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Reflections on the preferential liberalization of services trade

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Abstract

This paper takes stock of the forces that lie behind the recent rise of preferential agreements in services trade. It focuses first on a number of distinguishing features of services trade that sets it apart from trade in goods and shapes trade liberalization and rule-making approaches in the services field. The paper then documents the nature, modal and sectoral incidence of the trade and investment preferences spawned by preferential trade agreements (PTAs) in services. It does so with a view to addressing the question: how “preferential” is the preferential treatment of services trade? Finally, the paper addresses a number of considerations arising from attempts to multilateralize preferential access and rule-making in services trade.

Key words: Services, trade in services, preferential trade agreements, General Agreement on Trade in Services, multilateral trading system.

JEL classification: F10, F13, F15, L8

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I. Background

One of the striking features of trade diplomacy in recent years has been the seemingly unstoppable march of preferential trade liberalization and rule-making. Such a trend today very much extends to services. Of the 81 preferential trade agreements (PTAs) in force prior to the year 2000, 70 (86.4%) featured provisions dealing exclusively with trade in goods. During the ensuing decade, more than half of the 147 PTAs in force include provisions on services trade. The above trends signal the heightened importance of services trade in general, the growing need felt by countries to place such trade on a firmer institutional and rule-making footing and the attractiveness of doing so on an expedited basis via preferential negotiating platforms.

This paper takes stock of the forces that lie behind the recent rise of preferentialism in services trade. Its initial focus is on a number of distinguishing features of services trade that sets it apart from trade in goods and shapes trade liberalization and rule-making approaches in the services field. The paper then documents the nature, modal and sectoral incidence of the trade and investment preferences spawned by PTAs in services. It does so with a view to addressing the questions of whether and how the preferential treatment of services trade is truly preferential in character and effect? Finally, the paper addresses a number of considerations arising from attempts to multilateralize preferential access and rule-making in services trade.

II. What is special about services trade?

We consider first the salient features of services trade that distinguish it from trade in goods and have a bearing on the key issues under discussion in this paper. For starters, and in marked contrast to goods trade, the bulk of services trade involves

both trade and factor flows. There are four modes by which services can be supplied internationally and, unlike goods trade, trade in a broad range of services requires the physical proximity (and often simultaneous interaction) of the producer and the consumer for trade to materialize¹. The characteristics depicted above in turn help explain the nature of restrictions imposed on services trade and thus the means of according preferential treatment on, *inter alia*, the value of services output, the number of service suppliers, the amount of foreign equity permitted, the type of legal structure required for market entry purposes, the technical standards, licensing and qualification requirements applied, as well as the conditions of eligibility for service sector subsidies.

The fact that domestic regulation and not border taxation measures in the form of tariffs constitutes the prime negotiating currency in services trade, there are strong grounds to believe that the classic means of estimating the welfare consequences of preferential market opening and distinguishing the trade creating and trade diverting properties of PTAs pioneered by Jacob Viner² is almost assuredly of lesser analytical relevance in the services field. Given that barriers to services trade are often prohibitive and their removal seldom revenue-generating, and the fact that trade in services is more often constrained by quantitative restrictions than by overtly discriminatory practices, one may reasonably expect that determined efforts at dismantling service sector restrictions will result in lower costs of trade diversion than might be the norm in goods trade where border discrimination remains of paramount importance (in services trade, the border as a constraining device usually matters most for Mode 4 suppliers³).

An important caveat to the sanguine conclusion reached above flows from the work of Fink and Mattoo (2002), who noted that the sequence of liberalization may matter

¹ This is true of services delivered through Modes 2, 3 and 4.

² See Viner (1950).

³ Mode 4 trade refers to the temporary admission of business people and professionals and other contract-based service suppliers engaged in the cross-border delivery of labour-based services.

more in services than in goods trade. This is because location-specific sunk costs of production often assume considerable importance in several key service sectors, particularly those with infrastructural and/or network properties such as telecommunications, energy distribution, or transportation. In such sectors, even temporarily privileged access for an inferior supplier can translate into durable longer-term market advantages deterring market future contestability.

III. Implicit preference margins: country, sectoral and modal patterns

For a number of reasons rooted in the political economy of novelty, regulatory precaution, issue linkages and the greater overall difficulty of reciprocity-based bargaining, the liberalization of services trade under the WTO's General Agreement on Trade in Services (GATS) has yet to register meaningful advances. While the Doha Development Agenda (DDA) will almost certainly harvest some of the far-reaching advances made in opening service markets to competition since the curtain fell on the Uruguay Round, the fact remains that, in most countries, developed and developing, market opening in services has primarily proceeded along unilateral lines. This is especially true of the broad range of producer services (banking, insurance, telecoms, transportation, energy) where opening-up portends significant economy-wide benefits.

For instance, the average level of Mode 3 (commercial presence) access granted unilaterally via recent legislative changes in India is close to 70 percent in a number of key sectors, much higher than the 10 percent foreign equity ceiling embedded in India's initial (i.e. Uruguay Round) GATS commitments and significantly higher than the 44.8 percent average level of foreign equity put forward in its latest conditional offer in the Doha Round (Gasiorek *et al.*, 2007).

Beyond unilateral liberalization, a growing number of WTO Members have simultaneously turned to PTAs to deepen and quicken the pace of market opening in services markets. More often than not, and particularly when conducted along North-South lines and in agreements that resort to a negative list approach to scheduling market opening undertakings, PTA commitments in services tend to approximate and often lock-in the regulatory *status quo* flowing from recently enacted unilateral reforms.⁴ The result is an increasing gap – indeed a growing implicit margin of preference - between the level of opening obtaining in the WTO and that stemming from preferential advances.

With only a few exceptions (e.g. NAFTA, ANZCERTA)⁵, provisions on services trade brokered in PTAs prior to 2000 did not go significantly beyond what was negotiated in the GATS during the Uruguay Round (Hoekman & Sauv , 1994; Hoekman, 2006). However, in the agreements notified to the WTO since 2000, preferential access accorded to countries in services trade has resulted in what at first sight could be likened to a significant dilution of MFN access privileges. Such a trend appears to hold true across country groupings, modes of supplying services and sectors.

Drawing on the work of Marchetti and Roy (2008), Table 1 below compares the average level of commitments scheduled under Modes 1 (cross-border supply) and 3 (commercial presence) by OECD and non-OECD countries under the Uruguay Round, such countries' most recent Doha Round (DDA) offers and their most liberalizing PTA commitments. While the average level of sub-sectors bound in the prevailing GATS schedules is rather low (24% for Mode 1 and 30% for Mode 3), the DDA offers made to date (these are arguably likely to be enhanced depending on the

⁴ For a fuller discussion of recent trends in services liberalization and rule-making in PTAs, see Mattoo and Sauv  (2010).

⁵ NAFTA refers to the 1994 North American Free Trade Agreement linking Canada, the United States and Mexico; ANZCERTA is the 1987 Closer Economic Relations Trade Agreement between Australia and New Zealand.

ultimate outcome of Doha Round talks on agriculture and non-agricultural market access) have not altered this landscape markedly.

The market opening value-added of PTAs, on the other hand, appears quite significant. For instance, Mode 1 access in PTAs is twice that in the DDA offers while Mode 3 market access in PTAs is 1.67 times that in the DDA offers. The figures of Marchetti and Roy (2008) suggest that there are significant margins of preference for the two modes of supply which together account for close to 80% of world services trade by value.

While preference margins between DDA offers and “best” PTA commitments are considerably lower for OECD countries (suggesting a higher propensity for the latter countries to lock-in the regulatory *status quo* in their multilateral commitments or offers), the gap is much starker in the case of non-OECD countries. For the latter, the level of bound Mode 1 access in PTAs is some 2.5 times greater than in their latest DDA offers while Mode 3 access in PTAs is roughly twice that on offer in the DDA.

Table 1: Comparing the level of services trade and investment liberalization across country groupings and modes of supply

	GATS	DDA Offer (0 to 100)	PTAs	GATS/PTA (%)	DDA/PTA (%)	Preference Margin (%)
Total score	27	34	63	43	54	56-57
Mode 1	24	30	59	41	51	49-59
Mode 3	30	38	67	45	57	43-55
OECD						
Mode 1	43	51	59	73	86	14-27
Mode 3	53	59	67	79	88	12-21
Non-OECD						
Mode 1	18	23	60	30	38	62-70
Mode 3	23	32	67	34	48	52-66

Source: Author calculations based on Marchetti and Roy (2008)

Much the same picture obtains at the sectoral level. On the basis of the most liberalizing commitments in PTAs in Modes 1 and 3 reviewed by Marchetti and Roy (2008), Table 2 compares services liberalization undertaken across the sectors listed in the Central Product Classification of the GATS. Using an index that ranks scheduled commitments on a scale from 1 to 100, Marchetti and Roy show how PTAs have gone beyond both GATS commitments and the latest DDA offers across the full range of service sectors. This includes both sectors that have attracted less commitments and DDA offers under the GATS - for example, postal-courier, distribution or environmental services - as well as those that have generally proven more attractive in a multilateral setting - such as computer or tourism services.

Table 2: Comparing the level of services trade liberalization across sectors

Sectors	GATS	DDA Offers (o to 100)	PTAs	GATS/PTAs (%)	DDA/PTAs (%)	Preference Margin
Professional	30	39	67	45	58	42-55
Computer	55	74	93	59	80	20-41
Postal/Courrier	14	20	53	26	38	62-74
Telecoms	51	58	80	64	73	28-36
Audiovisual	17	20	50	34	40	60-66
Construction	40	46	75	53	61	39-47
Distribution	32	41	76	42	54	46-58
Education	18	25	57	32	44	56-68
Environmental	20	30	62	32	48	52-68
Financial	36	40	53	68	75	25-32
Health	8	11	34	24	32	68-76
Tourism	51	61	83	61	73	27-39
Maritime	12	23	57	21	40	60-79
Rail	14	20	52	27	38	62-73
Road	16	18	56	29	32	68-71
Aux. Transport	21	24	58	36	41	59-64

Source: Author calculations based on Marchetti and Roy (2008)

Interestingly, the two sectors with the lowest implicit preference margins are financial and telecommunication services, both of which were negotiated on a stand-alone, limited reciprocity, basis in the overtime negotiations that followed the completion of the Uruguay Round.⁶ Both also happened to be priority sectors for dominant OECD countries (especially the United States and the European Union, whose negotiating leverage in the Uruguay Round's overtime negotiations between 1994 and 1997 was significant).

Meanwhile, the large margins of preference (i.e. the much greater level of PTA liberalization relative to the GATS or the latest DDA offer) that characterize sectors such as audio-visual, transport (all modes), health or education services need to be understood in the context of highly specific sectoral narratives. These defy easy generalizations. For instance, marked preferential progress in audio-visual services relates almost solely to the PTAs to which the United States is a party and the fact that, confronted with "veto players"⁷ in the WTO, the U.S. has simply decided to assign greater prominence to PTA market opening efforts in the sector relative to the WTO.

In the case of transportation services, preferential advances most likely reflect gravity-related considerations as countries that share contiguous borders are significantly likelier to engage in deeper forms of trade-facilitating logistics cooperation across more transport modes than is feasible at the multilateral level. Seen this way, margins of preference in both of the above sectors may not shrink (i.e. be eroded) as much as in other sectors where genuine multilateral advances appear more feasible, such as in the area of environmental services.

⁶ The Uruguay Round's overtime negotiations in services also featured rapidly stillborn talks on maritime transport and Mode 4 trade, suggesting that sector- or modal-specific dynamics may, alongside constraints on reciprocal bargaining, play a key role in explaining the level of observed liberalization advances in services trade.

⁷ A 'veto player' is an individual or collective actor who has to agree for the legislative (or negotiating) *status quo* to change. See Tsebelis (2002).

IV. More (or less) than meets the eye? How “preferential” is preferential liberalization in services trade?

Tables 1 and 2 above reveal a landscape of significant contrast in liberalization dynamics between multilateral and preferential (bilateral or regional) settings. Looking at the continued gulf between latest DDA offers and PTAs, one might be tempted to draw sombre conclusions on the continued relevance of the WTO as a meaningful theatre of services trade liberalization. Yet how alarmed should one be at the scale of the implicit margins of preference in services trade depicted above?

The very rationale behind a PTA is the quest for (positive) discrimination – granting to one’s preferred partner what one may not be willing or prepared to accord to third country partners. Yet it may prove arduous, including in enforcement terms, if not impossible, to effect the opening of some services sectors or modes of supplying services on a preferential basis.

For starters, given that, as noted earlier, the very currency of services negotiations consists of domestic regulation⁸, the removal and/or reduction of most regulatory hurdles to market access and national treatment will tend *de facto* to proceed on an MFN basis. In part, this may simply reflect practical feasibility considerations. In many regulatory settings, particularly in resource-poor environments, this may reflect weak enforcement capacity and indeed a recognition that maintaining parallel regulatory regimes – one for insiders, another for third country suppliers, may result in undue regulatory compliance and/or enforcement costs. As an example, the number of partners in Indian accountancy firms is restricted to 20. If such a restriction were to be relaxed, it would be extremely difficult in practice to limit it to preferential suppliers. Similarly, much prudential regulation in financial markets or regulation targeting consumer or environmental protection concerns cannot

⁸ See Mattoo and Sauv  (2003).

meaningfully be applied in a preferential/discriminatory manner. In such cases, *de jure* preferential regulation (and hence access) becomes *de facto* MFN regulation and access.

One important caveat to the *de facto* multilateralisation of regulatory concessions depicted above is that even if all regulations ultimately apply to all suppliers, there may be first-mover advantages for the preferred partner in the form of incumbency advantages which could operate to the detriment both of suppliers from excluded countries and home country users or consumers. Preferential access to a services supplier could initially be in terms of market access, national treatment and/or regulatory requirements (e.g. licensing conditions). As noted earlier, these can translate into significant privileges in the domestic market once the foreign supplier has established a presence in it. As an example, one may think of a retail chain opening an outlet as part of a preferential agreement in a hitherto closed market. Such preferential market access could afford an incumbent significant advantages in terms of captive domestic clients and resources - access to land, labour, capital, entrepreneurship – and knowledge and use of the supply chain. These benefits may be sufficient to give it a competitive advantage even if it is inferior to more competitive suppliers from excluded countries. Such incumbency advantages could thus exert durably adverse welfare consequences relative to a MFN-based liberalisation under the GATS, leaving the host country stuck with weaker providers even when it subsequently liberalizes on an MFN basis.

The policy stance countries adopt with respect to service sector rules of origin (via so-called “denial of benefits” clauses) may offer an important means of addressing the risks described above.⁹ As in goods trade, the restrictiveness of agreed rules of origin will determine the extent to which non-members can benefit from trade or investment preferences. The multilateral disciplines of the GATS, embedded in

⁹For a fuller discussion of the economics and law of rules of origin in services trade, see Beviglia-Zampetti and Sauvé (2006) and Miroudot, Savaga and Sudreau (2010).

Article V.6, help to promote pro-competitive market outcomes by requiring that North-North and North-South PTAs (62% of notified PTAs and, more importantly, among PTA partners whose aggregate share of world services trade is far greater) adopt the most liberal rule of origin – i.e. the substantial business operations test, whereby any third country investor carrying out substantial business activities in the territory of a Party to a PTA must be treated like an investor from any PTA party. Under such circumstances, *de jure* PTA preferences become *de facto* multilateral commitments, a not insignificant development when one considers that Mode 3 is both the most important form of services trade (accounting for close to 2/3 of services trade) and, most importantly, that against which the greatest share of commitments (> 60%) are typically scheduled in all negotiating settings.

WTO disciplines are not, however, unambiguously virtuous, as GATS Article V.3(b) affords Parties to South-South PTAs the right to adopt a more restrictive rule of origin and deny the benefits of integration to third country investors that are not owned or controlled by juridical persons of a PTA Party. Many South-South PTAs – for instance Mercosur, ASEAN or the Andean Pact - have made use of the policy space on offer, with effects in terms of FDI attractiveness and overall developmental terms that are worthy of debate (to the extent that such restrictions are effectively enforced).

Thinking beyond Mode 3, it is unlikely that PTA partners may meaningfully enforce preferences applied to the growing volume of cross-border digital transactions (Mode 1 trade). Here again, feasibility issues suggest the convergence between *de jure* preferences and *de facto* multilateralized outcomes. Meanwhile, the question of rules of origin appears largely moot in regard to Mode 2 trade (consumption abroad), as few countries would seek to be overtly selective in discriminating in favor (or against) the consumption decisions of foreign consumers.

As a practical matter, it would appear that, as with goods trade, rules of origin in services trade assume importance only where the border matters as a tangible reality defining the possibility of market access. This is most obviously the case of Mode 4 trade, where service providers must physically cross a border in order to ply their trade internationally. Not surprisingly, rules of origin applied to Mode 4 suppliers rank among the most restrictive of all, with PTA benefits typically limited to citizens or permanent residents of PTA partners. However, it bears recalling that such restrictions affect a mode of supply that accounts for less than 5% of aggregate services trade.

V. *Multilateralizing services preferences*

PTAs are here to stay and have become a mainstay of modern economic diplomacy. They offer a number of benefits, potential and real, that heighten their attractiveness to governments and business constituencies concerned by the liberalization and reform agendas in services markets. This includes their heightened expediency (relative to the WTO), the greater ease with which they allow negotiating agendas rich in behind the border challenges to be addressed and lead to trade-facilitating regulatory convergence, the scope they offer (with markedly contrasting take-up) for novel advances in rule-making, particularly in areas of WTO blockage, etc.

There is generally little debate over the fact that services PTAs offer economic welfare gains relative to the *status quo*. One cannot however deny that the gains from multilateral liberalization are likely to be larger as MFN-based competition is unbiased and the first-mover advantages of possibly second-best service providers are thwarted. To the extent that WTO Members undertake enhanced liberalizing commitments across a broad array of services sectors and modes of delivery at the end of the Doha Round, PTA-induced preferences will be automatically eroded, even if not fully. However, given lingering uncertainties on the

ultimate fate of the DDA and the continued strong push towards PTAs of all types (North-North, North-South, South-South, bilateral, regional, trans-regional), the best alternative is perhaps to seek practical means of multilateralizing service sector preferences.

This paper has argued that one may be generally sanguine that the potential downsides of preferential liberalization may be less ominous or feasible in services trade. This is so even as the margins of preference implicit in many recent PTAs appear significant when compared to existing GATS commitments or the (still very partial) signals emanating from DDA liberalization offers.

Preferences in services may be more theoretical than real for a number of reasons. This includes, first and foremost, practical concerns over the very enforceability of preferences rooted in what are often non-discriminatory domestic regulatory regimes. In regard to rules of origin, it is also a direct result of multilateral rule-design insofar as the most statistically meaningful sample of PTAs and PTA partners is concerned (i.e. PTAs with a partner from the North) in the predominant mode of supplying services (i.e. Mode 3).

In contemplating the scope that may exist to multilateralize preferential advances, greater use could be made of the disciplines on recognition found in GATS Article VII on Recognition¹⁰ Article VII.2 of GATS states that “members of a mutual recognition arrangement (MRA) shall provide adequate opportunity for other interested excluded countries to negotiate their accession to such an arrangement or to negotiate comparable arrangements”. Article VII.4(b) further states that “such arrangements should be notified to the Council for Trade in Services well in advance

¹⁰ Recognition is the act of recognizing the education or experience of a foreign service provider for the purpose of meeting the domestic country’s authorization, licensing or certification requirements and is especially important in the case of trade in professional services. Such recognition can be accorded autonomously or can be embedded in an arrangement or agreement with the interested country(ies)- the latter takes the form of a Mutual Recognition Agreement (MRA).

of the start of negotiations to enable interested third parties to join these negotiations before they enter a substantive phase". Finally, Article VII.5 states that "wherever appropriate, recognition should be based on multilaterally agreed criteria."

Significantly, however, the above provisions have not enticed WTO Members to extend MRA benefits to third country suppliers to the extent that they have chosen to notify these under the "closed" integration provisions of Article V of the GATS which does not afford non-members an opportunity to accede to such an MRA. One means to multilateralize bilateral or plurilateral MRAs would be to make it mandatory for their members to notify them under Article VII of the GATS. An alternative would be to constrain eligibility for MRAs pursued under Article V solely to PTAs that share contiguous borders or a common geographical space given that geographical proximity is more likely than not to be associated with higher levels of regulatory cooperation, including in matters of recognition and labour market cooperation. Under such rules, MRAs concluded among geographically distant countries (i.e. trans-regional PTAs) would need to be notified under the "open regionalism" provisions of Article VII:2 GATS.

Matto & Sauv  (2010) have suggested another possibility wherein PTA members could be required to pre-commit to future multilateral liberalization by signalling a precise time-frame over which preferential treatment would be progressively eroded and/or eliminated. An alternative to the above prescription would once again proceed along geographical proximity lines, by allowing Parties to PTAs among contiguous or geographically proximate (i.e. forming a common geographical space) partners to dismantle preferences at a slightly lower pace. Such differentiated treatment could vary by level of development of PTA partners. It could, for instance, be limited solely to South-South PTAs in a manner analogous to the rule of origin provisions foreseen under Article V:3(b) GATS.

PTA rules of origin affecting Mode 4 suppliers should also be relaxed such that residents of a Party (subject potentially to a six-month to one year prior residency rule so as to avoid abuse) and not solely permanent residents or citizens, can enjoy temporary entry privileges within an integration area.

Finally, preferential services agreements adopting the most liberal denial of benefits provisions can be showcased as “best practice” agreements against which existing accords can be modified and/or future accords negotiated. Alternatively, WTO Members could be encouraged to agree to a set of voluntary best practice/pro-multilateralization guidelines directed those contemplating preferential liberalization and rule-making in services and against which existing accords could be modified and future accords negotiated.

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