Trade Agreements, Regulatory Institutions and Services Liberalization

Matteo Fiorini
Research Fellow, Robert Schuman Centre for Advanced Studies, EUI
Villa Schifanoia | Via Boccaccio, 121, 50133 Florence Italy
Matteo.Fiorini@eui.eu

and

Bernard Hoekman
Professor, Robert Schuman Centre for Advanced Studies, European University Institute
Villa Schifanoia | Via Boccaccio, 121, 50133 Florence Italy; Tel: +39 055 4685 497
Bernard.Hoekman@eui.eu [corresponding author]

Revised: April 30, 2018

Abstract

Many agreements to liberalize trade in services tend to be limited in scope. This is a puzzle considering the high share of services in total employment and value added and relatively high barriers to trade in services in many countries. In this paper we argue that neglected complementarities between services trade policies and domestic regulation may help to understand the limited ambition on services observed in many trade agreements. We show that the productivity effects of services trade liberalization are conditional on regulatory quality. Our findings suggest that greater effort to design trade agreements with a view to improving regulatory quality may be a necessary condition for deepening the services coverage of trade agreements and will enhance the welfare gains from services trade liberalization.

Keywords: trade in services; liberalization; regulation; trade agreements

JEL codes: F13; F15; O43

.

1. Services trade policies and economic performance

Modern economies are service economies. Different types of services account for both a significant share of final demand (e.g., health and recreational services) and intermediate consumption. Many services are inputs into production, accounting for a significant share of total costs of production (e.g., design, R&D, finance, transport, distribution, etc.). The efficiency of services sectors is determinant of the productivity and thus the competitiveness of the "downstream" industries that purchase services inputs, as well as the aggregate productivity of economies (Barone and Cingano, 2011).

Trade barriers to trade in services are often high in many countries (Jafari and Tarr, 2017), suggesting a presumption that liberalization will enhance economic welfare by lowering average prices and expanding the variety of services available on the market. It is therefore not surprising that services increasingly have figured on the agenda of trade negotiations. However, while most trade agreements concluded since the mid-1990s reference trade in services and many include substantive provisions,[1] analysts have found that frequently these do little to liberalize trade (Roy, 2011; Miroudot et al. 2010). Negotiations to expand the General Agreement on Trade in Services (GATS) as part of the WTO Doha round (launched in 2001) failed. A subsequent initiative by a group of WTO members to conclude a plurilateral Trade in Services Agreement (TiSA) in 2012 is in limbo at the time of writing following the election of President Trump. The 2016 Trans-Pacific Partnership (TPP) agreement included services but did relatively little in going beyond the GATS commitments of participating countries (Gootiiz and Mattoo, 2017).[2] Limited services liberalization is not restricted to trade agreements involving developing nations. Services have also been controversial in negotiations between high-income countries: in the context of the Transatlantic Trade and Investment Partnership (TTIP), civil society groups expressed strong concerns about opening public services sectors to greater foreign competition (Young, 2016).

Overall, trade agreements that include services are largely limited to commitments that "lock-in" prevailing policies as opposed to liberalization (Hoekman, 2008). This is not without value as it reduces policy uncertainty. The economics literature has stressed the role that international agreements can play as a policy commitment device (Maggi and Rodriguez-Clare, 1998) and the associated welfare benefits that are generated through curbing uncertainty, which supports investment by firms in greater trade. The salience of this function of trade agreements increases in periods of economic distress and trade policy tensions of the type that are presently prominent (Carballo, Handley and Limão, 2018).[3]

While this helps to understand the 'lock-in' value of trade agreements, the limited ambition of services liberalization commitments in trade agreements is something of a puzzle. Services account for most economic activity in middle and high-income countries – over 70 percent of GDP and employment in the EU is created by services sectors. Services are also activities where there is much dynamism – e.g., IT-enabled services and the digital economy more generally. By not including services much of the potential gains from trade agreements may be forgone. Recent research on the value-added content of trade has shown that a significant share of value added embodied in goods reflects services, and more generally, that the competitiveness (productivity) of manufacturers and farmers depends on access to high quality, competitively-priced services (Lanz and Maurer, 2015). As liberalization enhances such access it should be supported by a broad cross-section of businesses.

More generally, given a presumption that foreign firms bring new ideas and product varieties, liberalization should enhance overall welfare.

The question why trade agreements – outside of the example of the EU, which is of course much more than a trade agreement – have done relatively little to liberalize trade and investment in services is the subject of this paper. We argue that reasons suggested in the literature are partial at best and propose a complementary explanation: the impacts of services trade policy (barriers) and thus services liberalization depend importantly of the quality of economic regulation in a country.[4] Improving the quality of domestic regulation therefore should become an objective of services trade agreements, complementing the standard focus on market access liberalization. This is consistent with explanations that center on ownership and market structure and the magnitude and distribution of rents created by services trade restrictions and that point to the importance of effective competition law-type disciplines. However, we argue there is a broader need to consider the quality of regulatory institutions in the design of trade agreements to increase the prospects that services liberalization will enhance national welfare. This does not figure prominently in trade agreements. Our analysis suggests this is a weakness in extant approaches, as complementary efforts to improve domestic regulation will increase the gains from services trade liberalization.

The plan of the paper is as follows. Section 2 discusses explanations that have been offered why services liberalization is limited in most trade agreements and argues that the most compelling of these relate to concerns that services markets may be characterized by imperfect competition. Section 3 presents new empirical estimates for 57 countries of the impact of services trade restrictions on productivity of manufacturing sectors, and shows that this depends on the quality of prevailing regulation. Section 4 briefly discusses implications for the design of trade agreements. Section 5 concludes.

2. Services liberalization in trade agreements: Why so little?

Space constraints preclude an in-depth discussion of the evidence on the coverage and depth of services trade liberalization commitments in trade agreements. Numerous assessments have concluded that although many PTAs have broader sectoral coverage of services than what countries have committed to in the GATS (see, e.g., van der Marel and Miroudot, 2014), in practice the average agreement on trade in services does not generate significant liberalization of services trade.[5] This is reflected in research that shows that trade agreements have not resulted in reductions in trade costs for services – in contrast to agreements liberalizing trade in goods (Miroudot and Shepherd, 2014).

This is a puzzle given the importance of services in modern economies, the fact that most services are produced locally and relatively high barriers to trade in services (Borchert et al., 2014; Jafari and Tarr, 2017). Scholars have suggested several hypotheses to explain the puzzle (Hoekman, 2008). One is that political economy forces make trade agreements less salient in the services context: inefficient service industries that are sheltered by high barriers to trade imply downstream sectors and consumers will confront higher costs and/or have less choice, and thus have incentives to mobilize and push for unilateral policy reform. A problem with this argument is the stylized facts: why then do we observe high barriers to trade in services?

The problem is compounded if we consider that barriers to trade in services are often high. As the welfare cost of protection rises with the square of the ad valorem tax equivalent of a restriction, the potential benefits can be expected to be large. Moreover, the distributional costs of liberalization

may be smaller than in the case of goods trade. Although services are becoming more tradable because of technological changes, the provision of many services requires proximity in space and time between suppliers and buyers. In practice firms often provide services in foreign markets by establishing a commercial presence, i.e., liberalization may result in takeovers of local services firms or greenfield foreign investment. Such firms will, however, (continue to) employ local workers, in contrast with the goods case where (more) workers will need to find jobs in other sectors of the economy. This should in principle facilitate liberalization of services trade.

Other hypotheses center on potential consequences of the different channels or modes through which trade in services occurs – via telecommunications networks, through establishment (foreign direct investment) and the temporary physical cross-border movement of service suppliers or consumers/buyers. In the case of agreements between rich and poor(er) countries the latter are likely to have a comparative advantage in less skill-intensive services, which means an interest in facilitating the (temporary) cross-border movement of services suppliers (natural persons). Such liberalization may be resisted because of unwillingness to accept such cross-border movement and fears that temporary entry will become long-term (Mattoo and Carzaniga, 2003; Winters et al., 2003). If this mode of services supply is taken off the table, the incentives of developing countries to consider liberalization of other modes of supply that are of interest to trading partners will be attenuated. In practice this argument may be less powerful than it appears as most trade agreements offer many other areas where tradeoffs can be made – including on trade in goods.

A related argument is that because trade in services covers more "modes of supply" than trade in goods, expected welfare effects may be more complex to assess and obtain. Economic models show that if services trade policies create rents and services provision requires a commercial presence (investment), liberalization may lead to such rents being shifted to foreign firms if markets are not competitive, so that national welfare may not improve (e.g., Francois and Wooton, 2010; Balistreri, Tarr and Yonezawa, 2015).[6] In the case of developing countries that do not have effective competition legislation, foreign firms may crowd out domestic-owned firms while still being able to charge high mark-ups on the services sold to local consumers.

Yet another explanation points to the importance of market failures in many services industries that call for regulation—e.g., to ensure interconnection and/or access to telecommunication or transport services, to address information asymmetries (e.g., licensing of medical professionals) or achieve social equity objectives (e.g., public provision of education or health services) (Copeland and Mattoo, 2008). Concerns that trade agreements will impede enforcement of regulatory regimes that are deemed to be socially desirable may then lead to services not being tabled. However, such sensitivity applies mainly to public services that countries can and do exclude.[7] The European Commission, for example, has made very clear that trade agreements will not affect the EU's ability to set standards and regulate economic activity (Young, 2016).

These various considerations only partially address the puzzle, as many of them can be dealt with by modulating the commitments made in a trade agreement – e.g., guaranteeing the right and scope to regulate, safeguarding the ability to maintain public service provision and the ability to control temporary entry of services suppliers. More salient are concerns that national regulation may be inadequate to ensure that liberalization will improve national welfare. A related political economy factor that is likely to play a role in this regard is that the prevalence of (and need for) regulation complicates the process of negotiating a trade agreement because it calls for coordination across

government: the Trade Ministry and the Ministry of Finance, the two main actors in agreements liberalizing trade in goods, must bring on board the relevant line ministries and regulatory authorities responsible for different services sectors and activities (VanGrasstek, 2011). The point is that realizing the gains from liberalization may require complementary action to ensure markets are regulated appropriately.

3. Regulatory quality and benefits of services trade liberalization

In what follows we focus on a neglected potential explanation for the puzzle: interdependence between services trade policy and quality of economic regulation broadly defined to go beyond competition policy. 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; Ahsan, 2013). In the case of services this is particularly likely because of the prevalence of network externalities, information asymmetries and the fact that many services are credence goods (Copeland and Mattoo, 2008). Beverelli, Fiorini and Hoekman (2017) confirm this, finding that the positive effect of lower services trade barriers is strongly dependent on the quality of governance in countries. In what follows we replicate part of their analysis and implement a quantification exercise to illustrate that without an adequate domestic regulatory framework, removing discriminatory barriers to services trade might fail to deliver the expected positive effects, reducing the incentive to pursue ambitious services liberalization.

Empirical framework

In order to estimate the role of domestic governance in shaping the effect of services trade liberalization on downstream manufacturing we use the following model from Beverelli et al. (2017):

$$y_{ij} = \alpha + \beta CSTRI_{ij} + \mu\left(CSTRI_{ij} \times ER_i\right) + \gamma x_{ij} + \delta_i + \delta_j + \epsilon_{ij} \qquad (1)$$

where y_{ij} is the natural logarithm of productivity in manufacturing sector j in country i, ER_i is a measure of quality of economic regulation in country i, x_{ij} is a control variable (the average level of tariff protection for non-services inputs used by 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. $CSTRI_{ij}$ 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 (lower values of this variable reflect higher openness in services trade). The w_{ijs} are a set of weights that reflect the intensity of use of service s by manufacturing sector *j* in country i. Finally, δ_i and δ_j are country and sector fixed effects respectively. 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 services trade policy restrictions on downstream industries, assuming a non-zero level of demand for services is observed.

The estimated marginal effect of reducing barriers to services trade on the productivity of manufacturing sectors, accounting for heterogeneity in economic regulation is given by: $-\widehat{\frac{\partial y}{\partial CSTRI}} = -\hat{\beta} - \hat{\mu} \times ER_i$, where the minus sign in front of the marginal productivity effect reflects the fact that reducing services trade barriers means decreasing the values of $STRI$ which in turn lowers the value of $CSTRI$. The empirical case - found by Beverelli et al. (2017) - of manufacturing productivity increasing with lower services trade restrictions corresponds to a positive value for $-\widehat{\frac{\partial y}{\partial CSTRI}}$ while a negative value for $\hat{\mu}$ reveals that such positive effect of liberalization is increasing in the quality of economic governance in the liberalizing country.[8]

The variables used in the estimation come from four different sources. The services trade restrictiveness indices ($STRI_{is}$) are taken from the World Bank Services Trade Restrictiveness Database (STRD).[9] The STRD covers 103 economies, including many developing countries, ensuring variation in quality of economic governance needed for empirical estimation of how regulatory quality shapes the effects of services trade liberalization. $STRI_{is}$ are constructed to vary between 0 (complete openness) and 100 (complete restrictiveness). The measures included in the STRD are mostly discriminatory policies as opposed to regulatory measures which apply to both domestic and foreign economic actors. The proxy for the quality of domestic economic governance (ER_i) is sourced from the World Bank Worldwide Governance Indicators for 2007. This variable is constructed by aggregating information on different policy dimensions, including the prevalence of price controls, ease of starting a new business, and effectiveness of competition policy.[10] The policy variables included comprise conduct regulation that apply to all firms, in contrast to the discriminatory policies captured by the STRIs. Higher values of ER_i are associated with better quality of domestic economic regulation. The weights w_{ijs} used in the construction of $STRI_{is}$ are given by the technical coefficients computed from the mid-2000 OECD STAN input-output table of the United States.[11] Finally, we construct measures of sectoral labor productivity (output per worker) using the 2007 values of these variables in the UNIDO Industrial Statistics Database.[12]

The estimates of the parameters in model (1) 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 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:

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

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 country level variables: (i) the policy change required to remove all discriminatory barriers to trade; and (ii) the quality of economic regulation. This methodology permits counterfactual exercises to quantify the effects of services policy changes in country i assuming different levels of regulatory quality.

Regulatory quality and productivity impacts of services liberalization: a counterfactual exercise

What follows focuses on a counterfactual scenario where all discriminatory barriers to inward FDI (mode 3 restrictions in WTO speak) in four services sectors are removed – finance, transport, communications and professional services – and the impacts on productivity in industries that buy these services as inputs into production are assessed (i.e., $\%\Delta Y_{ij}$ in equation 2).[13] The four services are all used in other sectors of the economy to varying degrees. Complete removal of FDI restrictions is perhaps an extreme example that may not be achievable in practice, but the goal of the exercise is to identify potential impacts of ambitious liberalization. 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; and (ii) no account is taken of general equilibrium factor demand or investment diversion

effects. Thus, estimation of the overall net GDP effects from removing services trade restrictions is precluded, and the magnitude of the sectoral estimates will be upper bounds. However, our interest is not in the size of potential gains but whether gains are conditional on differences in quality of economic regulation. While the effects on downstream manufacturing is only one dimension of the potential effects of services trade liberalization, we limit attention to this channel because much better data are available for manufacturing sectors and because the economic literature has found that liberalization of input markets generates larger positive effects (through lower prices, higher quality and increasing variety of inputs available) than reducing trade restrictions on final goods (e.g., Amiti and Konings, 2007).

The quantification is conducted as follows. First, equation (1) is fitted with the estimation sample of Beverelli et al. (2017) augmented with additional data points for the US. Second, the resulting estimates – $\hat{\beta}$= 0.055 (robust standard error 0.029) and $\hat{\mu}$=-0.036 (robust standard error 0.011) – together with country specific values of regulation (ER_i) and the country-sector specific policy change entailed in removing all restrictions to FDI in services ($\Delta CSTRI_{ij}$), are used to compute values of $\%\Delta Y_{ij}$ following equation (2).

Table 1 reports results for the largest and second largest manufacturing industry in each of the countries for which we have data. As stated before, data are for 2007 as the STRI data reflect policy regimes prevailing in the late 2000s. While this is somewhat dated, the purpose of the exercise is not to provide an assessment of the effects of currently prevailing services trade policies across countries but to estimate how much services trade policies impact on downstream productivity performance and how this in turn is affected by the quality of regulation. The last 2 columns of Table 1 report each country's relative rank in terms of barriers to FDI in services and the quality of economic regulation. The lower the number the more open a country is to services FDI and the better is the quality of regulation. OECD member countries tend to have better quality regulation than other economies in the sample but there is much greater heterogeneity in the restrictiveness of services trade policy: several developing and transition economies– e.g., Ecuador, Georgia, the Kyrgyz Republic, Mongolia, and Mauritius – are more open than many OECD countries. On average, however, barriers to inward services FDI are higher in developing countries.[14]

The potential downstream productivity impacts of removing FDI barriers are reported in the columns labeled "current reg. quality." Estimates vary widely across countries, ranging from 10-15 percent for several Central European countries to 50 percent or more for France and Germany. In contrast, estimates tend to be lower for developing and transition economies and many are not statistically significant, indicating that removing barriers to foreign investment in services will not have an impact. Economies with high estimated potential downstream productivity impacts of services liberalization tend to have high FDI restrictions, but the countries that stand to benefit the most in terms of size of the potential productivity boost from services liberalization are those with better economic regulation. The lower is the quality of regulation, the lower the productivity effect of services trade liberalization.

Table 1: Sectoral Labor Productivity Effects of Removing Barriers to FDI in Services on Manufacturing Sectors

	Productivity impact (sorted by *% Δ* between current vs. high regulatory quality)							Country ranking	
Country	***Largest sector***	***Current reg. quality***	***High reg. quality***	***2nd largest sector***	***Current reg. quality***	***High reg. quality***	***% Δ: current vs. high***	***Openness level (FDI)***	***Regulatory quality index***
Europe/Central Asia									
Ukraine	Basic metals	5.3	41.3	Food products	6.2	47.8	672	34	52
Kyrgyz Rep.	Basic metals	8.2	59.2	Food products	3.9	28.5	624	7	51
Albania	Textiles	8.3*	26.6	Food products	11.7*	37.1	219	8	40
Georgia	Food products	6.4**	16.2	Mineral products	4.6**	11.8	154	2	35
Turkey	Textiles	23.8**	58.6	Food products	41.8**	102.8	146	39	33
EU member states									
Romania	Food products	18.9***	39.4	Textiles	10.3***	21.5	108	12	29
Bulgaria	Food products	27.7***	53.4	Textiles	13.5***	26.1	93	26	26
Poland	Food products	22.5***	39.4	Metal products	13.9***	24.3	75	14	24
Greece	Food products	25.9***	41.8	Paper products	26.6***	42.9	61	17	23
Italy	Machinery	28.2***	44.7	Metal products	25.7***	40.8	59	32	21
Czech Rep.	Autos	13.8***	20.6	Food products	36.8***	55	49	22	20
Portugal	Textiles	19.7***	28.7	Food products	25***	36.4	46	9	19
Lithuania	Food products	21.5***	31.2	Textiles	15.8***	22.9	45	5	18
Hungary	Food products	34.7***	47.6	Autos	16.5***	22.6	37	23	16
Spain	Food products	25.1***	34.2	Metal products	15.5***	21.1	36	6	15
France	Food products	57.5***	75.5	Chemicals	54.7***	71.8	31	36	14
Belgium	Chemicals	38.2***	47.1	Food products	40.4***	49.7	23	19	13
Finland	Radio/TV	36***	41.8	Paper products	38.3***	44.4	16	25	10
Sweden	Machinery	14.1***	16.1	Paper products	14.3***	16.4	15	3	9
Germany	Machinery	51.9***	58.6	Autos	24.4***	27.5	13	35	7
Austria	Machinery	44.5***	48.4	Metal products	38.8***	42.3	9	27	6
Netherlands	Food products	49.5***	51.9	Chemicals	46.5***	48.7	5	20	4
Ireland	Chemicals	37.4***	38.5	Food products	39.7***	40.8	3	13	2
UK	Food products	44***	45.3	Paper products	38.2***	39.2	3	15	3
Denmark	Food products	49.6***	-	Machinery	35.2***	-	0	16	1
North America									
US	Food products	51.1***	60.8	Chemicals	46.6***	55.4	19	28	11
Canada	Food products	55.2***	62.8	Autos	25.1***	28.6	14	41	8
East Asia/Pacific									

Vietnam	Food products	4.6	49.9	Textiles	3.8	41.9	996	42	54
Indonesia	Food products	23.1	137.4	Textiles	15.1	89.6	494	54	49
Mongolia	Food products	3.7	19.2	Textiles	3.5	18.3	422	4	46
China	Basic metals	12.6	54.4	Food products	20.5	88.3	330	47	43
Malaysia	Radio/TV	45.8***	94.2	Coke/oil	17***	35	106	51	27
Korea, Rep.	Machinery	35.8***	57	Radio/TV	40.9***	65	59	40	22
Japan	Autos	14.8***	21	Machinery	32.4***	45.9	42	33	17
New Zealand	Food products	15.7***	17	Paper products	21.2***	23	8	11	5
South Asia									
India	Chemicals	25.3	133.6	Basic metals	23.6	124.3	428	56	48
Sri Lanka	Textiles	11.2	58.9	Food products	16.1	84.4	425	48	47
Latin America									
Brazil	Food products	17.1*	61.2	Chemicals	15.5*	55.4	258	30	42
Uruguay	Food products	15.9**	43.8	Coke/oil	7.7**	21.1	176	44	39
Colombia	Food products	11.8**	31.3	Chemicals	10.7**	28.4	165	31	38
Peru	Food products	12**	30.9	Textiles	7.5**	19.1	156	10	37
Chile	Food products	19.6***	23.5	Chemicals	19.4***	23.2	20	21	12
Ecuador	Coke/oil	0	-	Food products	0	-	-	1	57
Middle East									
Yemen, Rep.	Food products	3.4	83.3	Mineral products	3.3	81.2	2361	45	55
Lebanon	Food products	24.1	120.4	Mineral products	39.7	198.3	399	52	45
Morocco	Food products	10.4	48.3	Textiles	6.6	30.8	365	29	44
Saudi Arabia	Chemicals	29.1*	95.8	Food products	31.5*	103.4	229	49	41
Kuwait	Coke/oil	13.9**	35.6	Chemicals	42.1**	107.8	156	55	36
Jordan	Food products	49.1**	121.4	Chemicals	46.2**	114.2	147	53	34
Qatar	Coke/oil	17.9**	40.1	Chemicals	46.7**	104.7	124	57	32
Oman	Coke/oil	14.3***	27.4	Mineral products	69.5***	133.8	93	50	25
Africa:									
Ethiopia	Food products	-7.6	158	Mineral products	-12.5	259.2	2179	58	56
Malawi	Food products	4.8	42.9	Chemicals	4.6	41.2	791	37	53
Burundi	Food products	-7.6	44.8	Basic metals	-2.7	16.1	686	24	58
Tanzania	Food products	9.4	67	Mineral products	11.9	85.1	615	38	50
Botswana	Furniture	24.9**	55.3	Food products	27.7**	61.6	122	43	31
Mauritius	Textiles	14.2***	29.8	Food products	23.3***	49.1	110	18	30
South Africa	Food products	43***	88.9	Coke/oil	13.2***	27.3	107	46	28

Source: Own calculations based on methodology and data used in Beverelli et al. (2017).

The importance of regulatory quality is illustrated further by the columns in Table 1 labeled "high reg. quality." These replace each country's reported regulatory quality indicator with that of Denmark, the best performing country in the sample. Again, this is purely for illustrative purposes – what level of improvement is feasible in practice will be country-specific. For OECD countries the percentage difference is not very great, reflecting relatively good regulatory quality. However, for developing countries the productivity impacts increase by a factor of two or three or more.

These results suggest that part of the answer to the puzzle – why is services liberalization limited in trade agreements – may reflect regulatory weaknesses in countries that reduce or even nullify the potential positive effects of services trade liberalization. This is complementary to but distinct from the market structure/rent redistribution rationale for not pursuing liberalization – i.e. not having an effective competition policy regime. Note that this argument is also potentially relevant for the EU. The significant differences across EU member states in average levels of external services trade restrictiveness and in the quality of economic regulation implies that the gains within the EU from reducing external barriers via trade agreements may be distributed quite asymmetrically, resulting in less political support for liberalization in states with weaker quality of economic regulation.

4. Designing trade agreements to support services liberalization

Trade agreements are primarily instruments to improve access to markets – to liberalize trade between signatories and reduce policy uncertainty for companies. Improving the quality of domestic regulation is not a goal. Insofar as regulation is addressed in trade agreements, the aim is to constrain the use of measures that discriminate against foreign products and firms and thus erode the value of negotiated market access concessions. This is the primary purpose of the national treatment rule found in most trade agreements.

Many trade agreements go beyond national treatment by introducing specific disciplines for product regulation: so-called technical barriers to trade (TBT) (product standards) and sanitary and phytosanitary (SPS) measures (for foodstuffs, plants and animal health) (Dür et al. 2014; Hofmann et al. 2017).[15] In addition, many trade agreements also increasingly include provisions on competition policy. The rationale for this is like that for rules on product regulation: to provide assurance that market access commitments cannot be eroded through restrictive business practices by national firms.[16] The foregoing discussion suggests inclusion of provisions aiming to improve the quality of economic regulation could enhance the welfare benefits of services liberalization. Doing so would require trade negotiators to go beyond the prevailing view that disciplines on product-specific regulation should be seen through the lens of preventing erosion of market access commitments. A greater focus on the substance (quality) of regulation would be consistent with the market access goal that is central to trade agreements – insofar as weak quality regulation limits the extent to which governments are willing to lower barriers to trade in services in trade agreements.

In practice, improving regulatory quality will require actions by the governments concerned. Trade agreements could support such actions by creating a focal point for considering regulatory quality, thus helping to ensure that this gets greater attention in domestic policy formation and resource allocation. If improving regulatory institutions is made an objective, trade agreements could include enhance regulatory performance as part of the work of committees and working groups charged with overseeing implementation, monitoring progress and addressing problems that arise.

Although the analogy is imperfect, it is helpful to contrast the attention given by the EU to improving

the quality of public administration and economic regulation in countries that are candidates for accession to the Union, which is accompanied by technical assistance and regular policy dialogue and interaction, with what is done in EU trade agreements with third countries (Bruszt and McDermott, 2014). The accession context includes engagement on a broad set of regulatory matters and related institutions, including not only political rights, social/labor standards, and environmental norms, but also product regulation and market regulation (competition law and the business policy environment), i.e., matters that fall under the heading of the quality of economic regulation. EU trade agreements, in contrast, focus primarily on market access issues. While these include an emphasis on social, civil and political rights in partner countries, as well as more recently, a focus on anti-corruption (Lejárraga 2014), they do not focus explicitly on improving the quality of economic regulation, let alone recognize the relationship between regulatory quality and the size and distribution of the gains from market opening.[17]

The inclusion of provisions on social and environmental regulations in trade agreements reflects both normative values (they are deemed to be desirable in and of themselves) and competitive considerations, to ensure that trade is "fair" by leveling the playing field and preventing so-called social dumping.[18] However, this neglects the complementarities between the quality of economic regulation and the effects of services trade reforms. This may reflect a perception that there is limited appetite for the latter by many trading partners, but the causality may run the other way: regulatory weaknesses may be a reason for limited interest in services liberalization. Complementing the emphasis on social and political rights with a greater focus on improving regulatory quality could help to establish a more conducive environment for services liberalization.

Revisiting the design of trade agreements to focus more on improving the quality of economic regulation can take different forms. We do not advocate the negotiation of binding (enforceable) commitments on economic regulation. Social preferences differ across countries and regulators should have discretion in acting to further the public interest in addressing market failures. The goal should be to improve regulatory quality through a process of analysis, deliberation, joint action and monitoring of outcomes and impacts, accompanied where needed with technical and financial assistance. A necessary condition is to establish mechanisms to identify areas in which regulatory improvements are needed and a priority from a trade liberalization perspective – to establish the preconditions needed to assure or increase the welfare benefits from opening services markets to greater foreign competition.

In practice this is an agenda that revolves around bolstering regulatory institutions and performance. In that sense it is independent of trade objectives per se, even though adoption of better regulatory practices and bolstering regulatory institutions is likely to increase the benefits from services trade opening. Adopting better regulatory practices, including assessment of the effects of regulatory policies, has become a major focus of international cooperation in fora such as APEC and the OECD. This centers on identifying good practices, based on sharing of experiences and objective analysis of the effects of alternative approaches to achieving shared regulatory objectives. This type of cooperation is transferable to the trade agreement setting – in effect what is needed is to incorporate it into the design and implementation of agreements.

A key feature in the APEC setting is that cooperation takes the form of soft law – there are no binding, enforceable, commitments. Instead, activities center on defining good practices, which individual governments can then decide to implement on a voluntary basis. APEC has developed a

checklist on good regulatory practices, developed jointly with the OECD, and associated tools for regulatory impact assessments that member governments can adopt. The specifics and the speed with which these principles and tools are implemented varies widely, reflecting differences in capacity and priorities. A trade agreement can build on such approaches by making good regulatory practice a focal point for cooperation and putting place mechanisms through which governments work together to implement them.

A model here is the WTO Agreement on Trade Facilitation (TFA).[19] This largely involves WTO members agreeing on a set of policies to facilitate trade that were collectively determined to constitute good regulatory practices. Thus, the TFA goes somewhat further than the APEC model of cooperation by incorporating these practices into a treaty that signatories commit to implementing. However, in the case of developing countries it is left to each government to specify when different trade facilitating measures will be implemented, which in turn can be made conditional on having received assistance if the country indicates it will need help to do so. This structure assures countries that they will be able to realize the benefits from implementing the various good practices.

While helping to identify what constitutes good practices and providing a focal point for efforts to implement them is a useful general role that trade agreements can play, a more specific focus is needed to determine priorities for action to support services liberalization goals. Defining this will require deliberation involving government officials, regulators and stakeholders, including economic operators and consumer groups, to identify priorities for regulatory strengthening and address associated political or capacity constraints. Hoekman and Mattoo (2013) argue that knowledge platforms can be a useful mechanism to help inform and support such a process. These have been used by national governments and international organizations to collaboratively generate a common understanding of specific policy challenges and potential solutions. Dihel and Goswami (2016) describe an example that was created in Eastern Africa to build a common understanding of the potential benefits and factors impeding greater trade in professional services.

Organizing such platforms in a way that brings together representatives of different actors that provide services across a range of value chains can help identify specific areas where regulatory practices or gaps are impeding growth in economic activity. This may cut across several sectors – e.g., business visas may be important for many types service providers, calling for a focus on facilitating temporary cross-border movement of service suppliers while ensuring that the regulatory mandates of immigration authorities are attained at lower cost/more efficiently. Anti-corruption policies (e.g., anti-money laundering regulations) may have adverse effects on the ability to trade many types of services by impeding access to payment systems. What matters most will vary across countries and over time – implying that trade agreements that take the regulatory agenda seriously should establish systems that help to identify priorities and ensure that attention is devoted to addressing them.

One can argue that what is being suggested here does not require a trade agreement—the same thing can be pursued through regulatory cooperation and, in the cases where this involves high-income and low- or middle-income economies, development assistance. This is true in principle. But beneficial regulatory cooperation may not occur for a variety of reasons. Nor does improving regulatory quality figure prominently in the allocation of foreign aid, paralleling the relative neglect of regulation in the design of trade agreements. According to the OECD Creditor Reporting System (OECD, 2017) the percentage shares of total official development assistance (ODA) disbursements by

EU institutions in 2015 for policy and administrative management in the transport, communication and financial sectors were 1%, 0.04% and 0.9% respectively. The share of business support services and institutions was 0.8%. The relative neglect of support for economic regulation and related institutions is a more general feature of ODA disbursements. Similar ratios apply in the aggregate across all donors covered in the OECD database.[20] A trade agreement can add value as a commitment device – a mechanism to support regulatory cooperation and to increase the allocation of technical assistance to improving regulatory institutions.

5. Conclusion

Trade agreements increasingly include services but the extent to which liberalization commitments have been made in such agreements has been limited. One indication of this is research finding that estimates of services trade costs within trade agreements have not been falling (Miroudot and Shepherd, 2014). The stylized facts on services and trade agreements constitute a puzzle – the large share of services in output and employment and the relatively high levels of services trade restrictiveness prevailing in many countries suggest that liberalization could have significant positive economic growth effects. In this paper we have argued that liberalizing trade in services spans an agenda that goes beyond removing policies that discriminate against foreign services providers. To benefit more fully from efforts to enhance market access it often will be necessary to improve the quality of economic regulation. Most trade agreements do not engage with this subject, limiting the attention to efforts to ensure that regulatory measures are not used to circumvent market access commitments. Our analysis suggests that when it comes to services this focus is too narrow and may diminish the potential (perceived) gains from reducing services trade restrictions. Doing more to embed mechanisms and provisions into trade agreements that help to improve regulatory institutions in trading partners may increase prospects that predicted benefits of agreements to liberalize trade in services materialize.

References

Ahsan, R. 2013. "Input tariffs, speed of contract enforcement, and the productivity of firms in India," *Journal of International Economics*, 90(1): 181-92.

Amiti, Mary, and Jozef Konings. 2007. "Trade Liberalization, Intermediate Inputs, and Productivity: Evidence from Indonesia." *American Economic Review* 97 (5): 1611–38.

Balistreri, E., J. Jensen and D. Tarr, 2015, "What Determines Whether Preferential Liberalization of Barriers against Foreign Investors in Services Are Beneficial or Immiserizing: Application to the Case of Kenya," *Economics: The Open-Access, Open Assessment E-Journal*, 9(42): 1-134.

Barone, Guglielmo, and Federico Cingano. 2011. "Service Regulation and Growth: Evidence from OECD Countries." *Economic Journal* 121 (555): 931–57.

Bartels, L. 2012. "Human rights and sustainable development obligations in EU free trade agreements". *Faculty of Law Research Paper No. 24/ 2012*. University of Cambridge.

Beverelli, C., M. Fiorini and B. Hoekman. 2017. "Services Trade Restrictiveness and Manufacturing Productivity: The Role of Institutions," *Journal of International Economics* 104(1): 166-82.

Borchert, I., B. Gootiiz and A. Mattoo, 2014. "Policy Barriers to International Trade in Services: Evidence from a New Database," *World Bank Economic Review*, 28(1): 162-88.

Bruszt, L. and G. McDermott (eds.), 2014. *Levelling the Playing Field. Transnational Regulatory Integration and Development*. Oxford: Oxford University Press.

Carballo, J., K. Handley and N. Limão, 2018. "Trade cold wars and the value of agreements during crises," VoxEU. At: https://voxeu.org/article/trade-cold-wars-and-value-agreements-during-crises.

Cho, Yoon Je. 1988. "Some Policy Lessons from the Opening of the Korean Insurance Market." *World*

Bank Economic Review, 2(2): 239–54.
Ciuriak, D. and D. Lysenko. 2016. "Quantifying Services-Trade Liberalization: The Impact of Binding Commitments", C.D. Howe Institute Technical Paper. At http://dx.doi.org/10.2139/ssrn.2730265.
Ciuriak, D., A. Dadhah and J. Xiao. 2017. "Quantifying the Comprehensive and Progressive Agreement for Trans-Pacific Partnership", *East Asian Economic Review*, 21(4), 343-384.
Copeland, B. and A. Mattoo. 2008. "The Basic Economics of Services Trade." In A. Mattoo, G. Zannini and R. Stern (eds.) *A Handbook of International Trade in Services.* Oxford: Oxford University Press.
Dee, P. 2013. *Services Trade Reform: Making Sense of It*. World Scientific Studies in International Economics: Volume 28.
Dihel, N. and A. Goswami (eds.) 2016, *From Hair Stylists and Teachers to Accountants and Doctors - The Unexplored Potential of Trade in Services in Africa*. Washington DC: World Bank.
Dür, A., L. Baccini and M. Elsig, 2014. "The design of international trade agreements: Introducing a new dataset," *Review of International Organizations*, 9: 353-75.
European Parliament, 2016, "Good Governance in EU External Relations: What role for development policy in a changing international context?" EP/EXPO/B/DEVE/2015/02.
Fink, C. and M. Jansen, 2009, "Services provisions in regional trade agreements: stumbling or building blocks for multilateral liberalization?" in R. Baldwin and P. Low (eds.), *Multilateralizing Regionalism.* Cambridge: Cambridge University Press.
Francois, J. and W. Martin. 2004. (2004), 'Commercial policy, bindings and market access' *European Economic Review*, 48: 665–79.
Francois, J. and I. Wooton, 2010, "Market structure and market access," *The World Economy*, 33(7): 873-93.
Fukunaga, Y. and I. Isono, 2013, 'Taking ASEAN+1 FTAs towards the RCEP: A Mapping Study', ERIA Discussion Paper Series 2013-02, Jakarta: ERIA.
Gootiiz, B. and A. Mattoo, 2017. "Services in the trans-pacific partnership: what would be lost?," World Bank Policy Research Working Paper 7964.
Handley, K. and N. Limão, 2015. "Trade and Investment under Policy Uncertainty: Theory and Firm Evidence," *American Economic Journal: Economic Policy*, 7(4): 189-222.
Handley, K. and N. Limão, 2017. "Policy Uncertainty, Trade, and Welfare: Theory and Evidence for China and the United States," *American Economic Review*, 107(9): 2731-83.
Hoekman, B. 2008. "The General Agreement on Trade in Services: Doomed to Fail? Does it Matter?" *Journal of Industry, Competition and Trade,* 8(3): 295-318.
Hoekman, B. 2016. "The Bali Trade Facilitation Agreement and rulemaking in the WTO: milestone, mistake or mirage?" In J. Bhagwati, P. Krishna and A. Panagariya (eds.), *The World Trade System: Trends and Challenges*. Cambridge, MA: MIT Press.
Hoekman, B. and A. Mattoo, 2013, "Liberalizing Trade in Services: Lessons from Regional and WTO Negotiations," *International Negotiation,* 18(1): 131-51.
Hofmann, C.; A. Osnago and M. Ruta. 2017. "Horizontal depth : a new database on the content of preferential trade agreements," World Bank Policy Research Working Paper 7981.
Jafari, Y. and D. Tarr, 2017, "Estimates of Ad Valorem Equivalents of Barriers against Foreign Suppliers of Services in Eleven Services Sectors and 103 Countries," *The World Economy,* 40(3): 544-73.
Kaufmann, D., A. Kraay and M. Mastruzzi, 2010, "The Worldwide Governance Indicators: Methodology and Analytical Issues," World Bank Policy Research Working Paper 5430.
Krajewski, M. 2003. "Public Services and Trade Liberalization: Mapping the Legal Framework," *Journal of International Economic Law*, 6(2): 341–67.
Lamprecht, P. and S. Miroudot (2018). "The value of market access and national treatment commitments in services trade agreements", *OECD Trade Policy Paper*, No. 213, OECD Publishing. At http://dx.doi.org/10.1787/d8bfc8d8-en.
Lanz, R. and A. Maurer, 2015, "Services and global value chains: Servicification of manufacturing and

services networks," *J. Intl Econ. Comm. Policy*. 06.
Lechner, L. 2016. "The domestic battle over the design of non-trade issues in preferential trade agreements". *Review of International Political Economy*, 23(5): 840-71.
Lejárraga, I. 2014. "Deep Provisions in Regional Trade Agreements: How Multilateral Friendly?," OECD (TAD/TC/WP(2014)16/FINAL).
Maggi, G. and A. Rodriguez-Clare. 1998. "The Value of Trade Agreements in the Presence of Political Pressures," *Journal of Political Economy* 106 (3): 574–601.
Mattoo, A. and A. Carzaniga (Eds.), 2003, *Moving People to Deliver Services.* Washington DC: World Bank.
Mavroidis, P.C. 2016. *The Regulation of International Trade*. Cambridge: MIT Press.
Miroudot, S. and B. Shepherd, 2014, "The paradox of preferences: Regional trade agreements and trade costs in services," *The World Economy*, 37(12): 1751-72.
Miroudot, S., J. Sauvage and M. Sudreau, 2010, "Multilateralizing Regionalism: How Preferential Are Services Commitments in Regional Trade Agreements?" OECD Trade Policy Working Paper 106.
OECD DAC 2017. *Aid Statistics. Creditor Reporting System*. Paris: OECD.
Rajan, R. and L. Zingales, 1998, "Financial Dependence and Growth," American Economic Review 88(3): 559-86.
Rodriguez, F. and D. Rodrik. 2001. "Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence," in B. Bernanke and K. Rogoff (Eds.) *NBER Macroeconomics Annual*. Cambridge: MIT Press.
Roy, M. 2011. "Services Commitments in PTAs: An Expanded Dataset," WTO Working Paper ERSD-2100-18.
Transparency International, 2017, Anti-corruption and transparency provisions in trade agreements.
VanGrasstek, C. 2011. "The political economy of services in regional trade agreements", *OECD Trade Policy Papers*, No. 112, OECD Publishing. http://dx.doi.org/10.1787/5kgdst6lc344-en
Winters, A., T. Walmsley, Z. Wang and R. Grynberg, 2003, "Liberalising Temporary Movement of Natural Persons: An Agenda for the Development Round," *The World Economy*, 26(8): 1137–61.
Young, A. 2016. "Not your parents' trade politics: the Transatlantic Trade and Investment Partnership negotiations," *Review of International Political Economy*, 23(3): 345-78.

Author Bios

Matteo Fiorini is Research Fellow in Global Economics at the Robert Schuman Centre for Advanced Studies of the European University Institute in Florence, Italy. His research focuses on international trade, trade policy, migration and development. He holds a PhD in Economics from the European University Institute.

Bernard Hoekman is Professor and Director, Global Economics, at the Robert Schuman Centre for Advanced Studies, European University Institute in Florence, Italy and a CEPR Research Fellow. His research focuses on trade and development, commercial policy, trade in services and the multilateral trading system.

Notes

[1] Virtually all agreements to liberalize trade in services include goods trade as well. Dür et al (2014) find that only 1 percent of extant agreements are pure services agreements and report that a total of 587 agreements concluded since the late 1950s, 17 percent include substantive provisions on services trade. Agreements covering services began to be negotiated in the late 1980s/early 1990s.

[2] The 2017 withdrawal from the TPP by the US led to an effort by the other 11 signatories to move forward nonetheless with the TPP without the US. This effort proved successful, resulting in a Comprehensive and Progressive Agreement on Trans-Pacific Partnership (CPTPP). This embodies most of what had been agreed in the TPP, with the notable exception of specific provisions where the US had been the major demandeur—mostly in the area of protection of intellectual property. See Ciuriak et al. (2017) for an analysis of the CPTPP.

[3] Francois and Martin (2004) provide an analytical framework to understand the role that policy commitments in trade agreements can play in reducing uncertainty for firms (investment). Recent papers that estimate the magnitude and benefits of such uncertainty reduction include Handley and Limão (2015, 2017), Ciuriak and Lysenko (2016) and Lamprecht and Miroudot (2018).

[4] For purposes of this paper this encompasses variables captured under the heading of the quality of regulation in the World Bank Worldwide Governance Indicators (WGI) database. These reflect "perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development" (Kaufmann et al., 2010). This includes the extent of price regulation, effective anti-trust (competition) policies, and the efficiency and transparency of administrative processes and requirements pertaining to business development (e.g., registration and licensing of new businesses).

[5] Assessments of the services coverage of trade agreements include Fink and Jansen (2009), Miroudot et al. (2010), Fukunaga and Isono (2013), Roy (2011), and Gootiiz and Mattoo (2017).

[6] This is a long-standing insight. For example, Cho (1988) demonstrates that the existence of rents in the Korean insurance market motivated efforts by U.S. companies to gain access to the market and participate in what was effectively a cartel. See Dee (2013) for further discussion.

[7] On public services-related concerns, see e.g., Krajewski (2003).

[8] In Beverelli et al. (2017) the marginal effect of lowering services trade restrictions increases with the quality of regulation ($\hat{\mu} < 0$) and is significantly positive (at a 0.05 percent level of statistical significance) for 65 percent of the sample observations. These authors show that this conditionality result is robust to controls that address measurement and endogeneity issues.

[9] See Borchert, Gootiiz and Mattoo (2014) and http://iresearch.worldbank.org/servicetrade/.

[10] For a detailed description of this variable and how it is constructed, see the documentation available at http://info.worldbank.org/governance/WGI/#home.

[11] As is standard in the literature, the US is taken as reference country to minimize endogeneity concerns (see for instance Rajan and Zingales, 1998 and Barone and Cingano, 2011).

[12] All the variables described here, except for the quality of domestic regulations, are used in the baseline estimation by Beverelli et al. (2017). We refer to that paper for a more detailed description of the empirical framework and related results.

[13] A weakness of the World Bank data relative to a similar exercise by the OECD is that the data are only available for one year and captures prevailing policy regimes at the end of the 2000s. While this limitation prevents the application of panel econometric techniques, the advantage of the STRD for this article is that it has much broader country coverage and captures discriminatory barriers to services trade, which allows us to interpret the counterfactual policy scenario as the removal of discriminatory barriers as opposed to that of domestic conduct regulations.

[14] The EU is quite open – across the 20 European countries in our sample, the average STRI is 16.6, as compared to 25 and 19.8, respectively for Canada and the US. There are substantial differences within the EU, with 'original' members of the EU having 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 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] These generally build on WTO rules, which include requirements that members adopt international standards where these exist and are deemed appropriate, rely on scientific evidence and risk assessment when designing product standards and ensure these are not more trade restrictive than necessary to attain underlying policy objectives (Mavroidis, 2016).

[16] Provisions on product-specific regulation are included in two-thirds of the 279 agreements covered in the most recent of these databases, compiled by the World Bank (Hofmann et al. 2017). Some 40 percent of agreements include provisions on competition policy, although in most cases these are soft law commitments and not enforceable. See https://data.worldbank.org/data-catalog/deep-trade-agreements.

[17] Provisions on political rights and labor standards generally have a "soft law" nature, although violation of human rights commitments can result in abrogation of the agreement (Bartels, 2012). The TPP broke new ground in this area by including a chapter on good governance which criminalized bribery and corrupt practices (Transparency International, 2017).

[18] There is a long-standing debate regarding the role of domestic import-competing interests in lobbying for inclusion of social 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.

[19] See Hoekman (2016) for a discussion of this agreement.

[20] To take the case of the EU as an example, between 2005 and 2014 the EU and EU member states allocated over US$60 billion to support governance reforms, 13 percent of total EU development aid. Public administration and financial management accounted for 60 percent of these funds, and human rights and democracy/civil society support another one-third (European Parliament, 2016).