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Policy Note

The Brussels Effect 2.0
How the EU Sets Global Standards with its Trade Policy

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The creation of uniform, legally binding norms and standards is an essential basis for the functioning of the EU single market, which at the same time is increasingly spread beyond the EU's borders through international trade relations. The shaping of global standards and regulations according to EU directives even beyond the EU's borders represents an important competitive advantage of the EU. The EU also manages to impose rules, regulations and standards only through market mechanisms in third countries without international treaties or agreements. This has in many areas contributed to the "Europeanisation" of important aspects of global trade. In the academic literature, this regulatory influence of the EU is defined as the "Brussels Effect". The focus of this study is to give a comprehensive overview of the Brussels Effect and to analyse the linkages regarding EU trade policy, outlining to what extent a Brussels Effect can be observed in the network of EU trade agreements. Based on a comprehensive and broad identification of the Brussels Effect, this study aims to quantify the trade effects in terms of the leading role in shaping global standards and regulations for the EU and Austria and to qualitatively identify further areas in which untapped potentials of a "Brussels Effect 2.0" seem possible in the context of EU trade policy.

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Regulatory cooperation and regulatory convergence are key elements of the EU and the European Single Market. They also build a cornerstone of EU enlargement, association and partner agreements as well as for the new generation of free trade agreements. While formal agreements with a focus on integration and market access reveal the strongest impact for regulatory cooperation and alignment to EU standards and regulatory practices, the informal spread of EU regulations driven by market dynamics and international economic actors only occurs in specific areas (e.g. chemical industries, data protection) and is independent from EU's proactive trade policy. While the primary goal of EU's regulatory activity focuses solely on establishing and strengthening its Single Market, the external dimension in terms of technical convergence and the shaping of the global regulatory environment happened rather unintended as "incidental externality", as the Single Market imposes costs on third countries. However, the EU also exerts regulatory influence over foreign countries through legislative mechanisms, such as extraterritorial application of EU law. In recent years the EU also applies trade agreements as tool to promote its regulatory preferences together with the EU's principles and values. The strength of the Brussels Effect thus depends on the size of the market and its net value for foreign exporters, as the EU can demand cooperative behaviour from trading partners in exchange for access. Additionally, the reach of EU regulation is further enhanced through trade agreements, in particular through association agreements. However, the EU has encountered difficulties in finding appropriate institutional frameworks for countries in its immediate neighbourhood such as the United Kingdom, Switzerland, or Turkey.

Despite various examples of EU's regulatory impact, the scope and depth of the Brussels Effects are not unambiguous and unquestioned in the economic literature. The main driver for regulatory cooperation is given by trade enhancing effects and cost reduction benefits. While positive trade and welfare effects of free trade agreements are well documented in the economic literature, there is little empirical evidence on the impact of regulatory cooperation on trade and investment flows. Contributing to this gap is the subject of the present study.

The empirical part of the study aimed at quantitatively assessing the trade and welfare effects of a potential Brussels Effect by means of structural gravity estimation and general equilibrium counterfactual scenario analysis. The structural gravity model separately studies the potential trade effects from three alternative measures aiming at capturing trade effects induced by the Brussels Effect, that goes beyond "traditional" trade effects stemming from direct trade polices such as EU membership, free trade agreements or the formation of and accession to the

WTO. The empirical findings indicate that a non-EU country that signs a free trade agreement with the EU reduces the number of non-tariff measures it issues by 24% to 29%. At the same time and as expected, the overall number of non-tariff measures enforced by an importing country reduces its bilateral trade with all its partner countries. In quantitative terms, ten additional non-tariff measures imposed by the importing economy decrease exports to this destination by approximately 0.5%. EU's free trade agreement policy thus induces direct and indirect positive trade effects. The first one is materialized via the reduction of bilateral trade costs with the free trade agreement partner economies. The indirect Brussels Effect stems from the reduction of non-tariff barriers by countries that enforce a free trade agreement with the EU.

These findings are used for the counterfactual policy analysis carried out with the KITE model, a multi-country, multi-sector general equilibrium new quantitative trade model. The findings from this exercise reveal the following: the effects of a lower number of non-tariff measures by countries that have signed a trade agreement on the EU on the global trade system are small. In terms of welfare, only a single country (Trinidad and Tobago) gained more than a tenth of a percent and welfare of EU countries was hardly affected. While the trade liberalization shifted production within the EU across sectors, the quantitative impact was also minor in the sectoral dimension. In a second scenario that counterfactually considers all countries to lower their non-tariff measures as if they signed an agreement with the EU has similarly small overall production and welfare effects, though some of the countries that currently are not part of an EU agreement could realize non-negligible welfare gains of up to 0.24%.

From a policy point of view, the quantitative analysis indicates that until now the trade and welfare effects induced by EU's regulatory regime (i.e., the Brussels Effect) are still rather limited in quantitative terms. Out of three empirical measures considered, only one, the number of non-tariff barriers, showed significant effects in the econometric analysis and even for this measure, the general equilibrium analysis unveiled rather small overall effects. Reasons for this could include regulatory competition between the three global economic powerhouses USA, China and the EU. Until recently, it seems that third countries do not uniformly prefer EU's regulatory regime over alternatives and, therefore, indirect trade and welfare gains from EU's standard setting seem to be limited.

In line with the quantitative assessment, the findings from the literature review on selected applications of the Brussels Effect reveal that the geoeconomics and geopolitical tensions and repercussions are likely to reduce the EU's global regulatory reach. The rise of regulatory initiatives in other parts of the world, especially in China and the USA but also other countries, as well as the deterioration of the multilateral order and pressing global issues, such as climate change, are challenging the strategic position of the EU and it has become crucial for the EU to sharpen its geoeconomic and geopolitical profile. Hence, EU's regulatory attractiveness in the future will depend on the solidity of the regulatory framework and EU's openness for a trade-regulation nexus together with third countries. To foster its geopolitical influence and its regulatory impact (as identified in its trade policy strategy) the EU needs to strengthen synergies between EU trade, regulatory and development cooperation policies to better integrate its different policy objectives. In this respect, EU's external regulatory policy will also demand sufficient enforcement, especially with respect to the implementation of new instruments in line with its "open strategic autonomy", and a review of appropriate tools, including active participation in international institutions, plurilateral agreements and equivalence agreements, to ensure EU's opportunities in different approaches of international regulatory cooperation. This also implies that the EU needs to identify key strategic priorities for regulatory cooperation. Given pressing global challenges these will include the digital and green transition, as well economic and geopolitical cooperation to reinforce the role of the WTO in terms of regulatory initiatives and "regulatory clubs" to enhance the joint participation in European standardizing bodies.

To achieve the climate targets set in the Paris Agreement is affecting many policy areas in the coming years, making skilful diplomatic negotiations and international cooperation a high priority. The EU should seize the opportunity of change to take a leading role in climate protection and set new standards in the international context in the areas of carbon trading, the structural development of new green technologies such as hydrogen, carbon product labelling and in the financial support of the Global South for the development of renewable energies. Further, to lead the digital transition, the EU needs to take the chance to provide digital solutions and enhance its competitiveness for technical standard focusing particular on artificial intelligence or quantum technologies. In these areas, the EU faces strong global competition for technological leadership, particular from China and the USA. To strengthen EU values in global trade, the EU can use its regulatory power in combination with its development policy as tool to support responsible business conduct along global value chains.

The EU should in general watch the strategies of other global players, namely China and the USA, more closely, when it comes to extending spheres of influence. Although the USA have not returned fully to their hegemonial role under President Biden and appear more reluctant in trade matters, they acknowledge the geopolitical rivalry with China and other autocracies in their National Security Strategy. The main aim is to lead and promote the multilateral rules based international system including a "favourable distribution of power" to the detriment of adversaries. Furthermore, President Biden stresses the importance of the Transatlantic Relationship. China's ultimate foreign policy goal is the containment of US hegemony, and China tries to achieve that goal with a set of instruments, namely by extending its reach in Southeast Asia via more economic interdependence and by extending its development cooperation and thus creating a counterweight to the West. China actively uses lending and development assistance as a strategic tool for gaining influence. Furthermore, it encroaches upon traditional US spheres of influence in South America and the Pacific. In order to be a geoeconomic force and counterweight to be reckoned with, the EU needs to finalize existing partnerships, as e.g. the Mercosur Agreement and its partnership with Africa.

Thus, the future of the Brussels Effect, i.e. the "Brussels Effect 2.0" depends particularly on the EU's strategy to foster cooperation and partnerships outside of Europe. Therefore, the reinforcement and strengthening of partnerships beyond trade relations, e.g. as emphasized in the Global Gateway Initiative or the recent EU standardization strategy are important instruments for the EU to gain more influence in the geoeconomics sphere.