage (say 5%).

14. The FTA should not allow safeguards for infant industry, balance of payments and export reasons. Its antisubsidy provision should be drafted in the same spirit than Article 87(ex92) of the Treaty of Rome.

15. The FTA should include a general safeguard provision. A first option could be to draft such a clause in the same spirit than Article 134(ex115) of the Treaty of Rome. As this option requires a regional decision-making procedure, an alternative could be to follow the WTO approach, that is, imposing strict deadlines to safeguard measures.

16. The intra-FTA general safeguard provision reduces greatly the need for an intra-FTA antidumping procedure. If the Signatories want to keep such a procedure, they should discipline it, for instance, by banning the initiation of antidumping cases for goods subject to "small" (say 5 to 10%) and similar tariffs.

17. The FTA should urge the Signatories to enable their independent competition authorities to discipline public monopolies which could behave in a non-competitive manner only in cases of general interest.

RECOMMENDATIONS ON THE ANNEXES

18. The FTA should adopt a tariff-only policy on all the farm products currently subjected to tariff-quotas which have been not fulfilled during the "x" (say 3) last consecutive years. Abolished quotas should be replaced by preferential (positive) tariffs.

19. For those farm products maintained under the tariff-quota regime, the FTA should specify that quotas should be allocated under the "past performance" method, with a specified proportion of the quotas to be "transferable" (operators can sell and buy transferable licences).

20. The FTA should specify the progressivity with which these measures will be enforced.

21. The FTA should include similar measures for the industrial goods included in the Annexes, and subjected to quantitative restrictions.

RECOMMENDATIONS ON THE MFN TARIFF SCHEDULE

The following provision on the MFN tariffs of the FTA members is the most important provision for the economic success of a regional FTA (as illustrated by the EC history).

22. The FTA should contain a joint commitment by the Signatories to make their MFN tariffs converge towards the lowest possible MFN tariffs, or (at least) to the EC tariffs, according to a specified time table. If the MFN tariffs chosen by the SP5 countries are lower than the current EC tariffs, the SP5 countries have always the possibility to bind their tariffs at the EC level in their WTO commitments, and to apply the lower tariffs chosen.

INTRODUCTION

INTRODUCTION

Following an evolution already observed in the rest of Europe, the Central European countries participating in the Stability Pact for South Eastern Europe (hereafter the SP countries) have begun to negotiate free-trade agreements (FTAs) between themselves. Since April 1997, nine FTAs have been signed, and five of them have already reached their expected date of completion[1]. An additional impetus to this evolution has been recently given by the European Community (EC) with its Regulation 2007/2000 announcing a substantial unilateral liberalisation with respect to imports from Albania, Bosnia-Herzegovina (BiH), and Croatia.[2] Article 2 of this Regulation makes clear that the EC liberalisation is conditional: the beneficiaries shall be ready "*to engage [..] in regional co-operation with other countries concerned by the European Union's Stabilisation and Association process, in particular through the establishment of free trade areas in conformity with Article XXIV of the GATT 1994 and other relevant WTO provisions*." This regulation has recently been extended to Macedonia, as originally planned, and to the FR Yugoslavia, owing to the recent developments there, with Regulation 2563/2000[3]

The note examines the issues raised by the creation of such FTA(s). It focuses on the SP5 countries directly concerned by the EC initiative (Albania, BiH, Croatia, Macedonia and FR Yugoslavia) though it can easily accommodate the other Central European countries participating in the SP initiative (Bulgaria, Romania, Slovenia, and Turkey). Moreover, the core recommendation of the paper (recommendation 22, see below) is designed in such a way that the countries of the region, such as Bulgaria or Romania, which may find interesting to join the SP5 FTA, could do so without endangering in any way their accession process to the EC, if they wish so.

This endeavour should meet legal, economic, and institutional objectives. From the legal viewpoint, the SP5 countries should conclude "WTO consistent" FTA(s) because all the SP5 countries are or will be members of the WTO: in other words, the WTO will be, and will stay as, the anchor of the trade policy of the countries of the region. From the key economic perspective, the SP5 countries should seize the opportunity to sign FTA(s) which boost their current and future growth, and contribute to solving their pending economic and institutional problems. This is a serious challenge because, contrary to widespread belief, FTAs can be costly for the signatories if they are not well designed: they are costly for consumers (be individuals, firms or governments) when they distort trade, production and investment patterns; and they are costly for governments when they create or amplify the risks of corruption and losses of public revenue. Lastly, from the institutional perspective, the new trade policy should be as simple as possible in order to reduce the burden imposed on scarce administrative resources (for instance, by requiring Customs to implement complex regulations: in such cases, international support is a second-best policy, and it is preferable to get the right set of provisions first), and to minimise incentives for corruption. This last aspect of trade agreements is often neglected, although it can save a huge amount of money and effort in transition countries.

(i) The SP5 countries should use the opportunity of these FTAs to generate a political "Big Bang" signal showing that the region is moving firmly in the direction of integrating the world economy. The recent past should serve as a lesson: the fact that five FTAs have been already completed has remained largely unnoticed by the rest of the world -- meaning that the costly efforts devoted to conclude and implement these agreements have not been rewarded. In a world which offers a vast

[1] The list of these FTAs reveal the role of a few countries. Five FTAs include Macedonia, the partners being Bulgaria, Croatia, Slovenia, Turkey and FR Yugoslavia. Three involve Slovenia (with Croatia and Turkey, in addition to Macedonia) and Turkey (with Romania, in addition to Macedonia and Slovenia), two Bulgaria and Croatia, one Romania and FR Yugoslavia. Table 1 provides the expected dates of full implementation.

[2] Council Regulations (EC) No 2007/1000 introducing exceptional trade measures for countries and territories participating in or linked to the European Union's Stabilisation and Association process. Official Journal L240, 23.09.2000. p.1-9.

[3] Proposal for a Council Decision concerning the suspension of the trade and trade-related provisions of the co-operation Agreement between the European Community and the former Yugoslav Republic of Macedonia signed on 29 April 1997. European Commission Proposal COM2000 (680) final.

range of opportunities, countries compete in terms of quality of their policies, in particular of their trade policies, and this is even more important for small economies (in 1998, the aggregate GDP of the SP 5 is estimated at US$ 50 billion, that is, one-fifth of the GDP of Belgium).

(i) The SP5 countries should take joint commitments converging towards well-defined results at specified deadlines. The convergence notion is the basic concept behind all the recommendations suggested. It allows the possibility of a "one (regional) FTA" option or a "several (standardised) FTAs" option -- though the first solution is shown less costly and risky, and much more supportive of the Big Bang signal -- because in both cases, the SP5 countries would converge towards a common "state of affairs" at a specified date. The convergence notion means that, as soon as possible, the SP5 countries should not hesitate to converge towards results already reached, or to be reached in the future, by the EC -- such as some key aspects of the "*acquis communautaire*" for liberalising in services.

The "Big Bang" and convergence notions are instruments to deliver a liberalisation that is done for the domestic benefits it brings -- not to comply with external pressures or constraints.

The note analyses the existing FTAs in three sections. Section 1 examines the provisions included in their main text. Section 2 analyses the exceptions included in the various Annexes to the main texts. Last but not least, section 3 examines the relations between the FTA preferential regime and the "most-favoured-nation" regime granted to the other WTO Members: these relations are crucial for assessing the economic impact of the present and future FTA(s). Each section provides recommendations that are summarised in the attached Executive Summary.

SECTION 1. PROVISIONS INCLUDED IN THE MAIN TEXT OF THE FTAS

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The existing FTAs are the last incarnations of the European attraction to FTAs. This is a feature that the SP5 countries should take into account when designing their trade policy. There are roughly one hundred FTAs in Europe, and two-third of all the FTAs notified to the WTO involve European countries. The image of a "spaghetti bowl" comes naturally to mind for describing this situation. This concentration of FTAs in Europe may be explained by the fact that Europeans have found no other way for integrating their economies. But it is clear that this process is far from efficient, and plagued by costly inconsistencies and distortions.

Simplifying seems thus the right and urgent thing to do - and this conclusion seems to hold even more strongly for the SP5 countries which are newcomers to European trade affairs. What follows shows that it is not difficult to simplify the provisions of the main texts of the current FTAs: as shown by Table 1, many provisions of these existing FTAs are very close, although not completely identical.[4] The fact that it is not difficult to merge in one "standard" text the existing texts implies that choosing the "one FTA" option can be reached at no cost (bilateral FTAs would simply duplicate each other), whereas it can bring substantial benefits by sending a much stronger “Big Bang” signal.

Table 1 summarises the existing provisions to be examined, and what follows uses the headings of Table 1 (not necessarily those used in the FTA texts, but easier to understand).

1.1 OBJECTIVES

The two key issues in this respect are the scope of products covered by the FTAs and the transition period.

The transition period raises no legal difficulty: all the existing FTAs meet the WTO requirement of 10 years at most. The only problem in the future is that, if the SP5 countries are not prepared to negotiate one regional FTA, sticking to a deadline expressed in a number of years is not supportive of the “Big Bang” signal: dates of completion will be scattered over several years, reflecting the dates of bilateral FTA signatures and/or ratification. The region could end up as a free trade area -- but without the rest of the world having noticed it. If the "second-best" option of several bilateral FTAs is chosen, it should, at least, impose joint and specified dates at which all the FTAs key outcomes will be implemented (**recommendation 1**).

In contrast with the transition period, the scope of the products in the current texts raises legal problems. If all the FTAs refer to the WTO or to GATT Article XXIV, only three FTAs make a specific reference to the WTO criterion according to which FTAs should cover "*substantially all the trade*." In all the eight agreements, agricultural and industrial products are treated separately and with a different logic for the liberalisation process: all the industrial goods are liberalised, except those indicated in a few provisions or annexes (negative list), whereas only the agricultural goods listed in the annexes are liberalised (positive list).

This specific treatment of agricultural products in the existing FTAs creates a problem. As is well known, there is no WTO agreed rule for defining the expression "*substantially all the trade*." What follows relies thus on the rule of thumb of 90% of existing and fully liberalised trade that is suggested by the EC (e.g. see the Guidance Paper). This minimal rule of thumb is sufficient for defining the problems to be faced by the SP5 countries. Table 2 shows that the shares of agricultural trade (imports) of the SP5 countries vary between 11.3% and 27.9% of their total bilateral trade (first line of Table 2) and that farm imports subject to full preferences (“fully liberalised” in EC parlance) reach a peak of 2% (tenth line of Table 2, except in the Slovenia-Turkey FTA). As a result, even if one

[4] There is the possible exception of the FR Yugoslav-Macedonian FTA which will be most often left aside in the remainder of the report, because of our lack of precise information on its content and procedures.

assumes that all the exceptions concerning the industrial goods are fully transitory (hence will be eliminated on time), the existing FTAs between the SP5s examined in Table 2 cover between 70% (Croatia-Macedonia, from the Macedonian side) and 89% (Croatia-Slovenia, from the Croatian side). In other words, they shall be modified through the "*evolutionary or amendment clauses*" included in the existing FTAs, and the future FTA(s) shall clearly include agriculture (recommendation 2). Section 2 will show that the consequences of these changes are less dramatic that it may appear at a first glance, and that they can be well kept under control.

SECTION 2. FREE MOVEMENT OF GOODS

The FTA provisions concerning the free movement of goods can be divided into three groups: the provisions liberalising the intra-FTA trade; those on technical barriers to trade; and those on specific sectoral provisions (exceptions and safeguards). The first draft of the note leaves aside an important aspect of these provisions, namely the relations between the intra-FTA liberalisation and the FTAs between the SP5 countries and other parties to the Stability Pact (in particular the EC). This issue will be *de facto* addressed in section 3.

2.1 PROVISIONS ON TRADE LIBERALISATION

They are very similar between the existing FTAs - again meaning that the one FTA option imposes no additional cost, compared to several bilateral FTAs, whereas it will bring additional gains because of the simplifications it allows. Again, if the SP5 countries want to stick to the option of several bilateral FTAs, they should at least adopt a standardised presentation. Four Articles could deal with the import side: on duties and on charges having equivalent effects (CEEs) such as special customs duties, fiscal duties, etc.; on quantitative restrictions and on measures having equivalent effects (MEEs). The same approach could be taken for the export side -- provisions on removing barriers to exports should be maintained in the future FTA(s) in order to cope with the possibly long-lasting consequences of the legal regimes generated by the wars and civil disturbance in the region.

In addition to these formal improvements, the existing provisions on trade liberalisation suggest two comments on substance, all of them being essential from an economic perspective:

(i) *Standstill clause*. All the existing FTAs contain explicit standstill clauses, and that should also be the case for the future FTA(s) (**recommendation 3**).

(ii) *Schedule of liberalisation*. Certain existing FTAs impose a complex timing of liberalisation. Complexity in this domain (indeed fashionable in the FTAs since the early 1990s) is more costly than beneficial. It is supposed to give breathing space to certain industries compared to others. But, this discriminatory "progressive liberalisation" has visible and less visible costs. The visible costs flow from implementing complex schedules of liberalisation. Tailor-made schedules may remove the immediate problems of pressure groups asking the government to be the last ones to be liberalised. But they impose high pressures later. Once satisfied, the supporters of the early harvest have few incentives (if any) to care for the "late" harvest which then remains stuck for a long time in the hands of vested interests reluctant to liberalise. The visible costs consist also in incentives to classify imported products under the tariff items to be liberalised later (a source of corruption of Customs). The less visible cost of complex schedules of liberalisation is that they modify the "effective" level of protection enjoyed by the various domestic products. More precisely, they increase, during the transition period, the protection enjoyed by the last manufactured products to be liberalised relative to the protection enjoyed by the first products to be liberalised. As the products which are liberalised late are precisely those which have been already able to mobilise powerful vested interests (this is why their liberalisation has been delayed in the first place), the producers involved will be increasingly anxious to keep the benefits of this increasing protection, hence they will be increasingly opposed to the liberalisation process. If some "progressive liberalisation" is perceived as needed by the Signatories, it is better to grant it to all the products (***recommendation 4***)[5]. Such an uniform timing would be very helpful for reaching the institutional objective of minimising the FTA-related burden and corruption risks on scarce administrative resources in public administration and private firms.

[5] This progressive liberalisation approach has been used by the EC, at its beginning, between 1958 and 1968, and it has been essential for its success in the public opinion. All the exceptions which can be found in the initial Treaty (agricultural goods, bananas, transport) are still a source of intra-EC problems and conflicts today.

2.2 PROVISIONS ON TECHNICAL REGULATIONS

All the FTAs have provisions on technical regulations - defined in this note as technical barriers to trade (TBT, for industrial goods) and sanitary and phytosanitary measures (SPS, for agricultural products). Provisions on such regulations (which can constitute severe trade barriers) can be classified in four types: *(a)* a loose commitment to co-operation; *(b)* a commitment to abide by the disciplines of the TBT and SPS WTO Agreements; *(c)* a commitment to sign mutual recognition agreements (MRAs) for enforcing technical regulations (these MRAs are limited to the mutual recognition of the testing and certification procedures of each other); *(d)* a commitment to sign MRAs on designing common technical regulations and on enforcing them under the same rules. In the existing FTAs, provisions on TBTs tend to be of the (c) type, whereas provisions on SPS are more of the (a) type.

From an economic point of view, it is important to state that harmonisation of the technical regulations is not necessarily the best solution. Diversity has many economic rewards, but it may also be a disguised way to create trade barriers. Such barriers are particularly costly for the economy in question because they harm both the imports from the trading partners, and the domestic exports to these partners -- in other words, they hurt domestic consumers and efficient domestic producers all alike, to the advantage of inefficient domestic producers.

A balanced view between harmonisation and diversity is thus necessary. Type (a) provisions are not likely to be appropriate: they open the door to protection too easily and, as they do not refer to WTO disciplines, they do not allow use of WTO dispute settlement in these matters. Type (b) provisions should thus be considered as the minimum obligation to be fulfilled by the SP5 countries (confirming the necessity for all of them to be WTO members). The choice between the two other types (c and d) of provisions may take into account the following points:

(i) The SP5 countries, except Albania, share a common heritage in terms of technical regulations (from former Yugoslavia). Keeping these technical regulations under type (d) provisions could then be a valuable option: it will remove most of the protectionist risks which can be related to technical barriers, it will rely on already existing common technical regulations and common ways to enforce them. However, the experience of the other Central European countries suggests that technical regulations that have been designed under central planning are often inappropriate, and difficult to adjust to market economies. Moreover, in the long run, the prospect of EC accession means the adoption of the *acquis communautaire* in these matters. In sum, keeping technical regulations inherited from former Yugoslavia is likely to be a measure useful in the short or medium run to the extent that it minimises the risks of disguised protection.

(ii) The SP5 countries could limit the scope of FTA provisions on technical regulations to MRAs on testing and certification procedures (type c). However, the experience shows that such MRAs are extremely difficult to negotiate and to implement (see for instance, the difficulties faced by the EC-U.S. MRA). Moreover, they leave open the problem of designing technical regulations, with its associated risk of disguised protection.

(iii) As a result, a valuable approach could be to look for the best technical regulations already available in the EC or in the rest of the world) -- that is, to adopt the "*acquis communautaire*" and the technical regulations of the Member state, or those of a country in the rest of the world, which are judged as the best and most appropriate regulations for the product and the SP5 country in question. This convergence approach could go as far as accepting the testing and certification bodies of the Member state (or the other country) chosen as the appropriate example to follow. This approach will diffuse protectionist risks under pressure from domestic lobbies in the SP5; it will remove the burden of designing norms and standards, it will be well received by large firms (investors) because it does not cut the domestic market

from world markets; last but not least, it will allow a progressive transfer of technology from the foreign testing and certification bodies to the domestic equivalents ***(recommendation 5***).

A last important issue about technical regulations has to do with transparency. For good (the best design of technical regulations) or bad (the protectionist use of technical regulations) reasons, countries are often induced to change their technical regulations. The FTA members should make the early notification of any new technical regulation to the other parties mandatory.

2.3 PROVISIONS ON SECTORAL EXCEPTIONS

There are only a few provisions on sectoral exceptions in industrial products included in the main texts. These provisions cover textiles and clothing, coal and steel products, pharmaceuticals and automobiles. As they refer to annexes for the detailed measures or to Memoranda of Understanding, they are examined in more detail in section 2.

They are no provisions on exceptions in agriculture (agriculture means the farm and fishery sector *largo sensu*, that is, it includes processed agricultural products). This is because the FTAs have adopted a "positive list" approach: only farm products listed in the annexes are to be liberalised within the FTA scope. By contrast, there are specific provisions establishing a sectoral safeguard for agricultural products and referring to the pursuance of national agricultural policy. As is well known, agriculture is a very difficult sector from the trade perspective: distortions from domestic agricultural policies are so large that they are associated with huge levels of protection in many countries (not all of them) and massively distort trade flows (as illustrated by the EC Common Agricultural Policy). These specific provisions raise two questions: are they WTO-consistent? If yes, how to handle them in a way which does not jeopardise the whole FTA exercise?

(i) *Special safeguard provision (SSP) in agriculture*. There is a SSP in the WTO, but it is limited to goods subject to tariffication (it cannot be invoked for goods already under tariffs), and it has to obey to strict conditions (based on a threshold for imports which is determined by the import share in the domestic market) and procedures of implementation. Ignoring the WTO status of the SP5 countries (three countries are still not WTO members) leaves the fact that the existing FTA provisions do not mention the conditions for intervention (they only refer to consultations) -- hence, they are not WTO consistent. A first option could be to get rid off this clause: as argued below, the other instruments of contingent protection included in the FTAs are powerful enough to handle any difficult circumstance, and the intra-FTA trade in agriculture can be subjected to preferential but positive tariffs (in order to cope with the world situation in the markets involved). A second option would be to put a deadline on the use of a WTO-consistent SSP: for instance, "x" (say 3 for instance) years after the inclusion of the farm good in question in the intra-FTA tariff regime, the SSP could no longer be invoked against it ***(recommendation 6)*.**

(ii) *Reference to the national agricultural policy*. There is nothing in the WTO that bans the possibility to refer to domestic policies in a trade agreement, as long as the national treatment principle is satisfied. As a result, the main problem raised by such a reference is the balance between its necessity and its cost. In the "Big Bang" context, such a reference is costly because the agricultural sector is large in the SP5 countries, and because there are many provisions in the FTA texts which could cope with the concerns expressed by this reference: *(a)* Article 1 or 2 specifies that the FTAs aim at promoting domestic economic activities; *(b)* the article devoted to General Exceptions allows to deal, in a non-discriminatory way, with all the possible situations concerning environment or health concerns; *(c)* the article(s) on safeguard measures, be specific or general, do(es) the same for emergency cases. As a result, it would be profitable to drop a specific article to such a reference. An alternative (weaker) option would be to make clear that the national agricultural policy will be carefully designed to de-couple farm production and trade, on the one hand, and, on the other hand, farm income issues ***(recommendation 7)*.**

SECTION 3. SERVICES, INVESTMENT, PUBLIC PROCUREMENT AND TRIPs

The existing FTAs look backwards. Almost 95% of their text is driven by considerations related to manufacturing and agriculture which represent only roughly one-third of the SP5 GDP -- a proportion which has been largely inflated by the recent wars and civil troubles, and is thus bound to decrease. By contrast, the FTA texts are almost completely silent on services (which represent 65%-75% of the GDP of a typical modern economy), on investment (which is as important as trade in the modern forms of globalisation), on public procurement (key for an economically sound reconstruction of the SP5 economies) and on TRIPs (important in the SP5 economies potentially rich in skilled labour).

3.1 SERVICES

There is no reason to believe that the SP5 countries have no comparative advantages in certain services. All the SP5 countries (except Albania, because of her past political isolation) have a past of both service providers and intensive users of services -- tourism being the best example of a service produced in the country and using many other services provided in both the countries of origin and destination of the tourists. In this context, the very limited provisions on services in the existing FTAs is a serious flaw: only four FTAs mention the possibility of future commitments in services and only one has a specific reference to the right of establishment.

The silence of the FTAs on services may be explained by well-known reasons. In particular, there is no clear and well tested way to negotiate in services -- as best illustrated by the so-called EC Single Market Programme EC (eight years of negotiations of between 1985 and 1993, a slow implementation starting effectively only in the late 1990s, with new negotiations on services already necessary for almost all the services). Moreover, services, although needing a friendly institutional environment, do not necessarily require public policies: for instance, an open attitude towards foreign investment can very rapidly change the way distribution services (wholesale and retail) are provided in a country, as best shown by certain Central European countries.

The importance of services requires thus action, even if this action could be kept minimal at the beginning. A way to reconcile these conflicting goals would be for the FTAs to focus on a handful of services where the situation is clearer and the solutions easier to conceive. For instance, a sector for some immediate action could be telecommunication services (hereafter, telecom), defined as a wide range of services from telecom calls to Internet, high-speed and large capacity networks, etc. Liberalisation in telecom presents many advantages (in addition to the essential fact that it has already made progress in the SP5 countries)[6] it is probably the most growth-conducive liberalisation (technical progress in this domain has massive positive spill-over effects on other good and service markets, and catching up in this sector can be quite rapid); it is a pre-condition for developing modern services (telecom is an essential input for many services); it creates many new jobs (skilled and unskilled) hence it generates very limited social problems; and it is the only example of successful WTO liberalisation (the WTO Agreement on financial services is a mere commitment to the status quo in terms of trade barriers). But, certain service sectors could be envisaged for very specific reasons (such as railways, see below).

The SP5 countries have several options for drafting the FTA provisions on telecom, and one can sketch a few of them. A minimal option would be to explicitly mention the progressive opening of services, with a special reference to telecom. A slightly more ambitious option would be to include

[6] In Albania, the national mobile operator was sold and the end of the monopoly on fixed-line service is planned for 2003. In Croatia, the main fixed line operator has been privatised and a new law providing for the establishment of an independent regulator has been passed. Bosnia and Herzegovina has a new telecommunications law since 1998. In Macedonia, a tender has been announced for a majority stake in the national operator. Finally in Slovenia, a draft law on telecommunications in line with EC directives was presented to the parliament in June 2000 and the government intends to sell its majority share in the national fixed-line operator. Indexes of progress in transition in the telecommunication sector range from modest (2-2+) to substantial (3-3+): 2 (Macedonia); 2+ (Slovenia); 3 (Bulgaria, Romania); 3+ (Albania, Bosnia and Herzegovina, Croatia) [EBRD, Transition Report 2001].

the principles of the WTO "Reference Paper" on telecom as the guiding principles of the FTA(s). A more ambitious option would be the joint commitment of the SP5 countries to adopt as national laws a few key EC Directives in telecom (on mobile telephony and network access) by a given deadline: the reference to EC Directives leaves a lot of flexibility to SP5 governments in their own domestic laws (EC Directives represent the "best" practice in an European environment dominated by a tradition of public telecom monopolies, and they can lead to noticeably different regulatory regimes, as illustrated by the differences between the current telecom regulations among the EC Member states). The most ambitious option would be to create a joint Telecom Regulatory Authority in charge of designing the regulations in telecom for the whole SP5 area, and of pooling the bids for telecom services for the area. The "pooling" aspect would protect somewhat the SP5 countries against two risks: to table bids in which no first-rank firm is interested (because the SP5 national markets are so small), that is, to avoid being obliged to work with less efficient foreign firms; and to minimise the high risks of having domestic markets monopolised by the winning foreign firms (in small markets, international operators ask often for monopoly rights) which mean that the gains from liberalisation may be captured by those foreign firms (under the form of rents or of resources wasted by inefficiencies), at the detriment of domestic consumers.

In addition to telecom, a few other services of prime interest for the SP5 countries -- such as railways (the heritage of the former Yugoslavian railways could be used as the basis for creating a regional independent regulatory agency opening the use of tracks to competition) or energy services (on the same basis) should be considered for an early harvest. The rest of services should be included in a built-in agenda for further liberalisation, with deadlines for starting negotiations and getting results ***(recommendation 8)*.**

3.2 FOREIGN DIRECT INVESTMENT

No FTA, except one, has a specific provision on investment. When mentioned, FDI is often limited to investment in services. In a certain way, that is not astonishing: there are no WTO rules on investment except in services, and the EC Treaties have always been weak in their investment component. As a result, it may be too difficult to use the FTA(s) for opening the SP5 capital markets.

However, this absence of multilateral rules is a handicap for small countries in transition: it induces them to "compete" for foreign investments in a very expensive way, as best illustrated by the many cases in Central European countries which have granted privileges to foreign investors (including under the form of very discriminatory trade regimes, such as in the car, electronic and tobacco industries) and subsidies at very high costs for the country in question. In this respect, the FTA(s) may be very helpful for setting common standards. The best option is to look at the two OECD Codes on capital movements and on invisibles in order to extract from them the few core principles that all the FTA(s) members will commit to abide by a defined deadline ***(recommendation 9)*.**

3.3 PUBLIC PROCUREMENT

The existing FTAs have very loose provisions on public procurement, when they address this issue. Public procurement is a key activity in countries in transition that, in addition, have faced some massive destruction during wars or civil distrubances.

The interest of some common rules is particularly important for medium-size contracts and bids -- large contracts are under the scope of international institutions, and small contracts do not require an urgent need of some co-operation. A pragmatic, but efficient, way to address this issue would be to draw from the WTO plurilateral agreement the key provisions, and to negotiate a joint list of public bodies (ministries, cities, provinces, etc.) which would launch regional bids ***(recommendation 10)***. Initially, the list could be short, if accompanied by an agreement to extend the list by fixed deadlines.

3.4 TRIPs

The WTO TRIPs agreement may be a discipline strict enough, so that there is no necessity to duplicate it at the FTA level (indeed, there are few EC Directives on TRIPs topics).

However, a balanced enforcement of the TRIPs agreement requires a substantial role from competition authorities. This balance should be recognised in the FTA(s) ***(recommendation 11).***

SECTION 4. COMMON PROVISIONS

Common provisions can be divided in three major types: rules of origin, instruments of contingent protection, instruments of competition.

4.1 RULES OF ORIGIN

FTAs require rules of origin because different tariffs are imposed on similar goods in accordance with their origin of "production." In fact, rules of origin are becoming easily and rapidly a source of considerable complexity and confusion -- hence a big nuisance to trade and costs on the economies. Two points deserve attention:

(i) As they impose a heavy burden on Customs which are required to make complex distinctions between often closely similar products, they are a source of direct costs: more Customs officers and regulations are necessary when there are rules of origin than in their absence. Moreover, as the detailed assessments of the Customs officers are essential and hard to monitor (except at very high costs), rules of origin easily become an important source of public spending and tax evasion (that is, a double source of costs for public budget), and of corruption (a source of costs for the society as a whole).

(ii) Rules of origin have the capacity to distort trade flows and to amplify the economic costs of FTAs. This point is seen in more detail in section 3.

As a result, a "cost-minimising" FTA should aim at minimising the complexity and product coverage of rules of origin.

(i) Minimising the number of different tariffs which can be imposed on a specific product is a way to minimise the complexity of the implementation of rules of origin. Ideally, the SP5 countries should commit themselves to have only three types of tariffs for every product: at most, two preferential sets of tariffs (between the SP5 countries and between the SP5 countries and the EC) and the set of MFN tariffs ***(recommendation 12)***. This approach has the additional advantage to impose some disciplines on the number of FTAs because it implies that any preferential agreement with a country should be aligned to one of the two preferential tariffs.

(ii) Fixing these three tariffs by product as close from each other as possible will reduce the product coverage of these rules of origin. For instance, if the preferential tariff for a good differs from the MFN tariff by (say) 5% or less, the risk of trade circumvention can be considered as so limited that there is no need for rules of origin for such a product ***(recommendation 13).***

All these ways to minimise the scope of rules of origin may help to keep them as simple as possible (that is, based on the change of tariff headings) -- a key goal to keep in mind.

A last important point (taken into account the vast nuisance capacities of rules of origin) deserves a remark: rules of origin constitute one of the strongest arguments in favour of one FTA between all the SP5. Rules of origin included in a single FTA will be much easier to implement than a set of rules, more or less well harmonised, and scattered in several FTAs.

4.2 INSTRUMENTS OF CONTINGENT PROTECTION

The existing FTAs rely on no less than six instruments of contingent protection: antidumping, anti-subsidy and four different types of safeguards (the first three of which echo the three versions found in the GATT text), namely general safeguard, safeguard for balance of payment reasons, safeguard for

infant industry (all of them involve imports) and safeguard for shortage (on exports). During the 1990s, the general tendency of the FTAs has been to be lax on these instruments (for instance, the general absence of precise and economically sound criteria for "injury to domestic producers"). At the time, this lax approach did not appear as costly to the FTA signatories: governments and firms alike did not pay much attention to instruments which (they believed) would remain rarely used. Today, the situation has dramatically changed: the use of instruments of contingent protection has been skyrocketing, in terms of users, coverage, level of protection -- and these instruments raise deep concerns all over the world. Adopting the lax approach of the 1990s in these domains would thus be a major mistake for the SP5 countries: it will ruin the region's efforts to build a "Big Bang" signal for a credible effort of joint liberalisation.

That being said, a pragmatic approach should be taken in order to discipline these instruments. It should be based on the following question: what will really be lost if the use of such instrument is limited? The history of world trade relations during the last decade suggests strongly that little (if any) will be lost by eliminating the safeguard for infant industry, and the anti-subsidy instrument, and not much more will be lost by limiting the safeguard for balance of payment reasons -- in other words, modern contingent protection relies almost entirely on antidumping, and much more marginally on the general safeguard.[7]

This conclusion (which merely reflects the use of the various instruments of protection during the last decade) is reinforced by the following legal and economic considerations. First, the GATT safeguard for infant industry is strictly related to the status of "developing country" (it is included in GATT Article XVIII), and none of the SP5 countries has so far requested such a status -- meaning that the existing FTAs are unlikely to be WTO-consistent. Second, anti-subsidy measures are rarely used because their implementation creates political difficulties (in contrast with antidumping) for outcomes which can be much more easily reached by antidumping. Lastly, the use of the safeguard for balance of payment reasons is an economic mistake (balance of payment problems should be cured by appropriate macroeconomic policies) and its misuse for protectionist purposes has an increasingly high political cost (it is much less fashionable that it used to be).

Ignoring these tendencies (that is, drafting the FTA(s) as if one were in the early 1990s) would be a huge mistake in the "Big Bang" perspective. Drawing the conclusions from these world-wide tendencies suggests the following actions with respect to the "redundant" instruments of contingent protection: *(a)* eliminating the safeguards for infant industry and for balance-of-payment reasons from the FTA provisions; *(b)* keeping the anti-subsidy instrument, but under its version of the Treaty of Rome (Article 87ex92) which makes much more economic sense because it requires that the subsidising country shall stop subsidies (and not that the importing country is allowed to countervail the subsidies of the FTA partners, as the WTO allows) ***(recommendation 14)*.**

That leaves the general safeguard provision and antidumping as the instruments of contingent protection -- a situation reflecting the current practice in most of the WTO members. Both instruments could be kept, but they should be disciplined (they involve the intra-FTA trade, not the trade with the rest of the WTO members):

(i) the general safeguard could be made closer to its counterpart of the Treaty of Rome (Article 134ex115 on both trade deflection and Member state economic difficulties). However, such an evolution may require a few years (it could be included by a pre-determined deadline). This is because it raises the issue of the existence of an executing body -- such as the Commission in the EC (as indeed, an anti-subsidy provision similar to Article 87ex92). This institutional problem could be solved by empowering a joint committee of independent national authorities in the SP5 countries (for instance, the competition authorities) to

[7] The shortage safeguard is a remenant of trade barriers under central planning (focusing on exports) and of the recent wars and civil troubles. It should be phased out (with the appropriate caution for goods, such as pharmaceuticals, in order to minimize price swings).

implement the general safeguard (and the anti-subsidy provisions as well). During the years preceding this solution, the SP5 countries may choose the WTO approach: imposing deadlines on the implementation of safeguards -- for instance, (say) three years plus two years ***(recommendation 15)*****.**

(ii) Disciplining antidumping between the FTA members is more difficult because of the (assumed) absence of any Secretariat that could handle the task that has been the Commission's task for the intra-EC antidumping provision. It is important to note that the EC has chosen to keep a safeguard clause (which has been used to a significant extent), and that it has almost never used the provision on intra-EC antidumping. This preference for safeguard over antidumping makes a lot of sense. Many studies have shown that in almost all the antidumping cases, dumping is not really what is at stake: it is only an excuse for protectionist measures, as best shown by its intensive use by the steel, chemical, or electronic industries in the world. The SP5 countries could then choose to follow the EC history, hence to eliminate the antidumping instrument, and keep only the safeguard instrument. Alternatively, they could try to impose limits on the use of antidumping. For instance, as dumping behind small and similar tariffs is a perfectly acceptable instrument of competition, [8] the use of antidumping could be banned for all products protected by small and similar tariffs ***(recommendation 16)*****.**

4.3 INSTRUMENTS OF COMPETITION

In small economies, competition flows largely from an open trade regime. Nevertheless, the SP5 countries have a heritage of public monopolies that may not be dismantled quickly (the GDP share of private sector ranges from 35% in Bosnia to 70% in Bulgaria). As a result, provisions similar to those of the Treaty of Rome making clear that public monopolies should be subject to competition in all activities, except those of general interest, would be essential. Moreover, a joint commitment of an increasingly wide and strict enforcement of existing domestic competition laws would be also useful, particularly for the services which will not be rapidly open to foreign competition ***(recommendation 17)*****.**

[8] In such a tariff configuration, the only possibility for an export price to be « unduly » lower than the corresponding domestic price (or cost) would be the existence of subsidies provided by the FTA partner. This problem should be addressed by the anti-subsidy approach suggested in the « common provisions ».

SECTION 5. THE ANNEXES

The section is largely devoted to agriculture: in this sector, the annexes are essential because concessions are *de facto* conceived as a regime of exceptions.

5.1 AGRICULTURE

What follows has two goals: *(a)* to assess in detail the scope and magnitude of the preferences included in the seven FTAs; *(b)* to suggest procedures for improving the existing concessions in order to meet the WTO requirement of substantially all the trade and to be more economically sound. As there is no information available for the Macedonia-Bulgaria FTA (the Macedonia-FR Yugoslavia FTA is again left aside in this first draft), the seven FTAs contain 14 lists of concessions (one for each of the FTA partners). Only five of these lists involve a SP5 country.

5.1.1 Scope of preferences: product coverage

In the seven FTAs, concessions in agriculture are granted on the basis of "positive lists:" only the farm products mentioned in the annexes are subject to some kind of preferences -- the other ones continue to be excluded from the agreements. Table 2 gives a sense of the product coverage of these positive lists by giving the number of HS 6 digit codes lines included in the lists of concessions. The product coverage is from very low to low: it ranges from 35 lines (concessions from Macedonia to Slovenia) to 144 lines (concessions from Slovenia to Croatia). As there are 739 lines for agricultural products (defined as the number of HS6 digit items falling into HS1 to HS24 categories), the product coverage (in terms of HS6 digit items) ranges from 4.8% to 19.5%.

Of course, this indicator is crude -- though its use is legitimised by the fact that trade partners tend to grant each other preferences on roughly the same number of tariff lines (as clearly illustrated by three FTAs). An additional indicator would thus be useful -- a natural candidate would be the import coverage. Before computing this indicator, it is necessary to describe the instruments used for liberalising.

5.1.2 Scope of preferences: the instruments used

Table 2 shows that concessions have taken essentially three forms. First, there are cases where tariffs are eliminated on all the imported quantities from the FTA partner, and where there is no quantitative restrictions. This situation is rare: it is present in only three FTAs and the SP5 countries have adopted this approach in only one instance (concessions from Macedonia to Turkey) out of the five lists of concessions involving them. Second, there are cases with tariff reductions and no quantitative restriction: these cases are slightly more frequent -- but again a SP5 country has adopted this approach only once. The last form of concessions is thus by far the most frequent one -- it is almost the only one used by the SP5 countries. It consists of tariff-quotas: the MFN tariff is reduced or eliminated within a defined preferential quota, and then raised back to its applied MFN level once the imported quantity exceeds the quota level.

This situation suggests a first general comment. Eliminating or reducing tariffs under a quota regime is likely to be a very costly policy: it leaves the rents associated with the quotas in the hands of private interests. A much better policy consists of imposing tariffs without quotas (the same tariff on all imported quantities of a product). Of course, this policy remains compatible with the FTA exercise: it corresponds to the case where the preferential tariffs granted by FTA members to each other are non-zero (positive) and uniform (the same for all the FTA members). Keeping such tariffs may be felt necessary by the SP5 governments for coping with the worldwide production and trade distortions in agriculture.

Which farm products should be immediately eligible for a tariff-only policy? The answer is all the products for which the existing quotas are not filled by imports. Assuming that a quota is filled when imports amount to 100% of the authorised quota (a conservative threshold, since a quota is often considered as filled when imports amount to 90% of the quota), Table 2 shows that most farm products imports under preferential regime do not fill their quotas -- meaning that tariffs are still high enough to limit imports, or that there is no substantial exporter of the farm products in question in the partner country. In sum, for all the farm products with non-filled tariff-quotas, the regime should be switched to a preferential tariff-only policy ***(recommendation 18)*****.**

When tariff-quotas are maintained, which should be the best way to allocate these quotas (to provide the quota licences)? Experience (confirmed by the recent implementation of the tariff-quotas adopted by the OECD countries under the Uruguay Round Agreement on agriculture) suggests that the best procedure is to allocate quotas to firms on the basis of past performance (for instance, the performance of the three last years), and make them transferable between all the firms, with a portion of the overall allocation put aside for new entrants to the market. This method should be adopted by the SP5 countries as the standard and common method for quota allocation ***(recommendation 19)*****.** If it is feared that shifting to a tariff-only policy without any transition could be accompanied by import surges (though those are likely to be limited by the tariffs still enforced), a progressive relaxation of the quotas (by an annual fixed percentage, say 10%) should be adopted ***(recommendation 20)*****.** In fact, this whole approach echoes the Uruguay Round in agriculture that has mainly consisted in shifting away from all kinds of perverse instruments of protection to *ad valorem* tariffs.

These recommendations do not address possibly frequent situation: it may happen that quotas have not been filled because the allocation method used has been a trade barrier powerful enough to deter imports. As illustrated by the implementation of the tariff-quotas adopted by the OECD countries under the Uruguay Round Agreement on agriculture, quota allocation methods still have strong potential to be a source of important restrictions. Unfortunately, in none of the examined FTAs, is the method of quota allocation clearly specified (moreover, each country applies its own licensing policy without having to report to the other party). However, the FTA texts suggest that many elements of non-tariff barriers are likely still to be present in the allocation methods used, in particular: *(a)* the allocation of the quota twice a year, introducing a seasonal element likely to protect domestic producers more strictly during the crop season; *(b)* the annual review of the tariff-quotas which could lead to reduced quotas; *(c)* the definition of the product under tariff-quota by means of very disaggregated tariff codes, and in some cases, by *ad hoc* description (wheat for sowing only). As a result, the FTA text should impose the notification of the quota allocation mechanism that will be used during the period necessary for eliminating the quota regime.

5.1.3 Scope of preferences: the tariff level

A last important note is the level of the tariff preference margin (the difference between the MFN tariff and the preferential tariff) for each farm product granted to the exporters of the FTA partner. Table 2 provides some information -- limited by the fact that the calculations are based on the *ad valorem* part of the duties only (most products are also subject to additional specific duties in Bulgaria, Croatia, Macedonia and Slovenia, with estimates varying between 5% and 20% *ad valorem* equivalent for Macedonia). Keeping in mind that the following figures may be gross underestimates in some instances, Table 2 shows that the magnitude of these preference margins varies considerably, from very limited tariff reduction at high tariff levels (Bulgaria) to significant concessions (Slovenia). Based on data available for Croatia, the weighted average of the margin of preference, relative to MFN treatment, granted on imports from Macedonia is 30.5%. Margins of preference granted by Macedonia are respectively 19.4% (Croatia), 26.6% (Slovenia) and 22% (Turkey). Starting with lower tariffs, margins of preference granted by Slovenia are lower: 12.2% (Macedonia) and 4.2% (Turkey, but also because tariff reduction is lower).

5.1.4 Scope of preferences: the import coverage

It is now possible to create indicators of the import coverage for assessing the level of preferences under the existing FTAs. Indicators have been calculated for three types of preferences:

(i) *Full preference*. It is measured by the share (with respect to total farm imports) of the imports benefiting from the complete preferential elimination of tariff and non-tariff barriers. This is the only indicator that could really qualify for the calculation of the 90% threshold for "substantially all the trade".

(ii) *Managed preference*. The share of the imports within the quota limits and subjected to tariff elimination, such as all the tariff-quotas in the Croatia-Macedonia FTA (ignoring the 1% registration duty) is added to the full preference share.

(iii) *Limited preference*. The share of the imports within the quota limits and subjected to some degree of tariff reduction is added to the managed preference share.

Three lessons can be drawn from these indicators provided by Table 2:

(i) the import coverage of the full preferences situation is tiny (except in the Slovenia-Turkey FTA, at least for the Slovenian list of concessions, since trade data is missing for calculating the trade coverage of the Turkish list). In none of the cases is this share large enough to reach the threshold of 90% to meet the WTO requirement of "substantially all the trade."

(ii) Managed preference dominates the FTAs signed by the SP5 countries. The fact that so few quotas are filled whereas tariffs are eliminated implies either that there are no efficient exporters among the trading partners, or that the quota allocation method is severely restricting trade.

(iii) Limited preference dominates the FTAs between the other SP participants.

These lessons strongly suggest that the recommendations presented above (in paragraph 1.2) should be implemented.

5.1.5 Scope of preferences: inconsistencies

Three SP participants (Macedonia, Slovenia and Turkey) have signed more than two FTAs (respectively 3, 3 and 4, out of the FTAs covered by Table 2). This feature raises the following question: to what extent are the concessions granted in one FTA by a country similar to the concessions granted in the other FTAs by the same signatory? The expected answer is that concessions should be relatively similar, at least in terms of product coverage (the magnitude of tariff reductions and quota sizes could vary, if only in reaction to the list of concessions from the FTA partner).

Tables 3 to 5 provide a quite different -- and surprising -- answer. Almost 75% of the concessions are exclusive to a single partner for Slovenia and Turkey, and the ratio is only slightly lower (70%) for Macedonia. The reasons for such differences are difficult to assess in the absence of more detailed information on the circumstances surrounding the negotiations and conclusions of the FTAs. More important than the reasons are the consequences of such a diversity:

(i) domestic farm sectors are exposed to fragmented foreign competition: a market open to one FTA partner is not open to the others. As a result, discretionary protection is maximised, and rents are easier to collect.

(ii) such bilateral differentiation of concessions paves the way for trade and FDI diversion, or for corruption based on inexperienced customs institutions, meaning that products will circumvent rules of origin in order to enter through the most beneficial tariff regime.

Reduced tariffs under PTAs may generate some trade creation effects, but, as they discriminate against potentially more efficient producers from other countries, they may also generate important welfare-reducing trade diversion effects. The more important the margin of preference, the potentially larger the diversion. Additionally, with the actual system of preference under tariff quotas, it is most likely that the trade creation effect will be considerably eroded (in particular because of wasteful rent seeking), whereas trade diversion will be magnified. Combating strong incentives to cheat like these ones requires that rules of origin are efficiently administered -- imposing a heavy administrative burden on SP5 governments which should devote their time and efforts to more growth-oriented activities. It is doubtful, however, with possibly permeable borders that circumvention will be eliminated.

5.2. MANUFACTURING

The regime for industrial products is much more simple. In all the FTAs (except again the Macedonia-FRY agreement, in which vehicles are excluded from the scope of the FTA and some industrial products are subjected to quantitative limitations), all industrial products are granted or will be granted, by the end of the transition period, duty-free access. In one instance, a specific regime is outlined for textile products, referring to a specific memorandum of understanding: however, in the absence of further information on the memorandum content, it is not possible to check whether (and to what extent) trade in this product is subjected to a specific regime. In any case, the following rule should be followed: if certain industrial goods are under quotas or tariff-quotas they should be subjected to the same recommendations to those suggested for the farm products ***(recommendation 21)*.**

The simplicity and transparency of the regime for industrial products in a FTA context must not, however, conceal the fact that a duty free regime for industrial products may result in the creation of possibly significant margins of preference that can be very costly for the FTA members. The following section addresses this essential problem.

SECTION 6. THE FTA(S) AND MFN TARIFFS

Economic literature insists on the fact that FTAs generate potential costs that can reduce, and even more than offset, their expected benefits. That FTA costs can be larger than benefits is not an academic curiosity: less than a handful of the 120 (or so) FTAs signed between 1950 and 1990 have survived more than a few years. The balance of FTA costs and benefits depends on three components: static, dynamic, and political.

6.1. STATIC COSTS AND BENEFITS

FTA-related static benefits flow from trade "creation": the producers from the FTA partner who are efficient by world standards are substituted to relatively inefficient domestic producers of the FTA signatory in question. FTA-related static costs come from trade "diversion:" the discriminatory reduction of trade barriers between two FTA signatories allow relatively inefficient producers from the FTA partner to substitute for more efficient producers located in the rest of the world. Economic analysis presents many reasons suggesting that static costs can easily offset (and more) static benefits.

What then can be done to minimise such static costs (trade diversion)? A reasonable rule of thumb can be drawn from looking at the "preference margin" (the difference between the MFN tariff and the preferential tariff imposed on every product by a FTA signatory). For instance, Table 6 shows that Macedonia imposes a MFN tariff of 34% on apparel (this average for the sector is taken as a proxy of the situation for each apparel product). If Macedonia grants a preferential tariff of 0% on apparel imports from the EC, she grants a preference margin of 34% on EC exporters of apparel. These preference margins are foregone tariff revenues for Macedonia on imports from the EC.

(i) In case of trade creation (EC producers are assumed to be among the most efficient firms by world standards), these foregone revenues go to the Macedonian consumers who then benefit from the lowest possible world prices (EC costs are assumed to be the lowest in the world, and there is no Macedonian tariff on these imports).

(ii) But, in case of trade distortion (EC producers are assumed to be less efficient than the most efficient firms in the rest of the world), the foregone Macedonian tariff revenues are captured by EC firms because these firms can export to Macedonia, even if their costs are 34% higher than the costs of efficient world producers. In sum, the Macedonian consumers pay no tariff revenue to their own government, but they pay this money to inefficient EC firms.

A symmetrical reasoning can be applied to the EC that imposes a tariff of 10.6% on apparel. If Macedonian firms are efficient by world standards, EC consumers pay no more tariff revenue, and they get better prices (equal to low-cost efficient Macedonian producers). If Macedonian firms are not efficient by world standard, then the foregone EC tariff revenue is captured by Macedonian firms. But then, note that the EC is "losing" less than Macedonia: Macedonian consumers may pay up to 34% more than the world price, whereas EC consumers may pay up to 10.6% more than the world price. In addition to such direct costs, the FTA generates indirect costs (as already mentioned, rules of origin are imposed in order to strictly segment the two markets; to be enforced, they require a heavy investment in Customs capability; nevertheless, they may also induce smuggling and corruption). Clearly, a much better solution would be for the FTA partner with the highest MFN tariff to converge towards the lower MFN tariff of its partner: its consumers will benefit from lower prices.

Allowing for more than two partners in the FTA may complicate this simple example (depending how much substitute products come from the various FTA members and how different the size of the FTA economies is). But from a policy perspective, the above rule of thumb remains useful: the smaller the preference margins are, the lower the risks (and costs) of trade diversion are -- and the key for achieving such a result is the MFN tariff policy. In the case of the FTA between the SP5 countries, this rule of thumb suggests two actions.

(i) In the case of farm products, the markets for which are heavily distorted by the farm policies of most OECD countries (in particular EC CAP), the SP5 countries may feel it necessary to keep high MFN tariffs so that limited preference margins could be achieved by moderate preferential tariffs. This option is the (admittedly imperfect) outcome of converging pressures from the distorting farm policies of most OECD countries, political constraints in the SP5 countries, and the tariff-only policy (see recommendation 18).

(ii) In the case of industrial products and farm products not much influenced by farm policies, preferential tariffs can be zero if MFN tariffs are low.

These two actions give the necessary degree of flexibility allowing *(a)* to fulfil the "substantially all the trade" condition, *(b)* to meet the economic condition of a liberalisation as uniform as possible (these two first points impose that trade liberalisation between the SP5 countries includes agriculture),and *(c)* to keep things under control (since it is not equivalent to the complete elimination of trade barriers in agriculture).

How "low" should the MFN tariffs of the SP5 countries be? A first solution would be that every FTA partner aligns its tariff for a product on the lowest tariff imposed by the other FTA members on the same product, or even to lower tariffs -- ideally up to zero tariffs, *à la Estonia*.

An alternative solution would be the joint commitment by the SP5 countries to make their MFN tariffs converging to the EC MFN tariffs by a specified date. Though more limited, this second approach keeps several advantages:

(i) It reduces *de facto* the risks and costs of trade diversion because the EC tariffs tend to be lower than the current SP5 tariffs (see Table 6) so that the SP5 countries have less chance of facing a trade diversion situation (or to face less costly trade diversions) than if they keep their current tariffs.

(ii) If all the FTA members enforce the EC tariff schedule, they will grant to each other (and to the EC) the same preference margins. In other words, they will eliminate situations of "asymmetric preference" - when one of the two FTA partners "grants" a higher preference margin than the other by keeping a higher MFN tariff which can be the cause of bitter conflicts.

(iii) The convergence to the EC tariff automatically eliminates all the tariff issues associated with the accession of the Central European countries to the EC before the SP5 countries, and of a SP5 country before its FTA partners. As other Central European countries are themselves converging towards the EC tariff, it will be easier for the SP5 countries to sign FTAs with them and by the same token increasing the size of the markets to which their products have access.

(iv) The convergence to the EC tariffs will make the fulfilment of recommendations on the "common provisions" part of the FTA text much simpler. For instance, it eliminates, or substantially reduces, the product coverage of rules of origin within the FTA and makes antidumping even more obsolete, leaving the safeguard instrument as the only sensible instrument of contingent protection.

(v) Once tariff convergence is achieved, the SP5 producers will operate in a tariff environment as stable as that of their EC competitors (instead of being obliged to adjust to a series of tariff changes).

(vi) last but not least, SP5 consumers will benefit from prices much closer to world prices (because the EC tariff is, on average, lower than the SP5 tariffs).

The convergence to the EC tariffs has obvious costs. The most important is that EC MFN tariffs have peaks for precise products or groups of products (as shown by Table 6). These are often amplified by barriers, such as quotas in textiles and clothing, anti-dumping duties or voluntary export restraints (not shown in Table 6).

This is why the SP5 countries may be well advised to blend the two convergences: to the lowest tariff politically acceptable in the region and to EC tariffs in other instances. ***(recommendation 22).*** Such a blend can be done in a very flexible way if the SP5s bind their WTO tariffs at the EC level -- but apply lower-than-bound tariffs when they feel that it is in their economic interest. Such a blend solves many problems. First, the future accession of the SP5s to the EC will not create difficulties: when acceding to the EC, the SP5 country will raise its tariffs on its SP5 partners from their applied to their bound level. Second, such an approach is flexible enough for allowing countries in the region, such as Bulgaria or Romania, which may be interested in joining the SP5 FTA to do so without endangering their own accession process in any way. Last but not least, it allows the SP5 countries not to tightly link their trade barriers to the EC: since their accession to the EC is far away, the SP5 countries have a strong interest in keeping as many tariffs as possible lower than those of the EC -- in order to reap all the potential benefits from trade liberalisation.

6.2. DYNAMIC COSTS AND BENEFITS

FTAs may generate dynamic benefits and costs because of changes in production location or investment pattern. They may decrease the "costs of trading" (for instance, through the mutual recognition of product standards or of regulations of services) and/or generate foreign direct investment and technology spillover. Such gains can be reduced or (more than) offset by costs. For instance, discriminatory agreements require rules of origin making customs procedures that are more complex and costly, investment decisions more based on trade regulations and less based on economic comparative advantages. These costs are very likely in the case of "hub and spokes" FTAs between a large and dominant economy and small economies (such as between the EC and every SP5 country). For instance, hub and spokes FTAs induce technical regulations more in favour of the hub country industries, and investments to be located in the hub country, to the detriment of the small economies.

Many of the above recommendations aim at minimising these costs. For instance, the "tariff convergence" policy reduces the need and scope of rules of origin -- hence the transaction costs between the SP5 countries and between them and the EC. Concerning investment location problems, the further away from a strictly bilateral hub and spokes regime the set of European FTAs will be the smaller the risks for concentration of investments in the EC will be. In other words, the largest the FTA including the spoke countries (SP5 countries and Central European countries) may be, the smaller the investment location issues may be.

6.3. POLITICAL COSTS AND BENEFITS

Political benefits from PTAs could flow from *(a)* security (becoming a member of a larger economic area, and/or benefiting from substantial financial transfers from the richest FTA partner); *(b)* credibility (locking its policies of economic reforms by international treaty); and *(c)* insurance (locking the capacity of the dominant country of the agreement to take unilateral trade restrictions).

Security issues *(a)* can be hardly addressed by an appropriate drafting of FTAs: they come under the heading of foreign or aid policies. By contrast, problems related to credibility *(b)* and insurance *(c)* can be dealt with to a substantial extent by the above recommendations. In particular, the MFN convergence policy is an appropriate solution to getting the benefits of (b) and (c) as it will reassure observers who have seen the (sometimes high) increases of CEC tariffs during the negotiations of the Europe Agreements between the EC and the CECs.

CONCLUSION

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It is important to underline the complementary aspects of all the above proposals. For instance, the MFN tariff convergence policy eliminates *ipso facto* many difficulties from the GATT legal point of view, boosts the economic gains from liberalisation, and reduces considerably the institutional burden of the FTAs. More generally, the above solutions represent a policy that is as economically sound as possible from a domestic perspective: by opening new markets to efficient SP5 producers, they improve the welfare of the domestic consumers without changing the situation of SP5 inefficient producers very much,. They also offer interesting political trade-offs within the European environment: the EC will get a quicker and larger expansion of its common external tariff (that it should "pay" by restricting its use of contingent protection, in accordance with recommendation 16) meanwhile the other countries participating in the Stability Pact will get a much simpler (hence transparent) trade regime, and an excellent preparation for accession to the EC. Lastly, at world level, a single FTA will contribute to a serious simplification of the "spaghetti bowl" in Europe – a benefit for the WTO trade regime.

Last but not least, the SP5 countries often highlight their lack of human resources for managing the transition to market economies integrated into the world economy. The above proposals allow huge economies in terms of negotiators, custom officers and other kinds of trade officials. They minimise the corruption risks related to trade issues. In sum, they allow the scarce human resources that exist in the region to be allocated to more productive and profitable tasks.

APPENDICES

TABLE 1 STRUCTURE OF THE EXISTING FTAS BETWEEN THE STABILITY PACT COUNTRIES, DECEMBER 2000

TABLE 2 SUMMARY OF CONCESSIONS ON AGRICULTURAL PRODUCTS

TABLE 3 **MACEDONIA : SUMMARY OF AGRICULTURAL CONCESSIONS OFFERED IN VARIOUS PTAS**

TABLE 4 **SLOVENIA : SUMMARY OF AGRICULTURAL CONCESSIONS IN VARIOUS PTAS**

TABLE 5 TURKEY: SUMMARY OF AGRICULTURAL CONCESSIONS IN VARIOUS PTAS

TABLE 6 AVERAGE AND MAXIMUM AD VALOREM TARIFFS OF SELECTED COUNTRIES, 2000