

V. What behind-the-border reforms in services and investment are best done through trade agreements?

By Philippa Dee

Introduction¹

What behind-the-border reforms in services and investment are best done through trade agreements? One way to answer this question is to think of trade agreements as being exercises in piecemeal reform, in the sense that they provide opportunities for reform, but in a constrained, partial manner. The key policy question is whether countries should unreservedly take advantage of these opportunities, despite the constraints, or whether the nature of the constraints should temper the way in which they go about the reforms.

The key policy dilemma originates in the theory of the second best. Lipsey and Lancaster (1956) noted that if, for institutional or other reasons, one of the conditions for economic efficiency cannot be achieved, then the other conditions may no longer be desirable. Their definition of piecemeal policy was a situation where it was still a “second best” optimal to achieve the other conditions, even though the best could not be achieved. Examples of papers that have tried to characterize piecemeal second-best policy include Davis and Whinston (1965) and Boadway and Harris (1977).

In the context of goods trade, the principles of piecemeal reform are well understood. The economic cost of a tariff is a function, not just of the average level of tariff, but also of its dispersion. So a key guiding principle of piecemeal tariff reform is that it should not exacerbate the dispersion. Otherwise, partial reform may actually worsen economic well-being. In his seminal analysis, Corden (1971 and 1974) therefore examined options such as the “concertina” method – where high tariffs would be squeezed down to medium levels at the first stage, then these and the existing medium tariffs would be squeezed down to a lower level and “across-the-board” reductions – where each year, all tariffs would be reduced by an equal percentage.

This guiding principle is now sufficiently well-accepted in trade negotiating circles that it has been embodied in a negotiating modality. In the current round of non-agricultural market access negotiations under the World Trade Organization (WTO), tariff cuts will take place according to the so-called Swiss formula, which ensures that within each country the highest tariffs will undergo the greatest percentage cuts. According to this “ops down” formula, the partial reform achieved via the negotiations will reduce both the average level of tariffs and their dispersion.

¹ An earlier version of this paper was presented to ESCAP conference on ‘Emerging Trade Issues for Policymakers in Developing Countries of Asia and the Pacific: New Era of Trade Governance’, Manila, 4-6 March 2009.

The aim of this paper is to explore whether there are principles that can be brought to bear in negotiating the services and investment provisions of trade agreements, and which can help to ensure that the partial reforms achieved under those agreements add to, rather than detract from economic well-being. These principles might be seen as the services and investment equivalents of the “top-down” principle for tariff reform. It is not intended to go as far as developing a negotiating modality for services or investment, as that would be premature. However, the principles developed here could be used by individual countries on a voluntary basis when undertaking negotiations in services and investment.

There are two possible levels of analysis. One is to compare trade agreements to other modes of liberalization, as exercises in piecemeal reform. Should countries embrace trade agreements in services and investment whenever the opportunity arises, even though the liberalization achieved under them is likely to be constrained in various ways? Or should countries watch for instances when trade agreements might make things worse?

The second level of analysis is to consider which particular reforms should be included in trade agreements (the question posed in the title of this paper). Should countries negotiate whatever they can within trade agreements? Or should they worry about which reforms will avoid losses and/or deliver the biggest gains? The paper proceeds with those two levels of analysis in turn.

A. Trade agreements versus other modes of liberalization ²

Trade agreements can be either multilateral or preferential, but they typically involve the reciprocal exchange of trade concessions with one or more trading partners. They stand in contrast to unilateral liberalization, where a country “goes it alone”.

In the context of goods trade, the benefits of reciprocity are clearly understood. The key economic benefit is that reciprocity helps to neutralize the negative terms of trade effects of unilateral tariff reform (e.g., Bagwell and Staiger, 1999). It is also argued that reciprocity helps with the political economy of tariff reform – the benefits to exporting interests from a trading partner’s concessions can be offset against the losses to import-competing interests from a country’s own concessions (e.g., Baldwin and Robert-Nicoud, 2008).

In the case of services and investment, the benefits of reciprocity for either the economics or the political economy of reform have yet to be established. This section explores these issues; however, it must first be established exactly what types of partial reforms trade agreements can be expected to achieve in services and investment.

As noted recently (Dee and Findlay, 2009), there are at least four ways to define and evaluate the services and investment provisions of trade agreements:

- (a) Evaluate the rules;
- (b) Evaluate the commitments made under those rules;

² Parts of this section draw on Dee and Findlay, 2009.

- (c) Evaluate the extent to which the commitments constrain or change the status quo, given that there can be large gaps between bound and applied protection in the areas of both services and investment;
- (d) Evaluate whether any change to the status quo has economic significance.

1. Evaluating the rules

The General Agreement on Trade in Services (GATS) under WTO imposes one key discipline on all services trade – the most-favoured nation obligation. This requires a country to treat the services suppliers of all other countries equally. There is to be no discrimination among the various different foreign sources of services.

Beyond that, there are two other key disciplines that apply on a positive list basis, i.e., they only apply to selected services sectors that a country chooses to subject to those disciplines. The first is a national treatment obligation. This requires a country to treat the services suppliers of all other countries the same as its domestic suppliers. There is to be no discrimination between domestic and foreign suppliers. The second is a market access obligation. This requires a country to refrain from applying six specific types of quantitative restrictions on services suppliers, be they domestic or foreign suppliers. For example, there is to be no limit on the number of services suppliers or on the value of services transactions.

GATS recognizes the right of individual governments to regulate. Non-economic objectives can be pursued, for example, through universal service obligations. Services provided by governments are quarantined. However, GATS also requires that domestic regulatory regimes be the “least burdensome” necessary to achieve their objectives. Although this provides a further WTO discipline on non-discriminatory measures that fall outside of the narrow scope of GATS “market access” commitments, the discipline is rather loose, especially since the definition of “least burdensome” has yet to be decided on by WTO members.

The presumption exists that the services provisions of preferential trade agreements (PTAs) will be GATS-plus. That is, they will impose rules at least as liberal as those of GATS, and impose them on at least as many sectors. In part, this presumption is written into GATS itself. For the services provisions of PTAs to be WTO-consistent, they need to have substantial sectoral coverage, and provide for the absence or elimination of substantially all discrimination, in the sense of the national treatment obligation. However, it should be noted that there is no WTO requirement for PTAs to address non-discriminatory market access limitations, or to address domestic regulation. In fact, enforcing WTO consistency has proved no easier in services than it has in goods.

In practice, when PTAs have included services provisions, they have tended to be of two types. GATS-style agreements have included national treatment and market access obligations for services on a positive list basis, and have included investment provisions only via the treatment of commercial presence in the services sector. In contrast, North American Free Trade Agreement-style pacts have included national treatment and market access obligations for services on a negative list basis. That is, the obligations apply to all services

sectors, except those nominated for exclusion in an annex of reservations and exceptions; they have typically included a separate chapter on investment that imposes most-favoured nation and national treatment obligations on investment in all sectors (again, subject to reservations and exceptions), not just in services.

Several recent studies have compared the rules established under PTAs to those of the GATS (e.g., Marchetti and Roy, 2008; Dee and Findlay 2009). They have shown that in many dimensions, PTAs are not as liberal on average as WTO agreements. This is in part because some PTAs have no substantive services provisions at all – only a minority of the agreements between developing countries have such provisions. It is also because many PTAs are silent on issues such as domestic regulation, monopolies, private business practices, safeguards and subsidies. These are not areas where PTAs have forged ahead of WTO disciplines. However, on the two core issues of market access and national treatment, PTAs are now more liberal on average than WTO. This is largely because of the growing list of agreements that include these disciplines on a negative list rather than a positive list basis.

2. Evaluating the commitments

On commitments, Roy, Marchetti and Lim (2006) and Marchetti and Roy (2008) find that PTAs tend to go significantly beyond GATS offers under the Doha Round, in terms of improved and new bindings. Further, the proportion of new/improved commitments is generally much greater in PTAs (compared with GATS offers) than in GATS offers (when compared with existing GATS commitments). Some countries are described as showing spectacular improvements in their PTA commitments. Among them are countries that have signed a PTA with the United States. On average, these now have mode 1 (cross-border) and mode 3 (commercial presence) commitments in more than 80 per cent of services subsectors, compared with commitments in less than half of the services subsectors in their GATS schedules/offers.

In most cases where PTA commitments improve on WTO commitments, it is primarily through new bindings rather than through improvements on existing bindings. Arguably, though, the commitments are more likely to imply real liberalization in the latter case than in the former. Exceptions to the general trend include China and India, whose PTA commitments (China with Hong Kong, China and Macao, China, and India with Singapore) tend to take the form of improvements to sectors already committed under GATS schedules/offers rather than new bindings, and are mostly limited to mode 3 (commercial presence).

Finally, the above authors note that PTAs provide for advances both for sectors that tended to attract fewer offers in the GATS (e.g., audiovisual, road, rail and postal-courier) as well as for sectors that were already popular targets for GATS offers (e.g., professional and financial services). One exception is health services, where PTA commitments do not appear to go significantly beyond GATS offers.

Overall, Roy, Marchetti and Lim (2006) concluded that “PTAs generally have provided for significant improvements over GATS commitments, sometimes even leading to

real liberalization of the market.

3. Evaluating the extent of real liberalization

In a recent exercise, Barth and others (2006) compared regulatory practice with actual WTO commitments in the financial sector for 123 WTO members. They found significant differences between commitments and actual practice. Some of their examples are:

- (a) More than 30 WTO members that prohibit foreign firms from entering through acquisitions, subsidiaries or branches in their WTO schedules allow such entry in practice;
- (b) Six WTO members do not allow foreign entry through subsidiaries or branches, even though in their schedules they indicated they do. This anomaly may reflect the “prudential carve out” in GATS, whereby members are not required to schedule limitations maintained for prudential purposes. However, it is highly questionable whether bans on foreign entry could be defended as purely prudential measures;
- (c) A large number of WTO members prohibit banks from engaging in insurance or securities activities in their schedules, but allow such activities in practice;
- (d) Twenty-six WTO members in practice set the same minimal capital entry requirements for domestic and foreign banks, even though in their schedules they do not commit to such non-discriminatory treatment.

Barth and others (2006) also looked for evidence of statistically significant correlations between WTO commitments and regulatory practice. Even if the two do not match exactly, they expect the correlation to be positive. However, their finding did not bear this out:

“The results...indicate that, on average, countries are more open based on actual practice than their WTO commitments. The difference in means between actual practice and commitments, moreover, is statistically significant. Also, there is no significant correlation between actual practice and commitments. These results hold for developing countries and countries with more than 2 million people, but not for the developed countries. The latter group of countries is, on average, less open based upon actual practice than commitments.”

This last, rather explosive finding passes without further comment!

As evidence about whether PTAs promote real liberalization, the findings are merely circumstantial. However, if WTO commitments lag in actual practice by a significant margin, then even if PTAs improve significantly on WTO commitments they may still themselves lag in actual practice.

Roy, Marchetti and Lim (2006) also attempted to assess whether PTA commitments led to real liberalization. They did not make direct comparisons with regulatory practice, but

looked for instances where PTA commitments were phased in over time, using the phasing mechanism as an indication that real liberalization is taking place. They noted that the group of countries making such phased commitments was fairly widespread, although it appeared that financial services and telecommunications dominated. Most phase-out commitments have been contracted by countries as part of a PTA with the United States, although not exclusively.

Certainly, the PTA experience with partners other than the United States can be dramatically different. It is widely recognized that in the Association of Southeast Asian Nations (ASEAN) members, WTO commitments and PTA commitments can lag in actual practice by a considerable margin (e.g., Stephenson and Nikomborirak, 2002). In fact, one of the recent PTAs that contains no services commitments whatsoever is that between ASEAN and China.

4. Evaluating the economic significance of real liberalization

Dee (2007) argued the following three propositions:

- (a) When real liberalization of services and investment occurs in trade agreements, it tends to involve the removal of discrimination against foreigners;
- (b) In PTAs, this tends to be on a preferential basis, i.e., only for the particular partner country;
- (c) Therefore, when real liberalization of services and investment occurs in trade agreements, it tends not to involve the liberalization of restrictions that affect domestic and foreign players equally.

This is despite the fact that GATS specifically recognizes certain types of non-discriminatory restrictions on market access, and imposes weaker disciplines on other non-discriminatory restrictions through its provisions on domestic regulation. This chapter outlines a number of reasons for these outcomes.

Some of the reasons are reflected in the attitude of trade negotiators. Two statements often heard from trade negotiators are that they “do not want to give away negotiating coin” and that “they are not in the business of negotiating on behalf of other countries”. This latter sentiment, in particular, places the imperative on ensuring that trade concessions in PTAs are restricted to being preferential, even when economic arguments suggest that a country could gain more from making them on a non-preferential basis.

With an imperative for PTA concessions to be preferential, this often dictates that the concessions need to target measures that explicitly discriminate against foreigners. This is because, in many cases, the only provisions that can feasibly be liberalized on a preferential basis are those that discriminate against foreigners. Furthermore, as noted, the requirements for WTO consistency only require PTAs to remove limitations on national treatment. They do not require them to address issues of market access or domestic regulation.

Another statement heard from trade negotiators is that they will only commit to things

that their country was planning to do anyway. According to this imperative, when commitments are made that affect domestic services providers as well as foreigners, they tend to involve no real liberalization that would not have taken place anyway. For example, Roy, Marchetti and Lim (2006) noted that the United States always lodged a broad exception for the market access obligation in its PTAs whose purpose was to ensure that those PTAs did not go beyond its market access obligations under GATS.

Other reasons for the above outcomes are reflected in the attitudes of a country's trading partners. Under the request-and-offer negotiating modality (which is currently being used in the Doha negotiations on services, and is the means by which many PTAs are negotiated), countries are asked to contemplate, not just reforms that are in their own best interests, but also reforms that are in their trading partners' best interests. It will tend to be in a trading partner's best interests to target only those provisions that explicitly discriminate against foreigners – in that way, the foreign market share is maximized. Foreign producers would generally have little interest in unleashing competition from promising domestic new entrants. They would rather join a cartel on a far more selective basis! Even if the preference they receive is eventually eroded by other agreements, they will receive a first-mover advantage that can confer a permanent benefit, particularly when establishing in the market involves sunk costs (Mattoo and Fink, 2002).

The above observations define the way in which trade agreements in services and investment tend to be constrained. The economic significance of the constraints comes from observing that different types of services trade restrictions can have different kinds of effects.

Some regulatory trade restrictions, particularly quantitative restrictions, create artificial scarcity. The prices of services are inflated, not because the real resource cost of producing them has gone up, but because incumbent firms are able to earn economic rents (excess profits) – akin to a tax, but with the revenue flowing to the incumbent rather than to government. Liberalization of these barriers would not only yield relatively small gains associated with better resource allocation, it would also have redistributive effects associated with the elimination of rents to incumbents. Such rent-creating restrictions are tariff-like, with the redistribution of rent having effects similar to the redistribution of tariff revenue.

Alternatively, services trade restrictions could increase the real resource cost of doing business. An example would be a requirement for foreign service professionals to retrain in a new economy, rather than to pass an accreditation process. Liberalization would be equivalent to a productivity improvement (saving in real resources), and yield relatively large gains. This could increase returns for the incumbent service providers as well as lower costs for users elsewhere in the economy.

This distinction has two important implications. First, the gains from liberalizing cost-escalating barriers are likely to exceed the gains from liberalizing rent-creating barriers by a significant margin. Second, in the context of PTAs, the danger of net welfare losses from net trade diversion arises if the relevant barriers are rent-creating, since rent distribution can have the same effects as tariff redistribution (see also Pomfret, 1997).

So the key to establishing the economic significance of any real services trade liberalization achieved in trade agreements is to establish whether it targets trade barriers that create rents or raise costs.

As noted above, the barriers that are easiest to liberalize on a preferential basis are explicit quantitative restrictions. These create artificial scarcity, and hence tend to generate rents. For example, one popular target for liberalization in PTAs has been barriers in banking and telecommunications. The limited empirical evidence suggests that in these sectors (where explicit barriers to entry are rife), barriers appear to create rents. In distribution services, where indirect trade restrictions also apply, barriers appear to increase costs. In air passenger transport and the professions, barriers appear to have both effects.

In particular, discriminatory barriers in the professions appear to create rents, while the non-discriminatory restrictions (such as restrictions that require partnerships, and require both the investors and managers of professional firms to themselves be licensed professionals) increase costs (Gregan and Johnson, 1999; Kalirajan and others, 2000; Kalirajan, 2000; Nguyen-Hong, 2000; Organisation for Economic Co-operation and Development, 2005; and Copenhagen Economics, 2005). In addition, theoretical arguments suggest that barriers in maritime and electricity generation primarily affect costs (Steiner, 2000; and Clark, Dollar and Micco, 2004).

Dee (2007) showed that if an East Asian PTA managed to eliminate all discrimination against foreigners in the sectors where empirical evidence was available, the gains would be small compared to a moderately successful completion of the Doha Round. In fact, they would be trivial compared to a comprehensive programme of unilateral regulatory reform that instead targeted non-discriminatory, behind-the-border restrictions on competition. The reason is that there appears to be a reasonably strong correlation in practice between measures that discriminate against foreigners and measures that create rents.

Thus, those who have evaluated the services and investment provisions of trade agreements according to their rules or commitments have tended to see “doughnuts”. Those who have evaluated them according to whether they create any real, significant liberalization have tended to see “holes”.

5. Whether to enter trade negotiations – principles of piecemeal reform

The above discussion suggests that for both PTAs and multilateral agreements, there are reasons to be cautious about the size of the potential gains. In both cases, there are also situations where the trade agreements could make things worse.

In the case of PTAs, the problem is that if concessions are made to a particular foreign trading partner, prior to removing non-discriminatory distortions and ensuring the general contestability of the market, then the concessions simply risk handing monopoly rents to foreigners. Furthermore, if the new trading partner has to incur sunk costs to enter the market, then a country risks landing itself permanently with a second-class supplier who is difficult to budge (see also Dee and Findlay, 2008; and Marchetti and Roy, 2008).

Multilateral trade agreements can avoid some of these problems by opening a market to many foreign players simultaneously. However, this does not mean that they are completely without problems.

At best, removing discrimination against all foreign suppliers simultaneously will not be sufficient to ensure the full benefits of market opening. It is useful to draw a comparison with the theory of goods trade. When goods are homogeneous and domestic and foreign varieties are perfect substitutes, removing all discrimination against foreign suppliers will be sufficient to ensure that the country can access goods at the lowest possible price (in this case, “the” world price), even if domestic suppliers are still penalized by domestic distortions. However, services are typically highly differentiated, often being tailored to the needs of individual customers. In this case, simply removing discrimination against foreign suppliers will not be sufficient to ensure that a country can access goods at the lowest possible price. If domestic suppliers are still penalized by distortions, the prices of their services will remain too high, despite the foreign competition. The empirical analysis by Dee (2007) suggested that this latter problem could be highly significant in practice.

At worst, removing discrimination against all foreign suppliers simultaneously can move a country’s resource allocation in the wrong direction, risking an adverse overall economic outcome. If domestic suppliers are subject to domestic regulatory impediments, the resources devoted to domestic supply will be too small, and in a first-best situation, the domestic sector should be bigger. However, subjecting the sector to more foreign competition, while keeping it subjected to its own domestic regulatory impediments, will tend to make the sector shrink rather than grow – domestic resource allocation is thus moved in the wrong direction. This has the potential to make economic well-being worse (depending on whether the sector is a general equilibrium substitute to complement to other sectors in the economy) (see also Dee, Hardin and Holmes, 2000).

Not only is this a potentially bad economic outcome, it is also a poor outcome in terms of domestic political economy. Potential domestic new entrants are a key group likely to be in favour of reform. Failure to lift the domestic regulatory impediments that hold them back therefore misses an opportunity to mobilize them as part of the pro-reform coalition.

To the extent that both PTAs and multilateral trade agreements focus on barriers to services trade and investment that create rents rather than raise costs, they both represent poor political economy in another sense. Often, the essence of barriers to services trade and investment is that they serve to protect incumbent service providers from any new competition, be it from domestic players or foreigners. Thus, incumbent service providers are often the most vociferous opponents of reform. Yet trade reforms that manage to lower cost structures have the potential to benefit even the incumbent service providers. Failure to lift the domestic regulatory impediments that hold them back misses an important opportunity to mobilize incumbents as part of the pro-reform coalition.

Indeed, the politics of regulatory reform is often the politics of incumbent versus a range of opposing interests – not just potential new entrants (either domestic or foreign), but also upstream supplying industries, downstream using industries, consumers and, sometimes,

even governments. Most of the protagonists are domestic. Trade negotiations are forums where the politics is domestic versus foreign. They are not forums that can mobilize the full range of domestic pro-reform interests.

The case for reciprocity in services and investment

In this regard, international reciprocity does not help greatly with the political economy of trade reform in services and investment. This is because the politics is primarily one of competing domestic interests, not domestic versus foreign interests (Dee and Findlay, 2008).

Furthermore, international reciprocity does not help greatly with the economics of trade reform in services and investment. In goods trade, the adverse terms of trade effects occur because goods trade barriers operate at the border. However, the regulatory barriers to services and investment are primarily behind-the-border barriers, and their first-round effects are primarily on domestic prices and costs. If unilateral trade liberalization has any impact on the terms of trade at all, it can often be positive rather than negative, particularly if the liberalization removes barriers that raise domestic costs. Thus, there are no benefits from reciprocity within services, as there are no adverse terms of trade effects to be neutralized (Dee and Findlay, 2008).

Nor are there likely to be significant benefits from reciprocity across sectors. One reason is that the most intensive users of services are often other services sectors. So the domestic benefits of services reform often flow to other services sectors, not to manufacturing or agriculture (for more details, see Dee and Findlay, 2008).

B. What to liberalize within trade agreements

Trade agreements may nevertheless provide useful venues to lock in certain types of reforms, despite all the qualifications noted above. A second key question is what types of reforms are best done within trade agreements.

An important first step, however, is to recognize how trade barriers in services and investment may interact with legitimate domestic regulation. This interaction can set additional limits on the extent of trade liberalization.

1. Limits to liberalization³

In many services sectors, there are legitimate reasons for domestic regulation. For example, a key reason for prudential regulation in banking and insurance markets is to guard against systemic instability of the financial system. A key reason for regulating transport industries is to ensure passenger safety. A key reason for having regulated access regimes in telecommunications is to avoid the inefficient duplication of infrastructure components that have “natural monopoly” characteristics.

³ Parts of this section draw on Dee, 2009.

In services such as education and health, there are typically at least two key regulatory objectives. One is to deal with asymmetric information. Almost by definition, the clients of health firms or education institutions are not sufficiently trained to know whether the services they are receiving are of high quality. In some markets, this problem is dealt with after the event, via product liability legislation. In education and health markets, this option is typically deemed unsatisfactory, so quality is regulated before the event – via training and perhaps licensing/registration requirements for individual service providers, and by licensing and quality assurance processes for institutions.

Note, however, that regulated quality assurance processes are not the only solution to this problem. Reputation also has a role to play. Services providers who plan to be in a market for the long term cannot afford to offer shoddy service forever, or they will lose clients. They have an incentive to offer quality, and to establish a reputation for doing so.

A second key regulatory objective in education and health markets is to ensure equitable and affordable access, either for all, or for particular disadvantaged segments of society. Government provision is the traditional method of meeting this objective. Government subsidies to private institutions and (through scholarships and the like) to consumers, are also ways in which it is achieved. However, few governments can afford to subsidize everyone. Therefore, typically there are limits on who can get government funding, simply for budgetary reasons.

In some services sectors such as banking and insurance, there is a relative clear-cut distinction between the regulatory instruments used for legitimate prudential reasons and those that are deemed regulatory impediments to trade. The instruments commonly used for prudential purposes include minimum capital requirements, capital adequacy ratios, liquidity reserve ratios, possible coverage by an insolvency guarantee or deposit insurance scheme, and a required frequency of publication of financial statements.

While there are a few grey areas, in most cases regulatory restrictions affecting trade in banking and insurance services can be dismantled without jeopardizing prudential objectives, which are achieved using other means. Of course, there is still a sequencing issue – it would be unwise to open financial markets without adequate prudential regulation and without adequate regulatory capacity to design and enforce it.

In health and education services, the distinction between instruments used to achieve quality and access objectives and those deemed to be regulatory barriers to trade is less clear-cut. Entry may be restricted to ensure that low-quality providers do not enter the market, or to protect incumbent service providers. Similarly, access to subsidies may be limited because governments cannot afford to subsidize everybody. Or access to subsidies may be limited in order to disadvantage new entrants.

Achieving quality objectives in health and education will inevitably mean that there are barriers to the entry and operation of at least some providers. However, a well-designed quality control framework will ensure that the providers who are locked out are the genuinely

low-quality ones. The framework can afford to be relatively neutral in its treatment of domestic and foreign providers, or incumbents and new entrants.

Similarly, even in the most open health or education system, not all providers or clients will gain access to government subsidies. If the system is to not unduly constrain trade, then this denial of subsidies should be the same for domestically owned and foreign providers. Ideally, to maximize efficiency, it should also be neutral with respect to incumbents and new entrants, finding some criteria other than incumbency as a mechanism to ration the subsidies. Governments may choose not to be neutral in their treatment of access to subsidies by domestic and foreign customers, however. For obvious reasons, they may choose to deny the right of foreign customers to local subsidies.

Because there are more targets than instruments in health and education, trade liberalization in these services cannot be expected to lead to the complete removal of entry barriers or restrictions on access to subsidies. What trade negotiations might be expected to do is to ensure that they are reduced to levels that are “no more burdensome than necessary, in the language of GATS. Where the rationale for regulation is quality assurance, then the logical way to put this necessity test into operation is to define minimum acceptable standards of quality that meet the needs of both sides.

To date, there has been little progress in putting a necessity test into operation for any services within WTO. Arguably, more progress might be made within a PTA among partners whose levels of development were not too dissimilar.

2. What to liberalize?

As noted above, trade agreements may provide useful venues to lock in certain types of reforms, despite all the qualifications noted above. The qualifications now include the fact that full liberalization might not be possible in situations where there is a “targets and instruments” problem – too few regulatory instruments available to achieve the desired targets.

If countries want to concentrate their trade negotiating efforts in areas that generate the biggest gains, they need to consider five characteristics of their own regulatory barriers:

- (a) The height of the trade barrier – that is, the extent to which regulatory restrictions have raised costs or created rents;
- (b) The impact of the barrier – whether the impact has been on costs or rents;
- (c) The incidence of the barrier – whether it applies only to foreign suppliers, or whether it also applies to domestic operators;
- (d) The size of the affected sector; and
- (e) The nature of its input-output linkages to other sectors.

All these factors will affect the overall economy-wide gains from reform. Dee and Findlay (2008) surveyed some of the evidence on the first three characteristics (more detailed

evidence is also available in Dee, 2005).

(a) *Height of the trade barrier*

In some services sectors, particularly banking and telecommunications, services trade barriers are typically much higher in developing than in developed countries. In most cases, the remaining barriers in the developed world are low or negligible.

In other services sectors, particularly the professions, the distribution sector (wholesale and retail trade) and electricity generation, the barriers still tend to be higher in the developing than the developed countries, but the barriers in the latter countries are often non-trivial. Particular developed countries have maintained quite high barriers to entry and operations in the professions, particularly the accounting and legal professions. Some have maintained significant restrictions on the operations of large wholesale and retail chains, either directly or through restrictions on such things as zoning and hours of operation, in order to protect local “Mom and Pop” stores. Trade barriers are also non-trivial in those developed countries that have yet to open their electricity generation sectors fully to competition.

In some sectors, barriers are as high in the developed as in the developing world. On bilateral air transport routes still governed by traditional bilateral air services agreements rather than open skies agreements, the restrictions are as high for developed as for developing countries.

Finally, for a few services sectors, the barriers are higher in at least some developed countries than in some developing countries. Maritime is a prime example. The United States maintains stringent cabotage restrictions, exempts liner shipping conferences from the normal disciplines of competition policy and maintains a range of other restrictions, including on hiring foreign crews and on shipping non-commercial cargoes. Its trade barriers in maritime have been estimated to be higher than in Latin America and most of Asia (McGuire, Schuele and Smith, 2000).

(b) *Impact of the trade barrier*

Whether barriers create rents or add to resource costs is currently severely under-researched. Some of the available empirical evidence and *a priori* argument on this was summarized above. In some cases, the empirical evidence is suggestive, but not conclusive, because only one performance measure has been used. In other cases, a price impact is estimated, and then it is simply asserted whether the effect operates through price-cost margins or through real resource costs. This is a key area where more thorough empirical research is needed.

(c) *Incidence of the trade barrier*

There is a great deal of variability among both developed and developing countries in whether barriers discriminate against foreign services providers, or also affect domestic

operators.

In particular sectors, some developing countries maintain high barriers that are also strongly discriminatory against foreign operators – for example, banking in Malaysia and telecommunications in Thailand. In other sectors, barriers are lower but also strongly discriminatory – for example, banking in Thailand. In other countries, barriers tend to be both lower and less discriminatory – for example, the banking and telecommunications sectors in the Russian Federation, the Baltic countries and much of south-eastern Europe.

In the developed world, trade barriers in banking and telecommunications are sufficiently low on average that any margin of discrimination is also trivial. At the other extreme, barriers in maritime are both high and discriminatory. In Europe, the trade barriers in engineering services tend to be non-discriminatory, while those in legal services can be highly discriminatory.

The one generalization that can be made is that when there are significant barriers to foreign supply, there are typically also non-trivial barriers to domestic supply. It is very rare to have a significant barrier to foreign entry and/or operations with no barrier affecting domestic new entrants.

(d) Size of the affected sector

The size of the affected sector is sufficiently important that it can sometimes dominate the height of the barrier. In an economy such as Indonesia, for example, barriers to trade in telecommunications services are higher than those in the distribution sector (i.e., wholesale and retail trade) while the height of the barrier in distribution is, in fact, quite modest. However, the distribution sector is bigger, accounting for around 15 per cent of the economy. Primarily because of this, the estimated gains from further reform in distribution are bigger than those in telecommunications, even after taking into account the potential productivity boost that could come from greater business-to-business e-commerce (Dee, 2008).

(e) Intersectoral linkages

Finally, a key consideration is which services sectors have strong intersectoral linkages to the sectors where a country's ultimate comparative advantage lays. Ghani (2009) draws a distinction between East Asia, where the ultimate comparative advantage is in manufactures, and South Asia, where the ultimate comparative advantage is in services itself (e.g., both ICT services and ICT-enabled services such as back-office professional services).

The services that have strong intersectoral linkages with manufacturing are those such as transport, logistics and energy services. The services that have strong intersectoral linkages to services are most other services. Therefore, East Asia will get relatively large economy-wide gains from liberalizing and improving productivity in transport, logistics and energy (this tends to be confirmed in empirical studies such as Dee, 2008). South Asia will record relatively large economy-wide gains from liberalizing and improving productivity in most services sectors.

3. Sectoral priorities: Principles of piecemeal reform

One important principle for piecemeal reform of services – the services equivalent of the “top down” principle – is to look for sectors where trade barriers tend to add to costs. These are typically not the areas where regulatory barriers have created artificial barriers to entry (although rents can still be converted to real resource costs in a number of ways, for example, by being capitalized into the cost of land). Instead, they tend to be areas where regulations create unnecessary procedures and red tape.

In the East Asian region, these services sectors also happen to be sectors with strong intersectoral linkages to manufacturing. Thus, the sectoral priorities in East Asia should include the various links in the logistics chain – customs, transport (road, rail, air and maritime), distribution and telecommunications – which is vital for e-commerce. They should also include energy services, particularly electricity, where poorly designed domestic regulation can add to costs. They should also include some less obvious backbone services, such as legal and accounting services, where at least some regulatory restrictions also add to costs.

At least some of these services involve significant physical infrastructure, and it is also well-recognized that the availability of infrastructure is also critical to economic growth. Thus, regulatory reforms that can improve the investment climate in these areas will have a doubly beneficial impact – increasing the resources available as well as improving the productivity of the resources that are employed.

In South Asia, services trade reforms do not need to be quite so targeted because of the relatively dense intersectoral linkages within the services area. However, the transport and distribution sectors are areas where regulatory trade barriers in South Asia are high, and are likely to be adding unnecessarily to cost structures.

C. Conclusion

A second key principle for piecemeal reform of services – arguably even more important than the first – is to look more broadly than just removing discrimination against foreign providers. This means that trade negotiators and trade ministers should not “let the tail wag the dog”. This means that:

- (a) They should not pursue services trade for its own sake, but rather define their country’s overall domestic reform objectives clearly and let the trade policy initiatives follow on naturally;
- (b) They should not get hung up on “negotiating coinage;” and
- (c) They should worry primarily about productivity in services and let trade look after itself.

References

- Bagwell, K. and R. Staiger (1999). "An economic theory of the GATT, *American Economic Review*, "vol. 89, No. 1; pp. 215-248.
- Baldwin, R. and F. Robert-Nicoud (2008). "A simple model of the juggernaut effect of trade liberalization", CEP Discussion Paper No. 845, Centre for Economic Performance, London School of Economics.
- Barth, J., J. Marchetti, D. Nolle and W. Sawanggoenyuang (2006). "Foreign banking: Do countries' WTO commitments match actual practices?" Staff Working Paper ERSD-2006-11, Economic Research and Statistics Division, World Trade Organization, Geneva.
- Boadway, R. and R. Harris (1977) "A characterization of piecemeal second-best policy", *Journal of Public Economics*, vol. 8; pp. 169-190.
- Clark, X., D. Dollar and A. Micco (2004). "Port efficiency, maritime transport costs, and bilateral trade", *Journal of Development Economics*, vol. 75; pp. 417-450.
- Copenhagen Economics (2005) *Economic Assessment of the Barriers to the Internal Market for Services*. Copenhagen Economics, Copenhagen.
- Corden, M. (1974). *Trade Policy and Economic Welfare*. Clarendon Press, Oxford.
- (1971). *The Theory of Protection*. Clarendon Press, Oxford.
- Davis, O. A. and A. B. Whinston (1965). "Welfare economics and the theory of the second best", *Review of Economic Studies*, vol. 32; pp. 1-14.
- Dee, P. (2009). "Services liberalization toward the ASEAN Economic Community" (mimeograph), Crawford School of Economics and Government, Australian National University, Canberra.
- (2008). "Benchmarking and assessing Indonesia's regulation of services" (mimeograph), Crawford School of Economics and Government, Australian National University, Canberra.
- (2007). "East Asian economic integration and its impact on future growth", *World Economy*, vol. 30, No. 3; pp. 405-423.
- (2005). "A compendium of barriers to services trade", prepared for the World Bank, Washington, D.C. Available at www.crawford.anu.edu.au/pdf/Combined_report.pdf.
- Dee, P. and C. Findlay (forthcoming). "Services in PTAs – donuts or holes?" in S. Jayasuriya, D. MacLaren and G. Magee (eds.), *Negotiating a Preferential Trading Agreement: Lessons from Australia and China*. Edward Elgar, Cheltenham.
- (2008). "Services: A deal-maker in the Doha Round?" in B. Blonigen (ed.), *Monitoring International Trade Policy: A New Agenda for Reviving the Doha Round*. Centre for Economic Policy Research, London.
- Dee, P., A. Hardin and L. Holmes (2000). "Issues in the application of CGE models to services trade liberalization", in C. Findlay and T. Warren (eds.), *Impediments to Trade in Services: Measurement and Policy Implications*; pp. 267-286. Routledge, London and New York.
- Ghani, E. (forthcoming). "Is services-led growth a miracle or a curse for South Asia", in

- Service Led Growth in South Asia* (chapter 1), World Bank, Washington, D.C.
- Gregan, T. and M. Johnson (1999). *Impacts of Competition Enhancing Air Services Agreements: A Network Modelling Approach*, Productivity Commission Staff Research Paper, Ausinfo, Canberra.
- Kalirajan, K. (2000). *Restrictions on Trade in Distribution Services*, Productivity Commission Staff Research Paper, Ausinfo, Canberra.
- Kalirajan, K., G. McGuire, D. Nguyen-Hong and M. Schuele (2000). "The price impact of restrictions on banking services", in C. Findlay and T. Warren (eds.), *Impediments to Trade in Services: Measurement and Policy Implications*; pp. 215-230. Routledge, London and New York.
- Lipsey, R. G. and K. Lancaster (1956). "The general theory of second best", *Review of Economic Studies*, vol. 24; pp. 11-32.
- Marchetti, J. and M. Roy (2008). "Services liberalization in the WTO and in PTAs", in J. Marchetti and M. Roy (eds.), *Opening Markets for Trade in Services: Countries and Sectors in Bilateral and WTO Negotiations*. Cambridge University Press, Cambridge.
- Mattoo, A. and C. Fink (2002). "Regional agreements and trade in services: Policy issues", Policy Research Working Paper 2852, World Bank, Washington D.C.
- McGuire, G., M. Schuele and T. Smith (2000). "Restrictiveness of international trade in maritime services", in C. Findlay and T. Warren (eds.), *Impediments to Trade in Services: Measurement and Policy Implications*; pp. 172-188. Routledge, London and New York.
- Nguyen-Hong, D. (2000). "Restrictions on trade in professional services", Productivity Commission Staff Research Paper, Ausinfo, Canberra.
- Organisation for Economic Co-operation and Development (2005). "Modal estimates of services barriers", TD/TC/WP(2005)36. Paris.
- Pomfret, R. (1997). *The Economics of Regional Trading Arrangements*. Clarendon Press, Oxford.
- Roy, M., J. Marchetti and H. Lim (2006). "Services liberalization in the new generation of preferential trade agreements (PTAs): How much further than the GATS?" Staff Working Paper ERSD-2006-07, Economic Research and Statistics Division, World Trade Organization, Geneva.
- Steiner, F. (2000). "Regulation, industry structure and performance in the electricity supply industry", Working Paper No. 238, ECO/WKP(2000)11, (12 April), Economics Department, Organisation for Economic Co-operation and Development, Paris.
- Stephenson, S. and D. Nikomborirak (2002). "Regional liberalization in services", in S. Stephenson, C. Findlay and S. Yi (eds.), *Services Trade Liberalization and Facilitation*; pp. 89-124. Asia Pacific Press at Australian National University, Canberra.