Services Market Liberalization, Economic Governance and Trade Agreements

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Abstract

Recent research on the interaction between services trade and investment restrictions and the quality of economic regulation has shown that the productivity growth benefits from liberalization depend importantly on the quality of economic governance. We provide quantitative estimates of the extent of potential downstream productivity gains from services liberalization for EU countries and how these are conditional on domestic economic governance performance and discuss several dimensions of the state of play in the EU with respect to implementation of the Services Directive and realization of the Single Market objective. We argue that more attention should be given in the design of services trade agreements to improving economic governance, and make several suggestions how this could be done.

Keywords: barriers to trade in services; regulation; governance; trade agreements; Single Market

JEL codes: F13; F15; O43

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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 enhancing the ability of foreign firms to contest services markets. 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. Services trade barriers frequently are high; in some sectors trade may be prohibited altogether. In the EU this is the case for example for health, educational and social services that are provided in the public interest, as well as audiovisual services. In the US, there are severe limitations on the ability of foreign firms to supply certain transport services. In virtually all countries there are licensing and certification requirements that generally imply additional costs for foreign providers even if they are permitted to supply services.

Recent compilations by the OECD and the World Bank have shown that barriers to trade in services are significant. There is therefore a presumption that liberalization will lower average prices, increase quality and expand the variety of services on the market. This in turn will benefit domestic firms that are buyers of services, and thus households – both indirectly as consumers of final goods and directly as buyers of services that satisfy final demand (e.g., leisure activities such as tourism). Insofar as this is the case, there is a good case for engaging in international negotiations to lower trade barriers. 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.

Services are an important element of the agenda of the bilateral talks between the EU and the US on a Transatlantic Trade and Investment Partnership (TTIP). One-third of all US services exports go to the EU, while 35 percent of US imports come from the EU. Bilateral shares are even higher for services provided via FDI: 43 percent of all services supplied by affiliates of US multinational companies in foreign countries were sold in the EU. Conversely, 55 percent of all sales of services by affiliates of foreign-owned firms in the US were of EU origin (Cooper and Nelson, 2014). Both trade heavyweights are also engaged in negotiations on a Trade in Services Agreement (TiSA), together with 22 other countries. Services are increasingly included in trade agreements the EU is negotiating with neighboring countries, and more generally are becoming more prominent in new trade agreements. Model-based simulation analyses of the potential economic effects of trade agreements covering services tend to find that the potential net benefits will be limited. In part this reflects an assumption that liberalization will not be ambitious and that many of the barriers to services trade cannot be tackled even if there was a willingness to do so by governments.[1] This may well be a realistic assessment – to date most trade agreements, outside of the EU itself, have not led to far-reaching liberalization of services markets (Miroudot and Shepherd, 2010).

Services liberalization has been problematic in many trade negotiations initiated by the EU with developing countries, notably in the context of Economic Partnership Agreement talks. But services have also generated controversy in the TTIP context with civil society and a number of EU governments making clear they have strong concerns regarding opening up services sectors to

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[1] For studies of TTIP coming to this conclusion see Francois et al. (2013), Egger et al. (2015) and Fontagné et al. (2013). Pelkmans (2016) provides a comparative discussion of alternative ex ante empirical analyses of the TTIP. Model-based assessments of the potential impacts of trade agreements may be biased because of the difficulties of accurately considering the different modalities of – and thus policies affecting – trade services (Mustilli and Pelkmans, 2013) and the longer term dynamic effects of services trade reforms on firm- and sector-level productivity performance.

greater foreign competition. The opposition to reciprocal commitments to liberalize services is a bit of a puzzle insofar as trade in services often will involve FDI and thus generate domestic employment, as foreign investors will employ host country workers and generate both direct and indirect demand for a broad range of local goods and services. One explanation is that although in principle domestic (national) regulatory standards apply to foreign providers in the same way as to domestic firms, civil society groups and voters may not believe arguments by governments and/or, in the case of the EU, the European Commission, that regulatory regimes will apply equally to foreign services providers and products. Such a lack of trust is an important matter that we return to later in this paper.

In what follows we argue that trade negotiations should explicitly consider the relationships between services trade and investment restrictions and the quality of economic governance and regulation,[2] and that trade agreements that span services liberalization should include provisions that target the performance of economic governance institutions. Our quantitative estimates of the potential gains from services liberalization suggest that these can be substantial, but are conditional on the quality of domestic economic governance: if weaknesses in the latter are not addressed gains from services liberalization may not materialize. Addressing weaknesses in economic governance institutions in the design of trade agreements will enhance the gains from services trade liberalization while at the same time improving the prospect of attaining good regulatory practices. An implication for the EU is that the performance of regulatory and economic governance institutions should feature more centrally on the agenda of trade agreements with other high-income economies.

The plan of the paper is as follows. Section 2 describes the methodology and empirical approach that is used to quantify the potential productivity impacts of services trade barriers on manufacturing productivity for a selection of industries and how these are affected by country-level regulation and economic governance variables. Section 3 briefly summarizes several dimensions of the state of play in the EU with respect to implementation of the Services Directive and realization of the Single Market objective. Section 4 discusses how trade agreements might be (re-)designed to enhance the prospects of opening markets to trade and investment and improving economic governance, and thus do more to foster productivity growth. Section 5 concludes.

2. Assessing the impact of services trade restrictions

Services are very heterogeneous. Some satisfy final demand – e.g., recreation, passenger transportation, health and cultural services – but many are intermediate inputs into production. In practice services account for a substantial share of all inputs used by firms, and the cost, quality and variety of services available to firms are an important determinant of competitiveness. Empirical research on the effects of barriers to services trade has identified the importance of the productivity impacts for industries that use services as intermediate inputs (Francois and Hoekman, 2010). This line of research is motivated by the fact that a variety of services such as finance, insurance, telecommunications, transport and distribution services are inputs into production. Consequently, sector-specific restrictive trade policies that impact on the degree of competition on services markets, and thus on markups and sectoral efficiency, will affect negatively downstream sectors as well as the performance of protected services sectors themselves.

Empirical studies analyzing the linkages between services trade policies and downstream productivity, both country-specific research using firm or plant-level data and studies adopting a cross-country perspective identify sizable positive effects of liberalizing services trade for the

[2] In this paper we 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).

productivity and export performance of firms operating in downstream industries (notably manufacturing).[3] In what follows we focus on the effect of services trade policy on downstream industries, recognizing that this is just one dimension of how such policies impact on economic welfare.[4] The purpose is not to assess the overall effects of services trade policies but to illustrate how such effects may depend on the quality of institutions and governance and draw out the implications for the design of trade agreements.

It has long been known that the magnitude of the net benefits from trade liberalization depend on country-specific conditioning factors, such as the quality of local governance institutions (Rodriguez and Rodrik, 2001; Freund and Bolaky, 2008).[5] Recent research has shown that this is also the case for services, and may in fact be particularly salient. Beverelli et al. (2017) find that the positive productivity effects associated with lower barriers to trade in services depend importantly on country-level economic governance variables. Using the World Bank's services trade restrictiveness indices (STRIs)[6] for a cross-section of 57 countries and following the widely used approach initially proposed by Rajan and Zingales (1998), Beverelli et al. (2017) estimate the following model:

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

where y_{ij} is the natural logarithm of productivity in downstream sector j in country i, EG_i is a measure of economic governance 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 $CSTRI_{ij}$ is a measure of the effective restrictiveness of services trade policy confronted by downstream sector j in country i.[7]

The estimated coefficients on $CSTRI_{ij}$ (β) and on the interaction term (μ) 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. Beverelli et al. (2017) find that higher STRIs are associated with lower productivity performance in downstream sectors, but that this effect if highly dependent on the quality of governance, as measured by indicators such as the strength of the rule of law, regulatory quality and control of corruption. The estimated marginal effect of reducing barriers to services trade on downstream productivity that accounts for heterogeneity in economic governance is given by $-\frac{\partial y}{\partial CSTRI} = -\beta - \mu \times EG_i$ where the minus sign in front of the marginal effect reflects the fact that reducing barriers means decreasing the values of STRI which in turn results in lowering the value of $CSTRI$. This marginal effect increases with the quality of governance ($\mu < 0$) and it is significantly positive (at a 0.05 percent level of statistical

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[3] Country studies include Arnold et al. (2011) for the Czech Republic, and Bas (2014) and Arnold et al. (2016) for India; cross-country analyses include Barone and Cingano (2011), Bourlès et al. (2013) and Hoekman and Shepherd (2015).

[4] Other dimensions include employment effects and the impacts on the productivity and composition of services activities.

[5] 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).

[6] Borchert, Gootiiz and Mattoo (2014).

[7] $CSTRI_{ij}$ 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).

significance) for 65 percent of their sample observations (33 countries out of the 57 in their analysis). This conditionality result holds across a number of robustness checks that address the measurement and endogeneity issues embedded in this econometric exercise.[8]

To quantitatively assess how much the downstream effect of services trade policy is influenced by economic governance quality in a country, the estimates of the interaction model can be used to calculate the productivity changes associated with complete removal of the restrictions to services. In the STRI database a fully unrestricted trade policy regime corresponds to an STRI value of zero.[9] Therefore, the policy change required by a country to remove all existing 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 then 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 (β and μ) can be computed as follows:

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

This expression is country-sector specific. The productivity effect of services trade policy is a function of services input intensities at the downstream sector level and of two variables at the country level. The first is the policy change required to reach complete openness; the second is the quality of economic governance. This methodology allows for counterfactual exercises to quantify the effects of policy changes for country i assuming different levels of economic governance quality. The next section uses this approach to assess the relative importance of – and interaction 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 estimated effects of the EU, the UK, the US and Canada as well as selected countries in the 'European neighborhood' of complete removal of barriers to FDI (mode 3 restrictions in WTO speak) in four producer services sectors – finance, transport, communications and professional services[10] – on productivity in downstream industries. This is done based on the expression for $\%\Delta Y_{ij}$ derived above and on the estimates for β and μ obtained in Beverelli et al. (2017). 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, limiting the focus 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 factors imply that the magnitude of the results for any given sector will be upper bounds, as no account is taken of factor

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[8] The robustness checks in Beverelli et al. (2017) include instrumentation and random assignment of the policy component ($\mathrm{STRI_{is}}$) of the composite restrictiveness indicator, estimation with alternative input-output weights or alternative productivity measures, variations in country and industry coverage.

[9] The STRI varies from 0 (no restrictions) to 100 (maximum restrictiveness).

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

[11] While no doubt far-reaching, 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, all sectors where greater foreign competition could have significant positive effects on productivity and choice.

demand or investment diversion effects.[12] However, the main point of the analysis is not the absolute size of estimated potential gains but to identify to what extent such gains are conditional on the quality of governance.

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

	Impact (%Δ —current institutions vs. counterfactual)									
Sector:	Largest Manuf. Sector		Autos		Medical/Instr.		Chemicals		Country Rankings	
	Impact %Δ	Sector	Current Inst.	High Inst.	Current Inst.	High Inst.	Current Inst.	High Inst.	STRI	Governance
Country	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(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	textile/app	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
Memo:										
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	41.82	62.97	41.37	62.29	18	11
Canada	59.8	food/bev	27.2	32.1	58.00	68.52	55.85	65.99	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.

Table 1 reports results for the largest manufacturing industry in each of the 19 EU countries for which we have data, plus the UK, 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

[12] Issues of trade/investment diversion 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.

Restrictiveness Indicators database and the Worldwide Governance Indicators database.[13] Note that 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. Also noteworthy is that 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 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.

A number of observations can be made. First, potential downstream productivity impacts vary widely, ranging from 10-15 percent for several Central European countries to 50 percent or more for France and Germany. Second, many countries with high estimated potential productivity improvements following services liberalization have high levels of mode 3 restrictions. Third, across sectors the potential productivity impacts also are very heterogeneous, reflecting differences in the intensity of service input use across industries. Fourth, countries that stand to benefit the most in terms of size of the potential productivity boost are countries that have the best 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 by the columns in Table 1 labeled 'high inst.' This reflects a counterfactual situation in which each country's governance indicator is replaced with that of the best performing country in the sample (Denmark). This reveals how much a difference better institutions can potentially make in augmenting the productivity effects of services liberalization in economies with weak governance performance.

Results for a sample of European Neighborhood Policy (ENP) countries as well as Turkey (an EU accession candidate country) 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.[14] As a result, the differences between potential productivity impacts under current as compared to best practice governance on control of corruption are particularly high for many ENP countries.[15] The economic intuition for the empirical findings is that removing restrictions on the ability of foreign providers to perform their services locally through establishment of a commercial presence may fail to have the expected pro-competitive effect if a weak institutional and business environment in the host country inhibits foreign firms to enter the market, or, in case they enter, results in them operating inefficiently.

[13] These are available at http://iresearch.worldbank.org/servicetrade/ and at http://info.worldbank.org/governance/wgi/#home.

[14] However, individual ENP countries are sometimes more open than the EU. Georgia is the most open country towards mode 3 in the set of EU and ENP countries.

[15] This is consistent with a related empirical analysis of the welfare effects of trade integration and the role of institutions for the trade patterns of the Eastern Partnership countries. Gylfason et al. (2015) use a gravity model framework to assess the trade effects of trade agreements and find that the agreements signed by these 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) for export performance of Eastern Partnership countries.

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

	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
Country	(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	52.29	140.	47.8	128.5	7 (29)	1 (16)
Lebanon	4.3	food/bev	3.0	92.6	4.51	141.1	4.1	127.5	6 (28)	7 (29)
Morocco	10.5	food/bev	6.7	34.7	9.03	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 countries[16] 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 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

[16] 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/wgi/#home.

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.

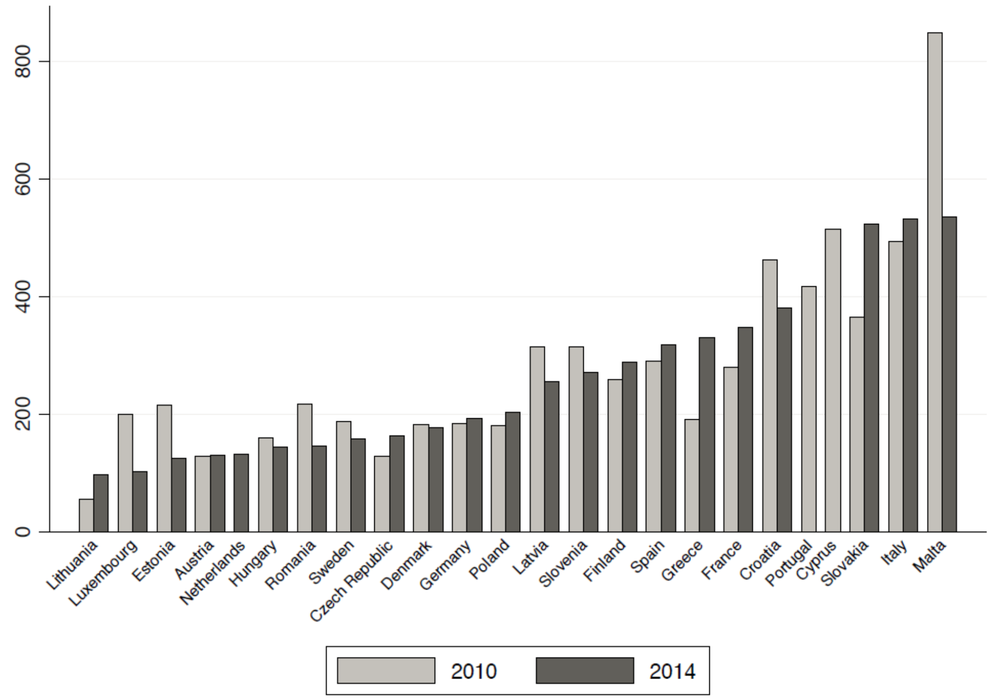
Table 3: Total Factor Productivity Effects of Removing Services FDI Barriers

			Impact (%Δ TFP —current institutions vs. counterfactual)					
	Biggest manuf. industry		Impact: Autos		Impact: Medical/Instr.		Impact: Chemicals	
	Impact: %Δ TFP	Sector	Current Inst.	High Inst.	Current Inst.	High Inst.	Current Inst.	High Inst.
Panel A: *Regulatory Quality*								
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
Panel B: *Rule of Law*								
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
Panel C: *Control of Corruption*								
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.

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; a focus on only horizontal governance measures is likely to be too narrow. 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.

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. EU internal market and the Services Directive

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 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, again complemented by mechanisms to assist partner countries upgrade administrative capacity and regulatory standards so as to support a process of convergence towards EU norms in the relevant areas prioritized by individual ENP governments. EU trade agreements with developing countries such as the Economic Partnership Agreements are much less far-reaching but still include 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. In all these cases the focal point for action is the "exportation" of EU law and practice and/or adoption of internationally accepted good regulatory practices and norms.

This focus on improving regulatory institutions and governance does not apply to EU members themselves. All the member states of the EU are of course subject to EU law and regulations, but in the context of trade agreements with third countries there are no provisions regarding the performance of member states in these areas. EU trade agreements do not include specific governance-related commitments or performance targets that apply to EU member states. 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 as opposed to trading partner governments or natural/legal persons to address.

The EU of course has an extensive body of legislation that binds member states that is relevant to many economic governance-related policy areas. Of particular salience from a trade perspective is that EU member states have agreed to abide by many specific regulations and directives that aim to achieve the Single Market goal. Implementation by member states is monitored by the European Commission, which has been mandated to identify instances of non-compliance and take this up with the countries concerned. If member states do not bring their measures into compliance the Commission can launch infringement procedures, and, if needed, take the matter to the Court of Justice.[17] Such infringement proceedings are complemented by other, less formal, mechanisms such as the EU Pilot and the SOLVIT Network.[18] The EU Pilot procedure, introduced in 2008, consists of an online database and communication tool that supports a consultation process in which the Commission flags potential violations, informs the relevant member state and requests clarification/rectification of a matter. This is a fast-track process in which both sides have 10 weeks to respond to each other. If the response to a query is not deemed to be satisfactory the Commission can open an infringement procedure.[19] There is some suggestive evidence of the EU Pilot of having played a positive role in decreasing the number of infringement cases (Fournier, 2014a). In contrast to SOLVIT (see below), the domain of EU Pilot cases is not limited to cross-border problems and issues (Pelkmans and Brito, 2012).

The SOLVIT network was created in 2002. It allows individuals and firms to signal instances of perceived non-compliance with EU legislation by an EU government to a national center established in each member state as part of the national administration (usually the Ministry of Industry and Trade, Economic or Foreign Affairs). The aim is to use administrative dispute settlement mechanisms as well as greater transparency and peer pressure as a problem-solving tool. Cases are registered through an on-line system managed by European Commission's internal market Directorate General, with each national SOLVIT center taking up eligible issues brought by a national (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 a mechanism to address disputes rapidly without having to go to court – indeed, a key feature of the system is that it does not involve legal proceedings, although it does preclude this (i.e., SOLVIT is an example of a mechanism that operates in the shadow of the law and hierarchy – 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.[20] Most cases addressed by SOLVIT are submitted by individuals as opposed to businesses.[21]

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[17] Italy is the EU member country with the highest number of pending infringement procedures that were open before May 1, 2015. European Commission, Single Market Scoreboard – Infringement. At http://ec.europa.eu/internal_market/scoreboard/_docs/2015/09/infringements/2015-09-scoreboard-infringements_en.pdf. See Börzel, Hofmann and Panke (2012) for an analysis of determinants of compliance by EU member states with EU law and the results of infringement proceedings and EJC rulings.

[18] Pelkmans and Brito (2012) provide a comprehensive overview and insightful discussion of the landscape of enforcement of EU legislation.

[19] There were 1260 open cases at the end of 2015, with the Commission opening some 900 cases in 2015 and processing almost 1,000 cases during that year. The resolution rate of issues raised by the Commission in 2014 and 2015 was around 75 percent. See http://ec.europa.eu/internal_market/scoreboard/performance_by_governance_tool/eu_pilot/index_en.htm

[20] 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.

[21] As reported by EC (2016), in 2005 the number of SOLVIT cases submitted by a citizen (309) was approximately twice the number of the cases submitted by a firm (142). The number of citizens' cases

Notwithstanding the various mechanisms established over time by the European Commission that aim at monitoring and improving the functioning of the single market, and the access that firms have to national and European courts to contest non-compliance with EU law, significant heterogeneity continues to exist in governance performance across EU member states (viz. Table 1). From a services trade liberalization perspective there is still much to be done to fully realize the vision of a single market. The extent of implementation of the 2006 Services Directive (SD) is particularly salient in this regard. Despite the SD being substantially less ambitious than originally conceived (Badinger and Maydell, 2009), in a number of policy areas and sectors there is a substantial gap between prevailing measures applied by member states and what is required by the SD. This reveals the limited success in ensuring the full implementation of what EU member states agreed to be the appropriate services trade and investment policy stance.

The European Commission maintains a database on compliance with a number of key requirements of the SD for 15 services sectors.[22] 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.[23] For example, the SD 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); requires the removal of explicitly discriminatory policies (Art. 14) – such as nationality requirements – and imposes disciplines on nondiscriminatory requirements that may impede market access (Art. 16) – e.g., limits on the number of establishments that are permitted, or a requirement that a firm employ a minimum number of employees (measures listed in Art. 16 are indicative and do not comprise an exhaustive list). However, these disciplines are hollowed out by Art. 15 (Fernández-Corugedo and Pérez Ruiz, 2014) which permits countries to maintain competition-restricting measures, subject to a process of evaluation whether they are necessary and proportional (examples mentioned in the SD include quantitative or territorial restrictions; restrictions on the legal form of an entity; requirements concerning equity holdings and price controls).[24]

The Commission 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 SD embodied in requirement r. This distance measure D_{csrt} takes four discrete values between 0 or 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 currently spans three years: 2009 (capturing compliance before the 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 $\overline{D}_{ct}$ across sectors and requirements. While the gap has been decreasing over time for all countries, especially in the period between 2009 and 2012, full transposition of SD requirements is not observed in any country-time pair and there is substantial heterogeneity across member states. Recently acceded countries Bulgaria and Romania

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increased to 2,121 in 2015, while those brought by companies remained relatively stable, rising to 212 in 2011 and falling to 107 in 2015. See also Pelkmans and Brito (2012).

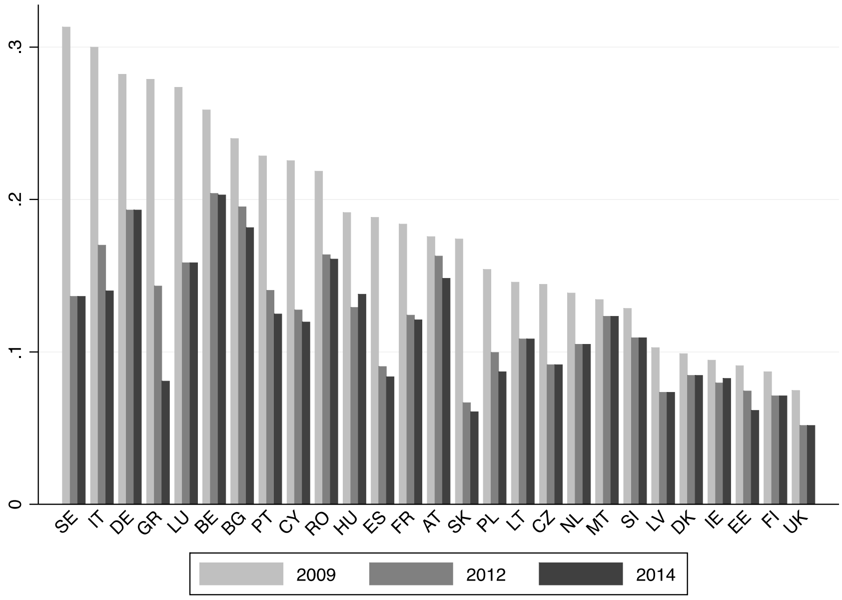
[22] A number of major service sectors are excluded from the SD, including financial, telecommunications, transport services and healthcare. These are not covered in the database.

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

[24] Art. 15 allows countries to maintain already existing non-discriminatory restrictions if these can be justified on the basis of being necessary to protect the public interest. If so, such requirements must be neither directly nor indirectly discriminatory according to nationality nor, with regard to companies, according to the location of the registered office; must be justified by an overriding reason relating to the public interest (necessity); must not go beyond what is necessary to attain that objective (proportionality).

register a substantial gap, which is not surprising. More striking is the heterogeneity across long-standing members of the EU, with Belgium and Germany registering the greatest average gaps in 2014. Italy, France, Austria and the Netherlands also have gaps that significantly exceed those of other countries. The UK, Slovakia and Estonia are the best performing countries when it comes to implementation of the SD.

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



Notes: The figure plots the country-level simple average of D_{csrt} across covered sectors and SD requirements.
Source: Authors' calculations using the European Commission SD database.

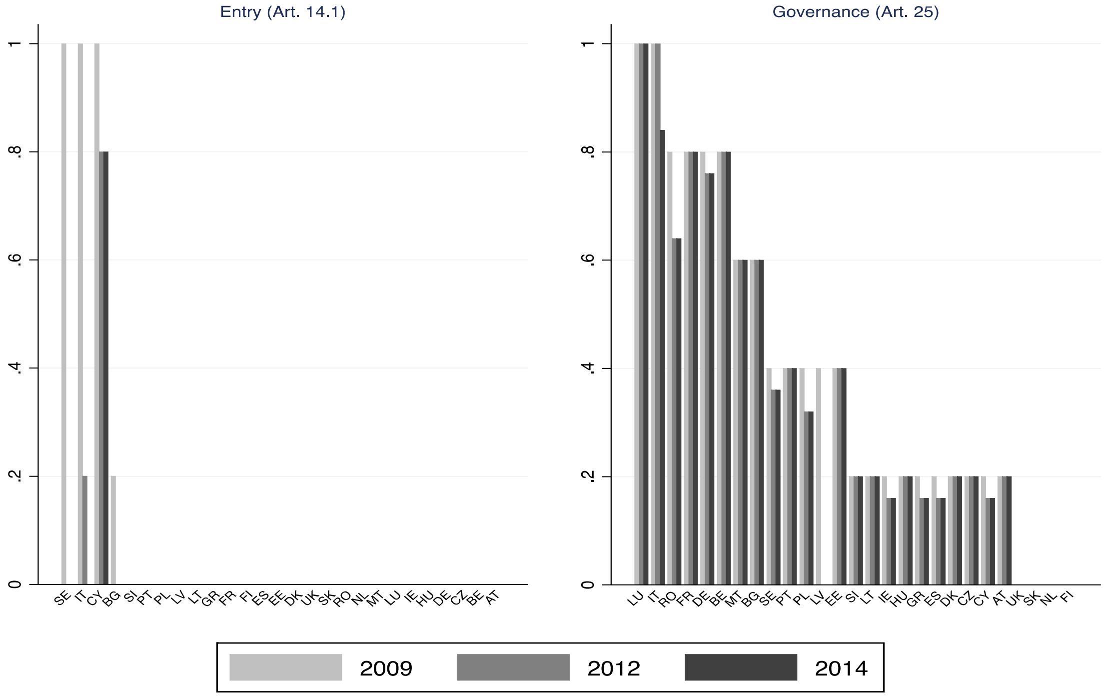
These data permit a more disaggregated analysis and focus on compliance in producer services that are intermediate inputs for other sectors. The SD covers a number of such services, including accounting, architectural, engineering, legal, and tax advisory services. The database includes measures that impact on market access as well as certain regulatory policies that impact on conduct. A representative market access related provision is the requirement in SD Article 14.1 banning discriminatory requirements based on nationality. An example of a conduct or governance related requirement is SD Article 25, which prohibits restrictions on service providers engaging in so-called multidisciplinary activities.[25]

Figure 3 plots the distance between the policy regimes prevailing in EU member states and these selected "market access" and "conduct" requirements for the above mentioned business services.[26] This reveals that with the exception of Cyprus, as of 2014 nationality requirements no longer apply in member state legislation (Figure 3, left panel). The SD did not play a big role in achieving this result as with the exception of only four countries EU member states were already in compliance

[25] Art. 25(1) calls on Member States to ensure that 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. In contrast to other requirements, such as Arts. 9 and 16, Art. 25 concerns conduct regulation as opposed to measures that restrict entry of foreign providers (market access). Van der Marel et al. (2016) provide empirical evidence that conduct regulation in the EU has a greater impact on the performance of downstream sectors using services.
[26] Simple averages are used to aggregate individual sectors.

with this requirement before 2009. In contrast, the specific aspect of conduct regulation captured by SD Art. 25 pertaining to multidisciplinary activities of services providers was and remains a constraint for business services: multidisciplinary activities are significantly restricted on average, with little progress observed for many EU member states between 2009 and 2014 (right panel Figure 3).

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



Notes: The two panels in the figure plot the country-level simple average of D_{csrt} across five business sectors (accounting, architectural, engineering, legal, and tax advising services) respectively 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.

4. Revisiting trade agreements to support services liberalization

The findings presented in the previous sections point to the importance of improving regulatory regimes and governance as complement to liberalization of services trade and the continuing gap between the vision of a single European market for services and the current state of play. The extent of policy and regulatory heterogeneity across EU member states spans both broad-based indicators of rule of law or control of corruption and more specific services-related measures.[27] Both have implications for economic effects of actions aimed to liberalize trade and investment in services and thus the potential net benefits of trade agreements that include services.

These observations suggest more consideration be given to using trade agreements as a vehicle to improve the quality of governance and reduce the trade-impeding effects of regulatory heterogeneity. To date arguments for considering the quality of regulatory institutions and governance in trade agreements have been limited to the context of initiatives between high-income and developing nations (so-called North-South trade agreements) such as the Economic Partnership Agreements the EU has concluded with ACP countries. The EU has long linked trade

[27] See Fournier (2014), Fournier et al. (2015) and Nordås (2016).

preferences for developing countries to commitments (and sometimes progress) on good governance. The research showing the effects of regulatory quality on the gains from services liberalization suggests that a focus on improving economic governance performance should extend to integration efforts (trade agreements) between high-income countries as well. In its 2015 "Trade for All" strategy, the Commission stated it would use trade agreements to monitor domestic reform in relation to the rule of law and governance, set up consultation mechanisms in cases of systemic corruption and weak governance, and "propose to negotiate ambitious provisions on anti-corruption in all future EU trade agreements, starting with the TTIP" (European Union, 2015, p. 26). Thus, inclusion of a stronger and explicit focus on governance performance is in principle fully consistent with the EU's trade strategy.

An implication of the estimates presented in Section 2 is that EU countries with better governance will benefit more from services trade and investment liberalization. In many cases EU members with better governance are also countries that have higher per capita incomes and that have realized better economic performance than other EU members. This has consequences for political support for trade agreements in that it affects the distribution of the aggregate benefits of liberalization of services trade and investment. There has been significant 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. This provides another rationale for focusing explicitly on regulation and governance in trade agreements. Trade agreements 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 EU regulatory standards – instead trade agreements need to incorporate mechanisms and processes that improve regulatory quality and outcomes (Hoekman and Sabel, 2017).[28] These are matters that go beyond the services liberalization focus of this paper, but are consistent with the argument that trade agreements should devote greater attention to regulatory quality of governance.

Figure 4 provides a very rough characterization of the state of play in trade agreements with respect to provisions on market access and regulatory cooperation and the ability of different actors to enforce them. Not surprisingly, the focus of trade agreements is mostly on market access commitments. These are enforceable through dispute settlement mechanisms that are established by each agreement. Such enforcement generally involves state-to-state processes: in most instances legal or natural persons do not have direct access to them. 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 (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 or violation of market access commitments by the EU or their own governments.

Turning to regulatory policies and governance, trade agreements tend to have much less in the way of substantive obligations. Governance-related provisions usually take the form of soft law, if any are included at all. This does not make them irrelevant of course as the associated dialogue and technical and financial assistance are instruments to engage with counterparts and support groups

[28] The need to develop operational approaches that are based on concepts such as equivalence has increased with the Brexit decision as this is one way to sustain deep integration of markets with non-EU countries.

in partner countries that have an interest in improving governance performance. But such provisions do not cover governance-related policies in the EU member states. In practice some elements of governance performance and regulatory policy may be contestable by natural or legal persons, whether EU-based or from partner countries, but this will generally involve non-trade 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 the use of investor-State dispute settlement (ISDS) procedures under a bilateral investment treaty (BIT). The former type of rights and the claims that they may give rise to have little overlap with the type of regulation and governance issues that affect trade and investment in services. ISDS cases are more salient from the perspective of contesting regulatory measures or the lack thereof, albeit 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.[29]

Figure 4. Scope for invoking market access/governance provisions of reciprocal trade agreements

	Policy area:					
	Market access restricting measures by:			**Governance performance by:**		
Actor:	***EU***	***EU members***	***Partner countries***	***EU***	***EU members***	***Partner countries***
EU bodies	na	EU pilot; Infringement procedures; ECJ	DSM	na	EU Courts (if EU law applies)	**No**
EU persons	EU Courts (EU law only)	SOLVIT; national and EU Courts (EU law only)	**No**	EU courts (if EU law applies)	National/EU courts (if EU law applies)	**No** (except ISDS)
Partner govts	DSM	**No** (trade is a EU competence)	na	**No**	**No**	na
Partner persons	National/EU courts (EU law only)	**No**	**No**	**No**	**No** (except ISDS)	If law permits

Notes: DSM: dispute settlement mechanism; na: not applicable.

Trade agreements could become more effective instruments to support productivity growth and raise economic welfare if the incidence of "No" in Figure 4 was less. Different approaches can be envisaged to achieve this, ranging from enhanced transparency, soft law and policy dialogue type mechanisms that provide opportunities for a broad set of actors to engage on both market access and governance matters, to the negotiation of binding policy commitments that can be enforced by businesses and natural persons (citizens).

A first step that can be considered is to enhance transparency. This can involve creation of mechanisms designed to support a process of identifying regulatory areas and governance institutions that impact on the benefits of services trade and investment and where current policy and/or performance is below par. Establishing mechanisms for discussion between regulators and stakeholders and high-level bodies that are tasked with reviewing the performance of economic governance institutions could help identify where the focus should be. Such mechanisms can be complemented by SOLVIT type of approaches, with national centers that are tasked to assess and engage with counterparts in partner countries to address complaints brought forward by citizens and businesses pertaining to the implementation of agreements. Such an approach can be designed to encompass issue areas on which no binding commitments have been negotiated as this will provide useful information regarding policy areas and measures that are of concern to stakeholders.

[29] 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.

A more ambitious approach would be to go beyond soft law, greater transparency and deliberation and use trade agreements to increase the incentives for EU governments to implement both market access liberalization commitments and provisions to improve regulatory institutions and governance. There has been much debate in Europe on the acceptability of including ISDS provisions in trade and investment agreements. A major reason for concern expressed by many opponents is the view that firms already have access to national and EU tribunals so there is no need for a separate system of arbitration that may undermine the democratic process by contesting what governments and legislatures deem to be welfare-enhancing changes in applicable regulation. These types of concerns have led to a reconsideration of the approach towards investor-State disputes, with greater attention to clearly defining carve-outs for regulatory policy space and the EU proposal to move to a system that is more multilateral and that has the features of a standing court system.

ISDS procedures were conceived as an element of bilateral investment treaties for a specific, limited purpose – investor protection. ISDS is driven by the self-interest of investors and those in the law profession providing the associated legal services, not by public good or general rule of law 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. Outside the area of investment, we can also point to the example of bid-protest and challenge mechanisms that are an element of the WTO Agreement on Government Procurement (GPA). These center on domestic review bodies that can be asked by foreign firms to review ongoing procurement contests and contract award processes that are perceived to violate the provisions of the GPA (see Georgopoulos, Hoekman and Mavroidis, 2017).

Permitting firms to challenge non-implementation of mutually agreed specific economic governance-related commitments would harness private interests to promote the public good. Least far-reaching would be to limit such recourse to already 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. Nonetheless, incorporation into trade agreements would increase the public profile of (non-)compliance with EU law by making this an objective of trade agreements and thus part of the agenda of monitoring exercises and the various committees and summits that oversee the implementation of an agreement. The upshot would be that current infringement proceedings brought by the European Commission through letters of formal notice, reasoned opinions and eventual referrals to the Court of Justice of the European Union would be complemented by parallel enforcement pressure by foreign firms and their governments.

A slightly more ambitious option would be to include specific regulatory performance and governance norms in trade agreements and create mechanisms through which legal and natural persons can engage and provide information and feedback to bodies that are mandated to monitor compliance with these norms. Consistent monitoring and reporting on implementation, based on regular interactions between national entities that are tasked to be focal points for complaints would increase the visibility of the associated set of policy commitments. Transparency is a first important necessary condition for progress. As important is analysis and deliberation on identifying 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 engagement with stakeholders, learning and peer pressure from partner countries may be more effective 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 can be addressed without going to court. It may well be that analogous mechanisms could be a positive force for improvement in governance and regulation-related areas.

Of course such SOLVIT type approaches are not a panacea and will not be sufficient. A premise of SOLVIT is that EU governments believe they are in compliance with EU law, and if not desire to be. That is, the problem in many if not most instances is assumed to one of practical application of local or national measures that happen to be inconsistent with the attainment of the objectives of an EU law or regulation. We showed in Section 2 that weak economic governance can hamper the positive downstream productivity effects of measures to liberalize services trade, while the discussion in Section 3 illustrated that in practice it may be possible to identify with some precision services sector-governance interactions that result in continued market segmentation despite substantial progress in removing entry restrictions. Incorporating the possibility of firms invoking more formal dispute resolution mechanisms into trade agreements that are limited to cases of violation of specific elements of EU legislation – e.g., Art. 25 of the Services Directive as in the case discussed in Section 3 – could further increase the utility of trade agreements as a tool to help the EU achieve services liberalization objectives without in any way questioning existing EU law and regulation. 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 probability of enforcement success is low and/and the (political) costs of sanctioning a government are high, the expected benefits of bringing an action may be less than the costs. 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.

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 et al. 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 services trade restrictions across EU member states, and in the prevailing business environment as measured by standard indicators of the quality of economic governance.

There has been much debate regarding the salience of concerns that deep and comprehensive trade and investment agreements 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 that little in the way of the welfare gains will emerge from trade negotiations (e.g., Francois et al. 2013). In this paper we have argued that trade agreements should devote more attention to improving economic governance. Options range from less to more intrusive. A greater focus on transparency and creation of deliberation mechanisms that leverage the political visibility associated with implementation of trade agreements would already be beneficial. Such mechanisms to foster dialogue and engagement with firms and other stakeholders could be complemented with more focus on ex post monitoring and learning, along the lines of the Regulatory Cooperation Councils envisaged in the CETA and proposed for the TTIP (Hoekman and Sabel, 2017). More ambitious would be consideration of provisions that give firms access to mechanisms to not just flag but challenge measures that violate not just market access commitments but common agreed good governance standards.

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 ensure that expected benefits of implementing an agreement actually materialize. But the case for including a greater focus on economic governance in trade agreements extends to initiatives between high-income economies.

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