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Economic Governance, Regulation and Services Trade
Liberalization

Matteo Fiorini and Bernard Hoekman

European University Institute
Robert Schuman Centre for Advanced Studies
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Abstract

Many agreements to liberalize trade in services tend to be limited in scope. Concerns about possible negative regulatory consequences of services liberalization is one reason for this. In this paper we provide quantitative estimates of the impact of governance quality on the magnitude of the potential productivity gains of external services trade liberalization, and, in the context of the EU, their distribution across member states. Our findings suggest that greater effort to design trade agreements with a view to improving economic governance would benefit both the EU as well as its trading partners. There is significant scope to incorporate elements of the approaches that have been used in the EU single market context into external trade agreements, and to use the latter to further the realization of a single EU market for services.

Keywords

Trade in services; regulation; trade agreements; economic governance

JEL codes: F13; F15; O43

1. Introduction*

With the gradual reduction of tariffs to average levels of 5 percent or less in many advanced economies, the focus of trade agreements has shifted to reducing nontariff barriers to trade in goods and liberalizing trade in services. In both instances, this involves addressing nontariff measures that impede the ability of foreign firms to contest markets (Egger et al., 2015). However, because services trade involves provision via telecommunications networks, foreign direct investment (FDI) and/or the temporary physical movement of service suppliers, barriers to trade in services span a broader set of policies than is the case for trade in goods, including measures affecting the physical movement of foreign service providers and the establishment of a commercial presence (i.e., engage in foreign direct investment—FDI). In addition, because most services provision is regulated, liberalization of trade in services is more complex than opening up markets for goods because it may require domestic regulators and legislators to consider recognition and acceptance of sectoral regulatory regimes in foreign countries, based on a determination whether regulatory regimes are equivalent.

Recent compilations of prevailing policies across countries by the OECD and the World Bank have shown that barriers to trade in services are often significant, translating into estimates of ad valorem tariff equivalents that are substantially higher than trade barriers for goods (Jafari and Tarr, 2017). There is therefore a presumption that liberalization will lower average prices and expand the variety of services on the market. In principle, the rationale for reciprocal exchange of services trade liberalization commitments is the same as for agreements to liberalize trade in goods: doing so helps small countries to overcome political economy constraints to lowering trade barriers unilaterally, while it helps large countries address the terms of trade loss that may be associated with unilateral liberalization. However, services liberalization has been problematic in many trade negotiations. Trade agreements often exclude services altogether, and, if included, frequently do little to actually liberalize trade (Marchetti and Roy, 2008; Fink and Jansen, 2009; Miroudot, Sauvage and Sudreau, 2010). Instead, the focus is on reducing the discretion of governments to put in place policies that would restrict trade more than currently applied policies do. Resistance to services liberalization is not just a matter for trade agreements involving developing nations. Services have also generated controversy in trade negotiations between high-income countries: in the TTIP context, civil society groups and several EU governments and parliaments made clear their concerns that opening up services sectors to greater foreign competition could erode regulatory standards (Young, 2016).

In this paper we build on recent economic research to argue that trade agreements should more explicitly consider the role of economic governance as a determinant of the gains from services trade liberalization. Economic governance is understood to span both variables that have an economy-wide impact, such rule of law or control of corruption, and the quality of sectoral regulation.¹ Section 2 presents empirical estimates of the quantitative effect of services trade barriers on productivity and the impact of country-level economic governance variables. There are substantial differences across EU member states in services trade policies towards the rest of the world. There is also significant regulatory heterogeneity across EU members that affects the size and distribution of the potential net benefits of external services liberalization. Section 3 discusses several features of the institutional mechanisms developed in the EU context to balance market access liberalization and sectoral regulation in implementing a single market for services. Section 4 contrasts the internal services

* We are grateful to Carl Hamilton, Petros Mavroidis and Patrick Messerlin for comments on earlier drafts.

¹ We therefore use the term economic governance in a broader sense than it has come to be understood in the literature on the EU, where it is commonly used to refer to macroeconomic policy disciplines, financial market supervision and management of the European Monetary Union – see e.g. Dawson (2015).

market integration approaches with those pursued in external trade agreements with third countries, and argues the latter could benefit from doing more to emulate dimensions of the internal market liberalization experience. The focus to date in EU trade agreements has been limited to labor and environmental standards and civil and political rights. While important in their own right, this neglects the importance of improving economic governance institutions that determine the magnitude (and distribution) of the gains from further opening services markets. Section 5 concludes.

2. Economic governance and the impact of services trade restrictions

Services are very heterogeneous. Some satisfy final demand – e.g., recreation, travel, tourism services – but many are intermediate inputs into production. Services comprise a substantial share of all inputs used by firms. The cost, quality and variety of services available to firms therefore are an important determinant of their competitiveness. Sector-specific restrictive trade policies that impact on the degree of competition on services markets, and thus markups and sectoral efficiency, will affect negatively downstream sectors as well as the performance of protected services sectors themselves (Francois and Hoekman, 2010). Empirical studies analyzing the linkages between services trade policies and downstream productivity identify sizable positive effects of liberalizing services trade on the productivity and export performance of firms.²

In what follows we focus on this dimension of services trade policy, recognizing it is just one, albeit important, way such policies impact on economic performance of countries.³ The purpose is not to assess the overall effects of services trade policies but to illustrate that such effects depend on the quality of economic governance. It is well known that the magnitude of the net benefits from liberalizing trade in goods depend on country-specific conditioning factors, including the quality of local governance institutions (Rodriguez and Rodrik, 2001; Freund and Bolaky, 2008).⁴ Recent research has shown that this is also the case for services, and that it may in fact be particularly salient because of their intangibility and because many services are not storable. These features imply that many services are regulated and that provision by a foreign supplier requires a physical presence in the relevant market. If so, foreign providers confront not only sector-specific regulatory requirements but also will be affected by the quality of economic governance that prevails in host countries.

Beverelli, Fiorini and Hoekman (2017) use the World Bank's services trade restrictiveness indices (STRIs)⁵ for a cross-section of 57 countries to estimate the following model:

$$y_{ij} = \alpha + \beta CSTR_{ij} + \mu(CSTR_{ij} \times EG_i) + \gamma x_{ij} + \delta_i + \delta_j + \epsilon_{ij} \quad (1)$$

where y_{ij} is the natural logarithm of productivity in downstream sector j in country i , EG_i is a measure of economic governance quality in country i , x_{ij} is a control variable (the average level of tariff protection for non-services inputs used by downstream manufacturing sector j) and $CSTR_{ij}$ is a

² Country studies include Arnold, Javorcik and Mattoo (2011; 2016) and Bas (2014); country analyses include Barone and Cingano (2011), Bourlès et al. (2013) and Hoekman and Shepherd (2017). Recent empirical analyses of the potential benefits from further liberalization of trade in services in the EU include Monteagudo, Rutkowski and Lorenzani (2012), Canton, Ciriaci and Solera (2014), Fernández-Corugedo and Pérez Ruiz (2014), Van der Marel, Kren and M. Iooty (2016) and World Bank (2016).

³ Other dimensions include employment effects and impacts on the productivity of services activities.

⁴ The role of economic governance and related institutions as sources of comparative advantage has been widely explored in the economics literature (see Nunn and Trefler, 2014 for a review).

⁵ See Borchert, Gootiiz and Mattoo (2014) and <http://iresearch.worldbank.org/servicetrade/>. The STRI varies from 0 (no restrictions) to 100 (maximum restrictiveness).

measure of the effective restrictiveness of services trade policy confronted by downstream sector j in country i .⁶

The estimated coefficients for $CSTRI_{ij}$ ($\hat{\beta}$) and the interaction term ($\hat{\mu}$) permit a qualitative assessment to be made of the impact of higher services trade policy restrictions on downstream industries, assuming a non-zero level of demand for services is observed.⁷ Beverelli et al. (2017) find that higher STRIs are associated with lower productivity performance in downstream sectors. They also find this effect is strongly dependent on the quality of economic governance in countries, as reflected in indicators such as the strength of the rule of law, regulatory quality and control of corruption compiled by the World Bank.⁸ The estimated marginal effect of reducing barriers to services trade on downstream productivity accounting for heterogeneity in economic governance is given by $-\frac{\partial y}{\partial CSTRI} = -\hat{\beta} - \hat{\mu} \times EG_i$ where the minus sign in front of the marginal productivity effect reflects the fact that reducing barriers means decreasing the values of $STRI$ which in turn lowers the value of $CSTRI$. This marginal effect increases with the quality of governance ($\hat{\mu} < 0$) and is significantly positive (at a 0.05 percent level of statistical significance) for 65 percent of their sample observations. This conditionality result is robust to controls that address measurement and endogeneity issues.⁹

The estimates of the interaction model can be used to calculate the productivity changes associated with complete removal of restrictions to services trade. An open trade policy regime corresponds to an $STRI$ value of zero. Therefore, the policy change required by a country to remove all barriers to trade in services sector s in country i is given by $0 - STRI_{is}$. The (negative) variation in the explanatory variable $CSTRI$ reflecting full liberalization of trade across services sectors is given by:

$$\Delta CSTRI_{ij} = \sum_s (0 - STRI_{is}) \times w_{ijs}$$

The associated change in productivity (expressed in levels) implied by the estimated coefficients ($\hat{\beta}$ and $\hat{\mu}$) then can be computed as follows:

$$\% \Delta Y_{ij} = 100 \times (\hat{\beta} + \hat{\mu} \times EG_i) \times \Delta CSTRI_{ij} \quad (2)$$

This expression is country-sector specific. The productivity effect of changes in services trade policy is a function of services input intensities at the downstream sector level and two variables at the country level: (i) the policy change required to remove all discriminatory barriers to trade; and (ii) the quality of economic governance. This methodology permits counterfactual exercises to quantify the effects of services policy changes in country i assuming different levels of economic governance

⁶ $CSTRI_{ij}$ is constructed by calculating $\sum_s STRI_{is} \times w_{ijs}$ where $STRI_{is}$ is the level of services trade restrictiveness for country i and service sector s going from 0 as complete openness to 100 as full restrictiveness and w_{ijs} are a set of weights that reflect the use of service s by manufacturing sector j in country i . The input-output matrix for the United States is used to calculate these weights to address potential endogeneity issues. Input output weights are given by shares of intermediate consumption. For discussion and assessments of the appropriateness of using US weights as an indicator of the technological linkages between industries see Rajan and Zingales (1998) and Barone and Cingano (2011).

⁷ This interpretation of the coefficients assumes away any (indirect) effect of services trade policy on downstream manufacturing sectors that is not channeled through the use of services as intermediate inputs.

⁸ At <http://info.worldbank.org/governance/wgi/#home>.

⁹ Beverelli et al. (2017) include instrumentation and random assignment of the policy component ($STRI_{is}$) of the composite restrictiveness indicator; estimation with alternative input-output weights; alternative productivity measures; and variations in country and industry coverage.

quality. This approach can be used to assess the relative importance of – and interactions between – the level of services trade restrictions and the quality of economic governance in country i .

Governance quality and the impacts of services trade liberalization

What follows focuses on the case of complete removal of barriers to FDI (mode 3 restrictions in WTO speak) in four services sectors – finance, transport, communications and professional services¹⁰ – on productivity in downstream industries (i.e., $\% \Delta Y_{ij}$). All four of these sectors are producer or business services in that their outputs are inputs into production of other sectors of the economy. Complete removal of all FDI restrictions is perhaps an extreme example of liberalization that may not be achievable in practice, but the goal of the exercise is to identify potential impacts of ambitious trade agreements.¹¹ Two features of the methodology should be noted: (i) it is partial equilibrium in nature, as the focus is limited to sector-specific productivity effects (estimation of the overall net GDP effects from removing services trade restrictions is precluded); and (ii) we assume that services FDI barriers are removed on a nondiscriminatory basis. These features imply that the magnitude of the sectoral estimates will be upper bounds, as no account is taken of factor demand or investment diversion effects.¹² However, the point of the analysis is not the absolute size of potential gains but to identify the extent to which such effects are conditional on differences in quality of economic governance.

The quantification is conducted in the following steps. First, equation (1) is fitted with the estimation sample of Beverelli et al. (2017) augmented with few data points for the US (this increases the estimation sample from 912 to 930). Second, the resulting estimates $\hat{\beta}=0.055$ (robust standard error 0.029) and $\hat{\mu}=-0.036$ (robust standard error 0.011),¹³ together with the country specific values of institutional quality EG_i , and the country-sector specific values of the policy change needed to remove all restrictions to mode 3 services trade $\Delta CSTR I_{ij}$, are used to compute values of $\% \Delta Y_{ij}$ according to equation (2).

Table 1 reports results for the largest manufacturing industry in each of the 20 EU countries for which we have data, plus Canada and the United States (columns 1 and 2), as well as for three specific sectors: autos, medical products and chemicals. (Data are reported for 2007 as the STRI data are for that year). The last 2 columns report each country's relative rank with respect to the level of prevailing barriers to FDI in services and the quality of domestic economic governance. Measures for the latter variables are from the World Bank, respectively the Services Trade Restrictiveness Indicators database and the Worldwide Governance Indicators database.¹⁴ Canada and the United States have higher barriers to FDI in services than the EU. Across the 20 European countries in our sample, the average STRI for mode 3 trade is 16.6, as compared to 25 and 19.8, respectively for Canada and the US. The original members of the EU have higher barriers to services trade than more recently acceded countries. The average mode 3 STRI for the original 6 EEC members is 22.8, similar to what is

¹⁰ See Borchert, Gootiiz and Mattoo (2014) for details on the sectoral classification used in the STRI database.

¹¹ In principle these are sectors where full liberalization should be possible. The scenarios do not include any of the sectors that have been taken off the table by the EU in its trade agreements, i.e., social, health, education and cultural services provided in the public interest.

¹² Trade/investment diversion issues are likely to be less salient in the case of agreements such as the TTIP given that the EU and the US are both large and have competitive markets.

¹³ The estimates obtained for the quantification exercise are almost identical to those in Beverelli et al. (2017). From the corresponding specification in Beverelli et al. (2017) (see column 4 in Table 2 in that paper), the estimated coefficients are $\hat{\beta}=0.054$ (robust se 0.031) and $\hat{\mu}=-0.037$ (robust se 0.012).

¹⁴ See <http://iresearch.worldbank.org/servicetrade/> and <http://info.worldbank.org/governance/wgi/#home>.

observed for Canada and the US, while that for the countries that joined the EU in 1986 or later is 14.4 – almost 40 percent lower.¹⁵

Table 1: Sectoral Labor Productivity Effects of Removing Services FDI Barriers in EU

Impact (%Δ —current institutions vs. counterfactual)										
Sector:	Largest		Autos		Medical/Instr.		Chemicals		Country Rankings	
	Impact	Manuf. Sector	Current	High	Current	High	Current	High	STRI	Governance
Country	%Δ	Sector	Inst.	Inst.	Inst.	Inst.	Inst.	Inst.	(9)	(10)
Austria	48.0	machinery	23.9	27.1	53.5	60.8	63.1	71.7	17	5
Belgium	34.6	chemicals	13.9	21.3	27.3	41.8	34.6	53.0	11	12
Bulgaria	13.1	food/bev	4.0	18.3	12.7	58.1	11.8	54.1	16	22
Czech Rep.	8.2	autos	8.2	23.2	16.5	46.9	20.5	58.4	13	18
Denmark	55.8	food/bev	19.7	19.7	44.2	44.2	52.1	52.1	9	1
Finland	46.3	comm. eq.	23.6	24.0	46.3	47.0	47.0	50.7	15	2
France	58.9	food/bev	23.5	33.8	44.6	64.3	56.0	80.8	21	10
Germany	50.5	machinery	23.7	30.9	57.2	74.7	65.0	84.8	20	9
Greece	16.8	food/bev	8.0	22.5	10.0	28.1	16.7	46.7	10	17
Hungary	23.7	food/bev	11.3	25.5	16.2	36.6	23.2	52.3	14	15
Ireland	33.8	chemicals	13.4	17.1	27.3	34.9	33.8	43.3	6	7
Italy	18.7	machinery	11.0	29.6	20.5	55.3	25.0	67.4	19	16
Lithuania	10.3	food/bev	4.1	14.0	7.5	25.3	9.9	33.5	2	20
Netherlands	53.3	food/bev	19.3	21.2	41.4	45.3	50.0	54.8	12	4
Poland	15.0	food/bev	6.0	17.8	10.8	31.8	14.4	42.4	7	19
Portugal	18.0	textiles	9.7	17.4	15.5	27.9	22.1	39.7	4	14
Romania	10.5	food/bev	3.7	15.6	9.7	41.0	9.5	40.1	5	21
Spain	21.8	food/bev	9.0	16.0	15.1	26.8	21.0	37.1	3	13
Sweden	16.7	machinery	7.5	8.1	19.2	20.8	21.2	23.0	1	3
UK	39.3	food/bev	15.5	20.0	28.7	37.2	37.5	48.6	8	8
USA	45.4	food/bev	17.1	25.8	41.8	63.0	41.4	62.3	18	11
Canada	59.8	food/bev	27.2	32.1	58.0	68.5	55.8	66.0	22	6

Notes: The estimates are derived by the authors based on the empirical analysis in Beverelli et al. (2017). “Impact” refers to the percentage change in sectoral labor productivity of removing all barriers to Mode 3 services trade in financial, transport, communication and business services. “High Inst.” measures effect on labor productivity if “control of corruption” was at the level of Denmark (World Bank Governance Indicators). Services trade policies from the World Bank Services Trade Restrictiveness Database. Labor productivity (output per worker in 2007) from UNIDO industrial statistics database. Sectors based on ISIC 2-digit classification (Chemicals: #24; Autos: #34; Medical/Instruments: #33; Machinery: #29; Food/Bev: 15+16; Communication Equipment: 32; Textiles & Apparel: 17+18+19). Estimates are statistically different from zero for all countries except Bulgaria and Romania.

The potential downstream productivity impacts are reported in the columns labeled “current inst.” i.e., the prevailing governance situation in each country. Estimates vary widely across countries, ranging from 10-15 percent for several Central European countries to 50 percent or more for France and Germany. The potential productivity impacts also are heterogeneous across sectors, reflecting differences in the intensity of service input use across industries. For any given sector, differences in productivity estimates across countries reflect differences in the level of FDI barriers. Economies with high estimated potential productivity improvements following services liberalization have high mode

¹⁵ This presumably reflects the fact that accession to the EU for more recent members was a very demanding process, encompassing policy conditionality that was not applied to incumbent countries.

3/FDI restrictions.¹⁶ The significant heterogeneity in estimated impacts of services reforms across EU countries in part reflects the fact that the EU is not (yet) a customs union when it comes to services trade and investment policies. As has been shown by the OECD's compilation of product market regulation¹⁷ and EU monitoring of the implementation of the Services Directive liberalizing trade in services between EU member states (discussed further in Section 3 below) there are significant differences across EU economies in the openness of services markets to foreign competition.

Countries that stand to benefit the most in terms of size of the potential productivity boost from services liberalization are those with better economic governance. The lower is the quality of governance, the lower the productivity effect of services trade liberalization. Weak economic governance explains why the estimated productivity benefits for a country such as Italy are low, despite Italy having barriers to FDI in services that are among the highest in the sample, which should imply high gains from liberalization. The importance of institutions is illustrated further by the columns in Table 1 labeled "high inst." These replace each country's governance indicators with that of Denmark, the best performing country in the sample. In the case of some countries, e.g., Italy, the potential productivity effects double. In many cases EU member states with better governance are countries with higher per capita incomes and stronger economic performance than other EU members. This may have consequences for political support for external trade agreements such as TTIP. Insofar as differences in governance quality affect the distribution of the aggregate benefits of EU-wide liberalization of services trade and investment, this may help explain opposition against ambitious agreements such as the TTIP that would benefit the EU as a whole. Doing more to address regulatory and governance weaknesses would not only increase the aggregate benefits of services trade liberalization but as, if not more important, improve the distribution of such benefits across EU member states.

Results of the same exercise for a sample of European Neighborhood Policy (ENP) countries and Turkey are reported in Table 2. The ENP countries tend to have both higher levels of services trade restrictiveness and weaker governance than EU member states.¹⁸ As a result, the differences between potential productivity impacts under current as compared to best practice governance are particularly high for many ENP countries.¹⁹ The economic intuition for the empirical findings is that removing restrictions on the ability of foreign suppliers to provide their services locally through establishment of a commercial presence may fail to have the expected pro-competitive effect if host countries have a weak institutional and business environment. Bad governance may result in foreign firms not entering the market, or, in case they do enter, operating inefficiently.

¹⁶ The data reveal that EU member states are not fully open to inward FDI. At an aggregate level the STRI data on FDI restrictions, which are consistent with those compiled by the OECD in its FDI Regulatory Restrictiveness Index (<http://www.oecd.org/investment/fdiindex.htm>), help to explain why for the EU as a whole cross-border FDI in services accounts for only 11 percent of total value added as opposed to 17 percent for goods (European Commission, 2016). As goods are much more tradable than services, in principle one would expect that the share of value added generated by FDI would be much higher for services than for goods.

¹⁷ See Fournier (2014b), Fournier et al. (2015) and Nordås (2016).

¹⁸ However, individual ENP countries are sometimes more open than the EU. Georgia is the least restrictive country towards mode 3 in the set of EU and ENP countries.

¹⁹ This is consistent with the findings of Gylfason et al. (2015) that the trade effects of agreements signed by Eastern Partnership countries with the EU have superior welfare implications than agreements with Russia. Gylfason et al. also show there is a positive effect of institutions (including both political institutions as measured by the level of democracy as well as economic governance indicators such as control of corruption) on export performance of Eastern Partnership countries.

Table 2: Productivity Effects of Removing Services FDI Barriers, Selected ENP Countries

Country	Impact (% Δ —current institutions vs. counterfactual)									
	Biggest manuf. industry		Textiles		Basic metals		Chemicals		Country Rankings	
	Impact % Δ	Sector	Current Inst.	High Inst.	Current Inst.	High Inst.	Current Inst.	High Inst.	STRI	Governance
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	
Albania	2.9	textiles	2.9	29.9	4.9	49.7	3.9	39.7	2 (5)	5 (27)
Georgia	3.9	food/bev	1.9	8.9	1.2	5.7	3.4	16.2	1 (1)	3 (25)
Ukraine	3.5	metals	2.6	34.9	3.5	46.4	3.8	50.0	4 (23)	6 (28)
Jordan	50.8	food/bev	34.6	93.1	52.3	140.0	47.8	128.5	7 (29)	1 (16)
Lebanon	4.3	food/bev	3.0	92.6	4.5	141.1	4.1	127.5	6 (28)	7 (29)
Morocco	10.5	food/bev	6.7	34.7	9.0	46.8	9.8	50.7	3 (21)	4 (26)
Memo:										
Turkey	20.5	textiles	20.5	65.9	24.2	78.0	32.9	106.1	5 (26)	2 (21)

Notes: See Table 1. Sectors based on ISIC 2-digit classification (Chemicals: #24; Food/Bev: 15+16; Textiles & Apparel: 17+18+19; Basic metals: 27). Estimates with country specific governance institutions (columns 1, 3 5 and 7) are statistically significant only for Turkey and Jordan. Country ranking columns (9 and 10) report within selection rankings as well as (in parentheses) rankings relative to the larger sample of countries reported in Table 1.

The foregoing used control of corruption as the moderator governance variable and labor productivity as the dependent variable. Table 3 reports the results for the same exercise using different governance indicators and sectoral total factor productivity (TFP) as the dependent variable. The use of TFP reduces the sample size substantially due to data availability constraints, but very similar qualitative results obtain. In the case of Italy, for example, improving economic governance would increase the productivity payoff of removing mode 3 barriers by 50 to 200 percent. This is of course a very wide range, and the variation in the estimated potential effects illustrate that some types of governance matter more than others for the impact of services investment barriers. That said, Table 3 shows that the finding that the magnitude of the effect of services liberalization is a function of the quality of governance practices is robust: it holds no matter what specific measures of governance or productivity are chosen as a focal point.

There is significant heterogeneity in estimated impacts of services reforms across EU countries. In part this reflects the fact that the EU is not yet a customs union when it comes to services trade and investment policies, but more important is that EU membership clearly does not imply common levels of institutional performance. Thus, there are apparent limitations on what can be achieved through – and what is implied by – membership of the EU. In practice this must mean that EU law and regulation (the *acquis communautaire*) is insufficient to drive convergence in the quality of economic governance and/or that enforcement mechanisms are inadequate to induce governments to improve institutional performance in areas that matter for business investment.

This raises the question what dimensions of economic governance matter most. To return to the example of Italy, its regulatory quality indicator is closer to that observed in better performing EU countries²⁰ than is the case for the broader horizontal (cross-cutting) governance indicators for control of corruption or strength of the rule of law. Therefore, the impact of improving regulatory quality is

²⁰ The regulatory quality indicator is a composite variable that reflects measures such as price controls, ease of starting a new business, prevalence of subsidies and state of competition on markets. See <http://info.worldbank.org/governance/wqi/#home>.

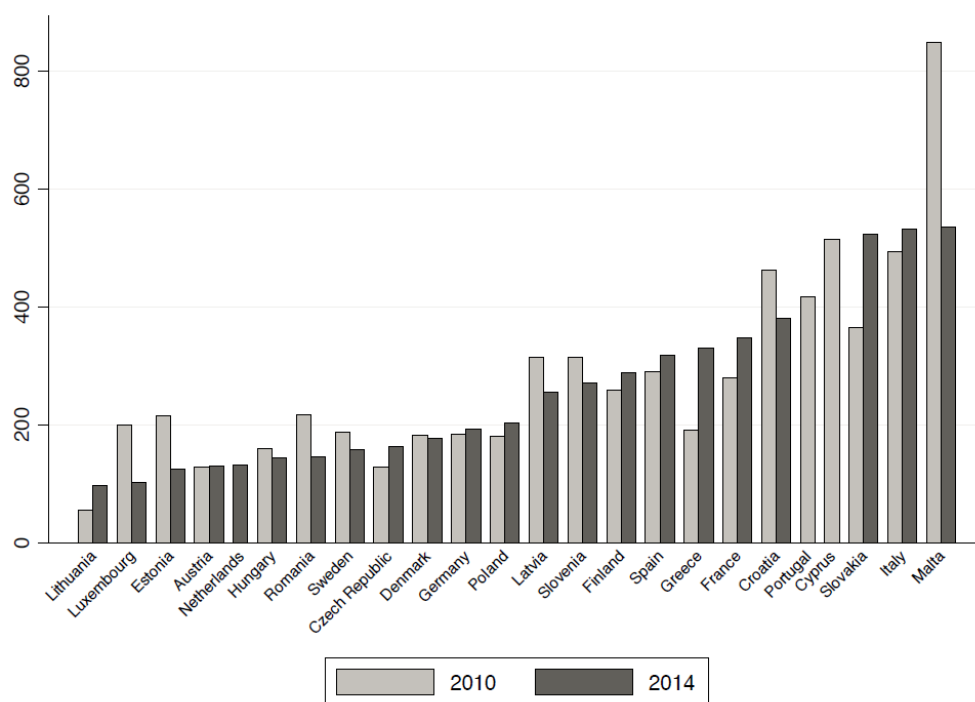
less than that associated with improving the other governance variables – as can be seen by comparing the results in panel A of Table 3 with panels B and C. These results are consistent with more granular data on the performance of institutions. The rule of law result, for example, is consistent with data on the number of days required for an average court of first instance to resolve all pending civil and commercial disputes. In the case of Italy, this stands at some 500 days on average as compared to 100 days in Lithuania (Figure 1). However, Lithuania has one of worst scores on control of corruption in the sample (see Table 1). This illustrates that analysis is required to ‘unpack’ the governance dimension so as to identify what areas should be a priority for institutional improvement from the perspective of downstream productivity effects. Different countries will have different circumstances and in practice the ‘binding constraints’ and thus priorities will vary across countries and over time. Moreover, it may well be that sectoral regulatory institutions are important for specific services activities, so that a focus on only horizontal governance indicators is likely to be too narrow. Both types of regulation/economic governance will have implications for effects of services trade and investment liberalization and thus the potential net benefits of services trade liberalization. Country-by-country analysis is needed to inform policymakers which types of regulatory and governance institutions should be bolstered in the context of efforts to liberalize trade in services so as to increase the aggregate net payoffs of services trade liberalization. As discussed further in Section 4, incorporating processes to help identify priority areas for (joint) action in trade agreements could help increase the benefits of such cooperation.

Table 3: Total Factor Productivity Effects of Removing Services FDI Barriers

Impact (%Δ TFP —current institutions vs. counterfactual)								
Biggest manuf. industry	Impact: Autos		Impact: Medical/Instr.		Impact: Chemicals			
	Current Inst.	High Inst.	Current Inst.	High Inst.	Current Inst.	High Inst.	Current Inst.	High Inst.
<i>Panel A: Regulatory Quality</i>								
Denmark	65.0	food/bev	22.9	-	51.5	-	60.7	-
Germany	68.5	machinery	32.2	36.0	77.7	87.0	88.2	98.8
Ireland	49.1	chemicals	19.4	19.9	39.6	40.7	49.1	50.4
Italy	38.2	machinery	22.5	34.5	42.0	64.4	51.2	78.5
Lithuania	28.9	food/bev	11.5	16.3	20.8	29.4	27.6	39.1
<i>Panel B: Rule of Law</i>								
Denmark	60.9	food/bev	21.5	-	48.2	-	56.8	-
Germany	64.8	machinery	30.4	33.7	73.4	81.4	83.4	92.5
Ireland	41.8	chemicals	16.5	18.6	33.8	38.1	41.8	47.2
Italy	21.5	machinery	12.6	32.3	23.6	60.3	28.8	73.5
Lithuania	18.5	food/bev	7.4	15.3	13.3	27.5	17.7	36.6
<i>Panel C: Control of Corruption</i>								
Denmark	62.6	food/bev	22.1	-	49.6	-	58.4	-
Germany	56.0	machinery	26.3	34.7	63.5	83.7	72.1	95.1
Ireland	37.5	chemicals	14.8	19.2	30.3	39.1	37.5	48.5
Italy	19.9	machinery	11.7	33.2	21.9	62.0	26.6	75.6
Lithuania	10.7	food/bev	4.3	15.7	7.8	28.3	10.3	37.6

Notes: Figures in bold and italics are not statistically different from zero. “Impact” refers to the percentage change in sectoral total factor productivity (TFP) of removing all barriers to Mode 3 services trade in financial, transport, communication and business services. “High Inst.” measures the effect on TFP if governance variables (regulatory quality, rule of law, and control of corruption, respectively, in panels A, B and C would be the same as in Denmark. TFP estimates are averages for 2006-2008 as reported in Beverelli et al. (2017). Sectors based on the ISIC 2-digit classification – Chemicals: #24; Autos: #34; Medical/Instruments: #33; Machinery: #29; Food/Bev: 15+16.

Figure 1: Days needed to resolve civil and commercial cases (1st instance courts)



Source: Authors' calculation from CEPEJ-STAT at:
<http://www.coe.int/t/dghl/cooperation/cepej/evaluation/2016/STAT/default.asp>

3. Services liberalization and economic regulation within the EU

The main focus of trade agreements is to reduce explicit barriers to trade, not to improve economic governance, although dimensions of the latter feature to some extent in EU trade agreements with developing countries and European neighbourhood countries.²¹ As mentioned previously, the stylized fact is that most trade agreements do little to liberalize trade in services beyond what governments have already decided to do on a unilateral basis. This is not the case for the EU itself, of course. The Single Market goal and associated EU regulations and directives, combined with monitoring of implementation by the European Commission, the possibility of infringement procedures and challenging specific policies before the Court of Justice of the European Union (CJEU), and, ultimately, penalties for non-compliance, make the EU a very special case.²² While the type of supranational institutions that have been created in Europe do not exist elsewhere, from a services trade liberalization design perspective there is much to be learned from the EU experience for the design of preferential trade agreements (PTAs) with third countries that seek to liberalize trade and investment in services. At the same time, the results of Section 2 show that even the very far-reaching EU integration initiative is accompanied by continued significant heterogeneity in the quality of basic economic governance variables, raising the question what external PTAs might do to improve governance in under-performing EU member states.

²¹ We return to this in Section 4.

²² Börzel, Hofmann and Panke (2012) analyze determinants of compliance by EU member states with EU law and the results of infringement proceedings and rulings by the CJEU. Italy has the highest number of pending infringement procedures that were open before May 1, 2015. See Single Market Scoreboard: Infringement at http://ec.europa.eu/internal_market/scoreboard/_docs/2015/09/infringements/2015-09-scoreboard-infringements_en.pdf.

Freedom to provide services is one of the four fundamental freedoms identified in the Treaty of Rome. To push forward in achieving the goal of a single EU market for services, a specific Services Directive (SD) was adopted in 2006 (Badinger and Maydell, 2009). The SD covers sectors accounting for some 45 percent of EU GDP. It imposes disciplines on the use of prior authorizations for provision of services, licensing for retail stores, specific authorizations for the sale of certain products at retail level and economic needs tests for retail outlets (Art. 9). It requires the removal of explicitly discriminatory policies such as nationality tests, requirements that a provider establish or join a professional body if this has already been done in an EU member state, that the firm's headquarters be located in the country, conditioning operations on economic needs tests, requiring financial guarantees or insurance from a host country provider, and involvement of (domestic) competitors in the process of granting authorization to operate (Art. 14). It also imposes disciplines on nondiscriminatory regulatory requirements that may impede market access— e.g., limits on the number of establishments that are permitted or requirements that a firm employ a minimum number of employees (Art. 16).

A key element of the SD is Art. 15, which imposes disciplines on countries maintaining potentially competition-restricting regulatory measures justified on public interest grounds. Such measures— e.g., quantitative or territorial limitations, restrictions on the legal form of an entity, requirements concerning equity holdings, or price controls – must be transparent. To help assure this, governments are required to establish Points of Single Contact – “one-stop shops” where firms can obtain all necessary information on requirements that need to be satisfied to provide services in a country. Art. 15 also imposes specific substantive disciplines. Measures may not directly or indirectly discriminate according to nationality and/or, in the case of companies, on the basis of the location of the registered office; they must be justified by an overriding reason relating to the public interest (a necessity test) and not go beyond what is necessary to attain the public interest objective (a proportionality test). An important dimension of implementation of Art. 15 is a mutual evaluation process. Member states are tasked with assessing for themselves whether their regulatory requirements satisfy the substantive criteria of Art. 15 (i.e., necessity, proportionality) and must share their reasoning with other member states. The aim is that this process of self-assessment and subsequent peer review will support policy reforms where needed and over time lead to a better understanding of alternative, less trade-restrictive approaches to attain the public interest objectives through mutual learning.

An important complementary Directive on professional services (2005/36/EC) requires that regulation of service providers be transparent and justified by public interest concerns and establishes disciplines for the recognition of professional qualifications. The 2013 revision of this directive includes a transparency process anchored on notification requirements and mutual evaluation based on criteria very similar to those in Art. 15 SD (e.g., regulations must be proportionate and necessary). All member states are required to prepare and share National Action Plans to address inconsistent qualification requirements and improve the respective regulatory regimes. As of end 2016, EU members had notified over 5,500 regulatory regimes pertaining to professional services providers (European Commission, 2017).

While it has been argued that Art. 15 makes the SD a less powerful instrument of liberalization than the original directive proposed by Commissioner Bolkestein because it permits measures that reduce competition (e.g., Badinger and Maydell, 2009; Fernandez-Corugedo and Perez-Ruiz, 2014), the deliberative approach has had positive results (European Court of Auditors, 2016).²³ Although monitoring by the Commission of prevailing services policies, as does OECD product market regulation data, reveals there is still a substantial gap between the vision of a single EU-wide market for services and the reality that is reflected in the heterogeneity of regulatory policies across member

²³ The wording of Art. 15 reflects resistance by the European Parliament to the initial approach proposed by the Commission under which home country regulatory standards would have to be accepted by host countries.

states (see below), the types of procedures put in place to implement the SD have helped to raise awareness and understanding of government entities of what is required under the SD and the Directive on recognition of professional qualifications, while allowing for balancing regulatory against trade liberalization objectives.

The SD spans measures that impact on market access as well as regulatory policies that affect the ability of foreign firms to provide services. A representative market access related provision is the requirement in SD Art. 14.1 banning discriminatory requirements based on nationality or the use of economic needs tests. An example of a regulation-related requirement is SD Art. 25, which prohibits measures restricting service providers from engaging in so-called multidisciplinary activities.²⁴ The European Commission maintains a database on compliance with the main requirements of the SD for fifteen services sectors. For each country-sector pair, the database identifies a number of key policy areas embedded in 20 requirements across five key articles of the SD.²⁵ The database permits the construction of an indicator of the distance or gap between the policy regime prevailing in country c , sector s , at time t and the objective specified by the SD embodied in requirement r . This distance measure D_{csrt} takes four discrete values between 0 and 1, with 0 (1) indicating minimum (maximum) distance from the SD requirement. Intermediate values of 0.2 and 0.8 are defined to account for partial compliance with SD requirements. The database spans three years: 2009 (capturing compliance before the 2009 transposition deadline), 2012 and 2014.

Figure 2 provides an aggregate picture of EU member state compliance with the SD requirements by plotting country-level simple averages of D_{csrt} across sectors and requirements. The gap has been decreasing over time for all countries, with the sharpest reductions observed in the period between 2009 and 2012. However, full transposition of SD requirements is not observed in any country-time pair and there is substantial heterogeneity across member states. Noteworthy is that a number of long-standing EU member states register above average gaps. The UK, Slovakia and Estonia are the best performing countries when it comes to implementation of the SD.

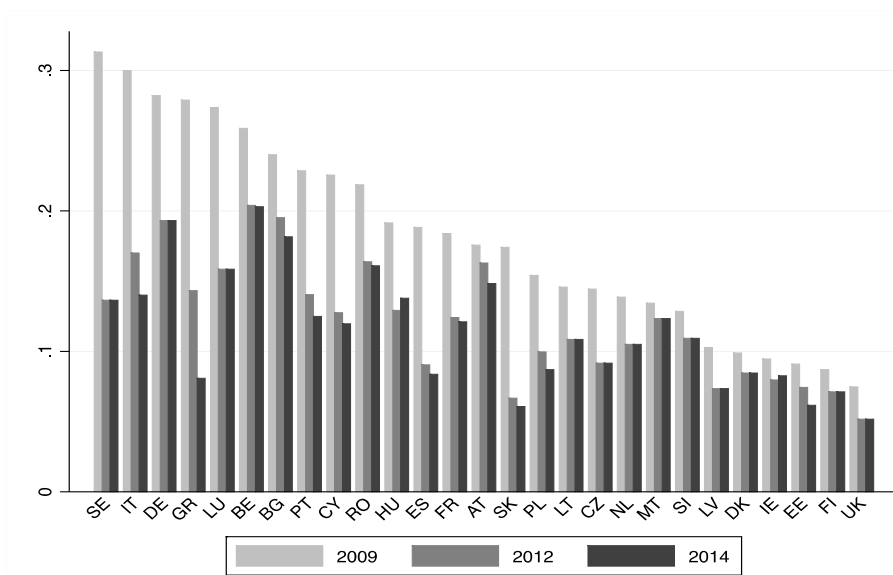
Figure 3 illustrates the complementarity between market access barriers and sectoral governance. It plots the distance between the policy regimes prevailing in EU member states and the “market access” and “conduct” requirements for a subset of producer services that are intermediate inputs for other sectors, including accounting, architectural, engineering, legal, and tax advisory services. The measures correspond to Art. 14.1 (nationality requirements) and Art. 25 (permitting multidisciplinary activities), respectively.²⁶ As of 2014, with the exception of Cyprus, nationality requirements no longer apply in member state legislation (Figure 3, left panel). In contrast, much less progress is observed on measures precluding multidisciplinary activities (right panel Figure 3). These data illustrate the importance of considering both market access barriers and sectoral regulatory regimes.

²⁴ Art. 25(1) requires member states to ensure that service providers are not subject to requirements which oblige them to exercise a given specific activity exclusively or which restrict the exercise jointly or in partnership of different activities.

²⁵ The relevant SD provisions are Articles 9, 14, 15, 16 and 25. For a detailed description of the database see Monteagudo et al. (2012).

²⁶ Simple averages are used to aggregate individual sectors.

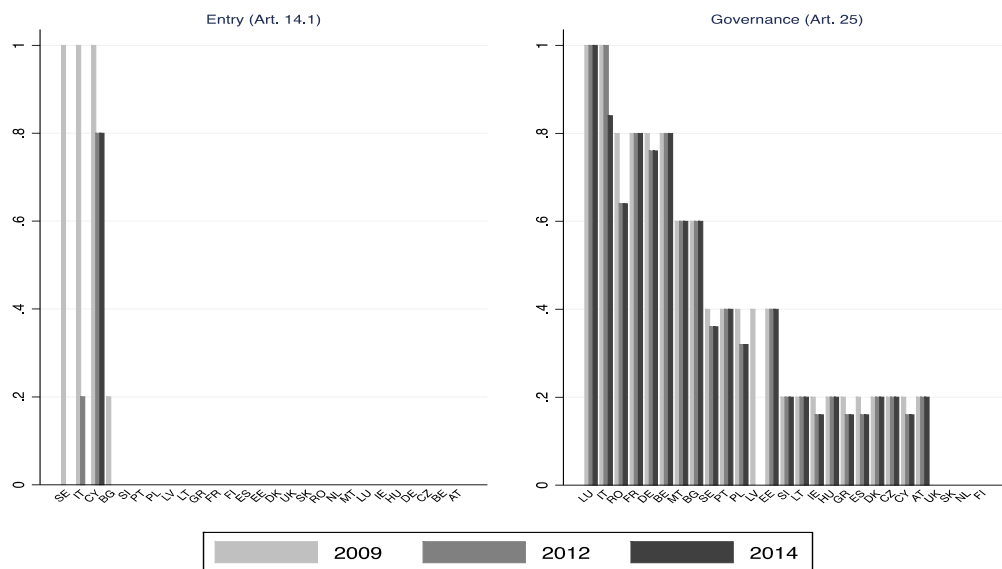
Figure 2: Average gap between SD requirements and Member State practice



Note: Country-level simple average of D_{csrt} across covered sectors and SD requirements – see text.

Source: Authors’ calculations using the European Commission SD database.

Figure 3: Gap between SD and applied policies, selected sectors and requirements



Notes: The two panels plot the country-level simple average of D_{csrt} across five business sectors (accounting, architectural, engineering, legal, and tax advising services) for requirements corresponding to SD Art. 14.1 (left panel) and SD Art. 25 (right panel).

Source: Authors’ calculations using the European Commission SD database.

Because regulatory measures that give rise to trade restrictive effects may be appropriate to achieve public interest objectives, the process of monitoring applied policies and the mutual evaluation of the necessity and proportionality of regulatory measures are key ingredients to promote compliance with

commitments. The transparency and review processes also provide for a stronger basis for eventual action to address non-compliance and resolve conflicts. In the EU, formal infringement proceedings by the Commission against member states are an important enforcement instrument that is not available under inter-governmental trade agreements, which are limited to State-to-State dispute settlement procedures. In practice, however, a variety of other mechanisms are used more frequently to support compliance by member states with EU rules. These include issuing country-specific recommendations and pre-infringement procedures. An example of the latter is the EU Pilot, a confidential procedure introduced in 2008 that centers on a consultation process in which the Commission flags potential violations, informs the relevant member state and requests clarification/rectification of the matter raised. The Pilot is supported by an online database and communication tool. It is a fast-track process in which both sides have 10 weeks to respond to each other. If a query is not resolved the Commission can open an infringement procedure.²⁷ The EU Pilot has played a positive role in decreasing the number of infringement cases (Fournier, 2014a; Pelkmans and Brito, 2012).

An alternative conflict resolution-cum-implementation mechanism used in the EU is the SOLVIT network. This was created in 2002 and allows individuals and firms to raise instances of perceived non-compliance with EU legislation by an EU government with a national center established in each member state (usually an office in the responsible Ministry). The aim is to use administrative dispute settlement mechanisms as well as greater transparency and peer pressure as a problem-solving tool. Most cases addressed by SOLVIT are submitted by individuals.²⁸ Cases are registered through an online system managed by the European Commission's internal market Directorate General, with each national SOLVIT center taking up eligible issues brought by a national person (citizen or business) with counterpart SOLVIT centers in other member states. Transparency is fostered through a database in which both claims and their eventual resolution are registered and documented. The goal of SOLVIT is to offer EU citizens and businesses an avenue to resolve disputes rapidly without having to go to court – a key feature of the system is that it does not involve legal proceedings, although it does not preclude this (i.e., SOLVIT is a mechanism that operates in the shadow of the law and hierarchy – see e.g., Börzel, 2010). The total caseload of the network has risen steadily since 2002 to over 2,000 cases per year in 2014 and 2015, with a resolution rate of over 85 percent.²⁹

In an assessment of European Commission enforcement of the SD, the Court of Auditors concluded limited use has been made of the EU Pilot and SOLVIT to address non-compliance with the SD. Less than one (four) percent of all SOLVIT (Pilot) cases addressed matters covered by the SD. The auditors also concluded that the number of formal infringement cases (nine) in the period between 2006 and 2014 was very low (European Court of Auditors, 2016). In its reply the European Commission noted the need to differentiate between elements of the SD that impose unconditional (legally binding) obligations and those involving assessments of proportionality and necessity and mutual evaluation processes. The latter are more of a conditional nature and involve regular

²⁷ The Commission started some 900 cases and processed almost 1,000 cases during 2015, resulting in 1,260 open cases at the end of that year. The resolution rate of these EU pilot cases in 2014/2015 was around 75 percent. See http://ec.europa.eu/internal_market/scoreboard/performance_by_governance_tool/eu_pilot/index_en.htm.

²⁸ In 2005 the number of SOLVIT cases submitted by citizens (309) was approximately twice the number of the cases submitted by firms (142). By 2015, the number of citizens' cases had increased to 2,121, while those brought by companies had fallen to 107 (European Commission, 2016b).

²⁹ http://ec.europa.eu/internal_market/scoreboard/performance_by_governance_tool/solvit/index_en.htm. (accessed March 1, 2017). See Pelkmans and Brito (2012), Guimarães and Egan (2012), Holbolth and Martinsen (2103), Vifell and Sjögren (2014), and Martinsen and Hobolth (2016) for analyses of SOLVIT. Martinsen and Hobolth (2016) conclude that most resolved cases are associated with a change in administrative practices.

interaction, analysis, sharing of experience and reflection on what constitutes good practice, and therefore call for a broader perspective on compliance when assessing the SD.

4. Revisiting trade agreements to support services liberalization

Summing up, the forgoing brief review and discussion of the EU experience illustrates: (i) that liberalization of trade and investment in services is very difficult – even in a setting like the EU where there is supranational enforcement; (ii) the necessity of focusing on sector-specific regulation as well as explicit barriers to trade and investment; and (iii) that a purely top down approach is neither feasible or desirable – learning processes and transparency mechanisms are needed to assess and consider whether regulations that impede trade are necessary to attain regulatory objectives. The latter is particularly salient for external trade agreements. These increasingly are motivated by a desire to reduce the trade costs associated with differences in regulatory regimes across countries. This has given rise to concerns regarding the potential erosion of regulatory policy space and weakening of regulatory standards. It has become clear that governments and EU institutions need to do more than simply assert that any agreement will not erode national or common EU regulatory standards – instead trade agreements need to incorporate mechanisms and processes that improve regulatory quality and outcomes (Hoekman and Sabel, 2017). These matters go beyond the services liberalization focus of this paper but are consistent with the argument made in Section 2 that trade agreements should devote greater attention to economic governance quality to enhance the gains from services trade liberalization.

The EU embodies a mix of “top down” disciplines on discriminatory measures and “bottom up” approaches involving self-evaluation, peer review and dialogue. Such approaches are not all dependent on the supranational nature of EU integration and related enforcement. Substantial elements of the EU approach to internal integration can be emulated in external trade agreements that are limited to inter-governmental cooperation. Both the substance of the disciplines that are embodied in the Services and Recognition of Professional Qualification directives, and the monitoring and engagement mechanisms that have been put in place in the EU are salient for the design of external trade agreements. Although the mechanisms developed in the EU address the role of sector-specific domestic regulation as a potential barrier to trade, the linkage between good economic governance more broadly and the gains from removing market access barriers discussed in Section 2 is not considered in the SD and related directives. Much attention is of course given in the EU context to improving the quality of public administration, controlling corruption and the ensuring the rule of law and independence of the judiciary, and so forth. However, this proceeds on a parallel track and is not part of the single market strategy.

This is also the case in the EU’s external trade agreements. As far as economic governance and regulation is concerned, the focus of EU trade agreements is on “economic and social rights” (ESR) and “civil and political rights” (CPR). The EU has long linked trade preferences for developing countries to adoption of international conventions relating to ESR and CPR, e.g., in the GSP⁺ program (see, e.g., Orbie and Tortell, 2009; van den Putte and Orbie, 2015). Provisions on protection of human rights, environmental safeguards and labour standards feature in all recent vintage EU trade agreements. ESR provisions increasingly include anti-corruption commitments, e.g., adoption of international anti-bribery conventions and measures to enhance public sector transparency (Lejárraga 2014). Language on such rights often is incorporated in sustainable development chapters and have a “soft law” nature.³⁰ The same is true for human rights commitments, although in principle these are

³⁰ The TPP broke new ground in this area by including a chapter on good governance which criminalized bribery and corrupt practices (including corrupt accounting practices) and made implementation of the various provisions subject to

more enforceable in that violations can result in abrogation of the agreement (Bartels, 2012; Bilal and Ramdoo, 2016). To date this has been the exception rather than the rule, however, and in practice the main instrument to promote ESRs and CPRs in EU agreements has been dialogue and development assistance (aid) including through the Development Cooperation Instrument and the European Development Fund. EU institutions and member states have provided substantial financial support for improving different dimensions of governance in partner countries, including for public sector reform and legal and judicial development.³¹

The 2015 EU “Trade for All” communication calls for doing more to use trade agreements to monitor domestic rule of law and governance reforms in trading partners, setting up consultation mechanisms in cases of systemic corruption and weak governance, and negotiating ambitious provisions on anti-corruption in future trade agreements (European Union, 2015, p. 26). This is a continuation and expansion of what has been EU practice for some time. The inclusion of ESR/CPR provisions is in part a reflection of normative values (i.e., considered desirable in and of itself as reflected in the provisions of the Treaty on European Union (TEU), as well as being justified by international conventions promoting such rights) and in part strategic, to ensure there is “fair trade” by levelling the playing field and preventing so-called social dumping.³² The EU trade strategy does not highlight the complementarities (interdependence) between sectoral regulation/economic governance and the expected gains from liberalizing services trade. This may reflect a perception that there is limited scope to achieve the latter with many trading partners. However, this neglects the fact that opposition to services liberalization may in part reflect regulatory concerns (Hoekman and Mattoo, 2013). The links between the quality of sectoral regulation/economic governance and gains from services trade liberalization do not figure prominently in EU trade cooperation with other high-income countries either. There is therefore some disconnect between approaches used in the internal service market integration context compared to external trade agreements.³³ Moreover, in both settings the importance of improving national economic governance is neglected.

Figure 4 provides a very stylized characterization of the state of play in the EU and PTAs with respect to provisions on market access on the one hand and governance on the other. The top half of Figure 4 focuses on internal EU liberalization and governance, the bottom part on provisions in external trade agreements. There are two relevant dimensions – the existence of and access to deliberative mechanisms, and the possibility for actors to invoke conflict resolution mechanisms to contest specific measures taken by governments or EU institutions. The market access (single market) instruments put in place in the EU were discussed in the previous section. On governance variables, measures that are inconsistent with the rule of law, fundamental rights and EU values as defined in Art. 2 TEU can be contested by private (EU) parties before national and EU courts, including the European Court of Human Rights. Art. 7 TEU establishes procedures through which EU governments, the Parliament or the Commission working through the Council, can contest violations of EU values by a member state, and potentially decide to suspend certain membership rights.

(Contd.) _____

dispute settlement. However, the TPP precluded the latter to be used to contest the application of national legislation and anti-corruption procedures (Transparency International, 2017).

³¹ Between 2005 and 2014 the EU and EU member states allocated over US\$60 billion to support governance reforms, 13 percent of EU development aid. Public administration accounted for 60 percent of these funds; human rights and civil society support another one-third. Only 1 percent went to anti-corruption projects (European Parliament, 2016).

³² There is a long-standing debate regarding the role of domestic import-competing interests in lobbying for inclusion of ESR provisions as a way of “raising rivals costs” – see e.g., Lechner (2016) for a recent empirical analysis of the political economy determinants of inclusion of nontrade issues in trade agreements; Koch (2015) on EU aid conditionality.

³³ The CETA and the TTIP talks include mechanisms to address the trade-impeding effects of differences in regulatory regimes through sectoral regulatory cooperation. While this can promote better regulatory outcomes and reduce trade costs (Hoekman and Sabel, 2017), it does not aim to harness complementarities between sectoral economic governance and services liberalization. Most CETA provisions relating to regulatory cooperation pertain to goods, not services.

Figure 4. Scope for deliberation & dispute settlement on market access/governance matters under EU law and trade agreements

EU integration (EU law and regulation)						
Intra-EU market access restricting measures by:				Governance performance by:		
Actor:	EU institutions	EU governments	Partner government	EU institutions	EU governments	Partner government
<i>EU institutions</i>	n.a.	EU law: EU Pilot; Infringement procedures; CJEU	No	EU Court of Auditors	Art. 7 TEU; structured dialogue; Council det. of breach (w/ Parliament consent); sanctions	Dialogue; potential sanctions (e.g., GSP+)
<i>EU governments</i>	Council dialogue; EU Courts	n.a.	No	Council; CJEU	No	Dialogue
<i>EU persons</i>	EU Courts	SOLVIT; national/EU Courts	No	EU courts	National courts; European Court of Human Rights; CJEU	No
<i>Partner government</i>	No	No	n.a.	No	No	n.a.
<i>Partner persons</i>	No	No	n.a.	No	No	n.a.
Preferential trade agreement provisions and mechanisms						
(Extra-EU) market access restricting measures by:				Governance performance by:		
Actor:	EU institutions	EU governments	Partner government	EU institutions	EU governments	Partner government
<i>EU institutions</i>	n.a.	Council; EU law	Dialogue/DSM	n.a.	n.a.	Dialogue/aid
<i>EU governments</i>	Council	n.a.	No (EU competence)	n.a.	n.a.	Dialogue/aid
<i>EU persons</i>	No	No	No	No	No	No (possibly ISDS)
<i>Partner government</i>	Dialogue/DSM	No (EU competence)	n.a.	No	No	n.a.
<i>Partner persons</i>	No	No	No	No	No (possibly ISDS)	If national law permits

Notes: DSM: dispute settlement mechanism under a trade agreement; CJEU: Court of Justice of the European Union; n.a.: not applicable.

The focus of EU external trade agreements is primarily on market access commitments. These are judicable through State-to-State dispute settlement mechanisms established by each agreement. Legal or natural persons do not have direct access to these. Indeed, while EU citizens or businesses can contest actions by EU governments that violate EU law, they cannot invoke the provisions of trade agreements signed by the EU in national or EU courts (Hoekman and Mavroidis, 2014; Petersmann, 2015). Nor do EU natural or legal persons have direct access to mechanisms to contest the actions of partner country governments with respect to market access provisions. Similarly, citizens and businesses in partner countries do not have access to mechanisms under trade agreements to directly contest non-implementation of market access commitments by the EU or their own governments.

Because ESR-related provisions in PTAs take the form of soft law, dialogue and technical and financial assistance are the main instruments to engage with counterparts and support groups in partner countries that have an interest in improving ESR performance. Some elements of governance performance may be contestable by natural or legal persons, whether EU-based or from partner countries, but this will involve non-trade agreement mechanisms. Examples include claims of violation of human rights or fundamental freedoms before the relevant (international) courts – e.g., the European Court of Human Rights – and investor-State dispute settlement (ISDS) procedures under a bilateral investment treaty (BIT). The former type of legal rights and the claims that they may give rise to have little overlap with the type of regulatory and governance institutions that affect the gains from services trade and investment liberalization. ISDS cases potentially are somewhat more salient from the perspective of addressing regulatory measures, but are limited to cases involving specific instances of foreign investment and allegations that (changes in) regulatory policies imply some degree of expropriation in violation of specific provisions of a BIT.³⁴ However, they are very unlikely to induce improvements in the type of economic governance that matters for increasing the economy-wide benefits of services trade liberalization.

Some options looking forward

Trade agreements covering services could become more effective instruments to support productivity growth and increase economic welfare if they did more to raise the profile of broader economic governance institutions as well as sector-specific services regulation, and did more to engage with the actors who are directly concerned with opening of services markets to greater competition. Complementing the current emphasis on market access narrowly defined (discriminatory policies) and support for ESR with concerted efforts to generate greater transparency of prevailing measures restricting access to markets and related sector-level regulation would help to identify factors that negatively affect cross-border economic activity. In practice much in the way of both economic governance and sectoral regulation is unlikely to be (ever become) subject to binding disciplines in a trade agreement. There are good arguments against this in any event as regulators should have discretion in taking action to further the public interest in addressing market failures. However, the EU experience suggests that progress can be made through deliberation and peer review processes to improve regulatory outcomes while facilitating trade and investment. Currently trade agreements do little to encourage compilation of information on prevailing measures or to engage in a dialogue on governance-related policies. Monitoring efforts are limited to solicitation and compilation of market access complaints from EU firms and concerns from civil society groups regarding the protection of ESRs. In principle these feed into the agendas and work of committees charged with overseeing the

³⁴ An example would be a change in regulations that undercut a so-called stabilization clause under which an investor was assured a specific legal regime would apply for the duration of an investment.

respective agreements, but there is little public information and reporting on the extent to which this occurs and what the outcomes are.³⁵

The EU experience reveals the importance of targeting both market access barriers and sectoral regulatory regimes, and that the latter is much more complex than the former. Different approaches can be envisaged to support greater attention for sectoral regulatory policies and broader economic governance variables in trade agreements, complementing the market access focus that is central in PTAs. These range from enhanced transparency and policy dialogue type mechanisms that provide opportunities for a broad set of actors to engage on both market access and related economic governance matters, including self-evaluation and peer review (mutual evaluation) on the one hand, to the negotiation of binding policy commitments that can be enforced by businesses and natural persons (citizens) on the other. The complementarities between sectoral regulation/governance and market access barriers will differ across countries and will also change over time. Thus, priorities and solutions cannot be determined *ex ante*, but call for analysis and deliberation involving government officials, regulators and stakeholders focused on reviewing and assessing the performance of economic governance institutions. Such deliberation will also generate information on capacity constraints, including at local level, that need to be addressed, including a lack of knowledge or uncertainty on the part of implementing agencies as to what is required of them.³⁶

Transparency is an important necessary condition for increasing the profile of regulatory and economic governance matters. As important is analysis to identify the measures that are most pertinent at the sector/services provision level. The prospects for improving governance and regulatory performance through a bottom up process of dialogue with stakeholders, learning and peer review by partner countries may be better than one based on hard law and binding dispute settlement procedures – not least because the latter may inhibit commitments from being made in the first place. The experience obtained with SOLVIT shows that many issues arising in the EU single market context can be addressed without going to court. Of course, a premise of SOLVIT is that government agencies want to comply with EU regulations, i.e., the problem in many cases is the application of local or national measures and not discriminatory intent. This is likely to be less the case in the PTA context. Nonetheless, analogous mechanisms involving the creation of national focal points could be a positive force for gradual improvement in governance and regulation-related areas. Whether or not such approaches can be adopted, what matters is to increase the attention for economic governance and sectoral regulation and to support processes to identify actions that will increase the benefits of services liberalization. This can be made part of the agenda of monitoring activities and the agenda of the various committees and summits that oversee the implementation of trade agreements, and could build on the experience and lessons obtained from intra-EU integration mechanisms, including the single points of contact and the process of mutual evaluation of sectoral regulatory measures.

A more ambitious approach would be to increase the incentives for governments to implement market access liberalization commitments and to pursue better regulation by leveraging the self-interest of firms. There has been much debate in Europe on the rationale for including ISDS provisions in trade and investment agreements. One reason for concern expressed by many opponents is the view that firms already have access to national (and EU) tribunals and that there is no need for a separate system of arbitration that may undermine the democratic process by contesting what polities deem to be welfare-enhancing changes in applicable regulation. ISDS procedures were incorporated into BITs for a specific, limited purpose – investor protection. ISDS is driven by the self-interest of investors

³⁵ The EU Market Access database, which covers all EU trading partners, does not appear to include data generated from monitoring the implementation of EU's trade agreements except implicitly – e.g., indicating if a preferential duty should apply to exports from the EU. See <http://madb.europa.eu/madb/indexPubli.htm>.

³⁶ This is one of the inferences that can be drawn from the SOLVIT process.

(and those providing the associated legal services), not by public good considerations. But the example of ISDS illustrates that it is possible for states to agree that enforcement of international agreements can be delegated to firms. In the trade area, so-called bid-protest (domestic review) mechanisms are an element of the WTO Agreement on Government Procurement (GPA). These allow firms to challenge ongoing procurement contests and contract award processes that are perceived to violate GPA provisions (see Georgopoulos, Hoekman and Mavroidis, 2017).

Creating mechanisms through which firms can challenge compliance with mutually agreed specific economic governance-related commitments would harness private interests to promote the public good. A first step in this direction could be to permit recourse by foreign persons to existing EU law and regulations pertaining to the Internal Market – as these are measures that have been agreed by EU member states and endorsed by the European Parliament. Indeed, this would not constitute much a change to the status quo as all such measures are already enforceable. Foreign firms already have access to formal and informal dispute resolution and enforcement mechanisms if they are established in the EU. Extending this possibility to firms that are not established in the market (have not established a commercial presence through FDI) could help expand the set of actors with an incentive to utilize existing channels to contest perceived violations of EU law and regulation. While this is unlikely to be feasible given the strong revealed preference on the part of the EU (and partner countries) for State-to-State dispute settlement processes, establishing platforms through PTAs where such matters can be raised and discussed can make a positive difference. Although existing mechanisms already permit enforcement actions to be taken in cases of non-compliance with EU law, the determinants of compliance are complex and multidimensional. As noted by König and Mäder (2014) there may be situations where the balance of incentives confronting the European Commission are insufficient to motivate enforcement action. If the (political) costs for the Commission of sanctioning a EU government are high, enforcement may not occur. Increasing the visibility of noncompliance and creating the prospect of action by trading partners may help to swing the balance of enforcement towards greater action. The upshot would be that infringement proceedings brought by the European Commission through letters of formal notice, reasoned opinions and eventual referrals to the CJEU would be complemented by parallel enforcement pressure by trading partners.

5. Conclusion

Services account for over 70 percent of GDP and an even higher share of total employment in the EU and other high-income countries. While services trade and FDI flows are substantial, the share of services output that is traded is much less than is the case for goods. Greater trade and cross-border investment in services is an important potential driver of productivity growth. Realizing this potential requires not just liberalizing trade in services (removing discriminatory entry-restricting policies) but improvements in economic governance. It is well known that there is still much to be done to achieve the goal of a single EU market and that this is a core element of improving the economic growth performance of the EU (e.g., Mariniello, Sapir and Terzi, 2015; Egan and Guimarães, 2016). Both the monitoring exercises by the European Commission and recent data compilation projects by the OECD show there is a great deal of variance in both the level of external services trade restrictions across EU member states, and the quality of economic governance.

There is an important asymmetry when it comes to EU trade cooperation initiatives in terms of the consideration that is given to regulatory regimes and the quality of governance institutions. In the case of EU accession candidate countries very significant conditionality is imposed by the EU centered on adoption of EU law, accompanied by extensive technical and financial assistance and comprehensive monitoring of progress in converging towards the *acquis*. In the case of deep and comprehensive trade agreements with neighboring ENP countries the focal point is also EU law and practice, but on an *à la carte* basis, complemented by assistance for partner countries to upgrade administrative capacity and

regulatory standards and gradually converge towards EU norms in areas prioritized by ENP governments. EU trade agreements with developing countries such as the Economic Partnership Agreements are much less far-reaching but still address some elements of economic governance – e.g., provisions calling for transparency and publication of applicable laws and regulations, or procedural rules pertaining to the enforcement of mandatory product standards, as well as soft law provisions on ESRs.

In all these cases the focal point for action is not to improve economic governance and related regulatory institutions in trading partners. Nor do EU trade agreements include specific governance-related commitments that apply to EU member states and that could help attain the Single Market. The presumption is that EU law and regulation is the baseline, that all EU member states are in compliance with that baseline, and if not, that this is a matter for EU institutions to resolve and EU persons to contest. In the case of North-South agreements such as Economic Partnership Agreements between the EU and developing economies the discussion in this paper bolsters arguments for the importance of complementing or conditioning liberalization on improving economic institutions in countries with weak economic governance performance, through e.g., aid for trade mechanisms, so as to increase the prospect that expected benefits of implementing an agreement actually materialize. But the case for including a greater focus on economic governance and services-sector regulation in trade agreements extends to initiatives between high-income economies. This could start with emulating the transparency, reporting, peer review and deliberation features of the approaches used in the EU single market context to support greater cross-border trade and investment in services.

There has been much debate regarding the salience of concerns that deep and comprehensive trade and investment agreements such as the TTIP may undermine regulatory goals and circumscribe policy space. Insofar as this results in reduced ambition and only limited progress to liberalize trade in services the consequence will be little in the way of welfare gains (see, e.g., Francois et al. 2013). Devoting more attention and effort to improving knowledge and understanding of the importance of improving economic governance as part of the agenda of trade agreements could increase the magnitude of the dynamic gains generated by trade and investment liberalization. A greater focus on leveraging the political visibility associated with implementation of trade agreements to enhance transparency of economic governance performance through collection of data and analysis of how outcomes depend on governance and sectoral regulation, complemented by creation of deliberation mechanisms to foster dialogue on regulatory matters and related learning would help support both market access objectives and make PTAs more useful instruments to improve regulatory outcomes. Concrete initiatives that could be taken within the framework of existing modalities and political guidance for the negotiation of PTAs to move in this direction include extending efforts that are already being made to monitor partner country trade policies (the EU Market Access Strategy and Database) with collection of data on regulatory measures and economic governance performance; fostering greater dialogue and engagement with and between industry associations and other stakeholder groups on economic governance matters in both the EU and partner countries; more support for sectoral regulatory cooperation (Hoekman, 2015); and greater focus on ex post evaluation of the economic effects of implementation of trade agreements.

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