

# ECONOMICS AND LAW OF TRADE IN SERVICES

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## I. OVERVIEW

*Services are the fastest growing sector of the global economy, and trade and foreign direct investment in services have grown faster than in goods over the past decade.*

Developing countries have witnessed even faster growth rates, and their share in world services exports increased from 14 per cent in 1985-89 to nearly 20 per cent in 1998-2002. Technological progress has greatly enhanced the scope for trade in conventional services, such as education and finance, and also created a host of new tradable services, such as software development and internet access. Moreover, liberalization in many countries is leading for the first time to the private and foreign provision of services such as telecommunications, transport, and finance.

*The performance of the services sectors can make the difference between rapid and sluggish growth.* Developing countries, in particular, are likely to benefit significantly from further domestic liberalization and the elimination of barriers to their exports. The income gains from a reduction in protection to services are estimated to be multiples of those from trade liberalization in goods.

*But the benefits from liberalization are not automatic.* Flawed reform programs can substantially reduce gains. The largest gains come from eliminating barriers to entry, but many developing countries have given priority to a change in ownership through privatization, while retaining limitations on new entry. Effective regulation ranging from prudential regulation in financial services to pro-competitive regulation in telecommunications is critical to the success of liberalization, but regulatory weaknesses are too prevalent in developing economies. Liberalization also frequently requires complementary policies to help improve access to essential services for the poor. The experience of several countries has demonstrated that universal service goals can be achieved in competitive markets.

*Multilateral engagement can be an important catalyst for liberalization.* Even though governments can initiate reforms of services individually, multilateral engagement can help in two ways. First, international negotiations, for example under the General Agreement on Trade in Services (GATS), could help accelerate domestic reform and improve access to foreign markets for developing countries. However, for these negotiations to be fruitful, all countries must recognize mutual interests in reciprocal liberalization. In particular, developed countries must see advantages to allowing the

temporary movement of individual service providers and continuing to maintain liberal conditions for cross-border trade in services. Developing countries must see advantages of multilateral agreement to increase competition, to enhance credibility of potential domestic reform and to strengthen domestic regulation. Recognizing these potential mutual gains will allow reciprocal “concessions” that benefit both.

In parallel, global cooperation is needed to provide support for developing countries at four levels: in devising sound policy, strengthening the domestic regulatory environment, enhancing their participation in the development of international standards and in ensuring access to essential services in the poorest areas.

## II. PATTERN OF TRADE IN SERVICES

Services include activities as disparate as transport of goods and people, financial intermediation, communications, distribution, hotels and restaurants, education, health care, construction, and accounting. In contrast to merchandise trade, services are often intangible, invisible and perishable, and usually require simultaneous production and consumption. The need in many cases for proximity between the consumer and the producer implies that one of them must move to make an international transaction possible. Since the conventional definition of trade – where a product crosses the frontier – would miss out on a whole range of international transactions, the GATS took an unusually wide view of trade, which is defined (in Article I) to include four modes of supply:

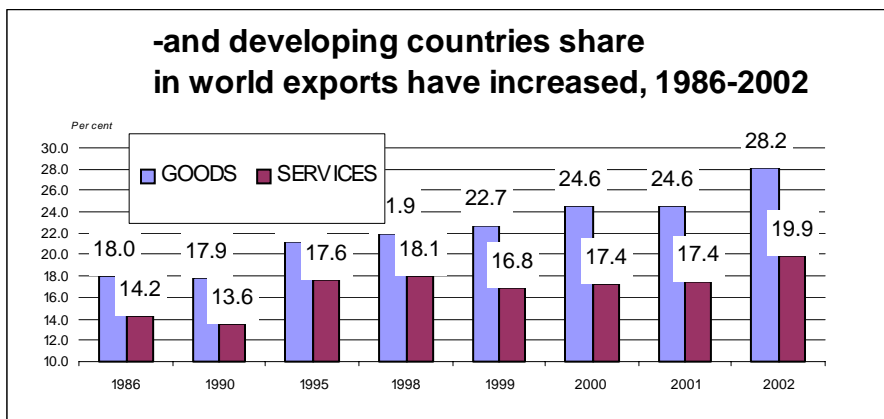
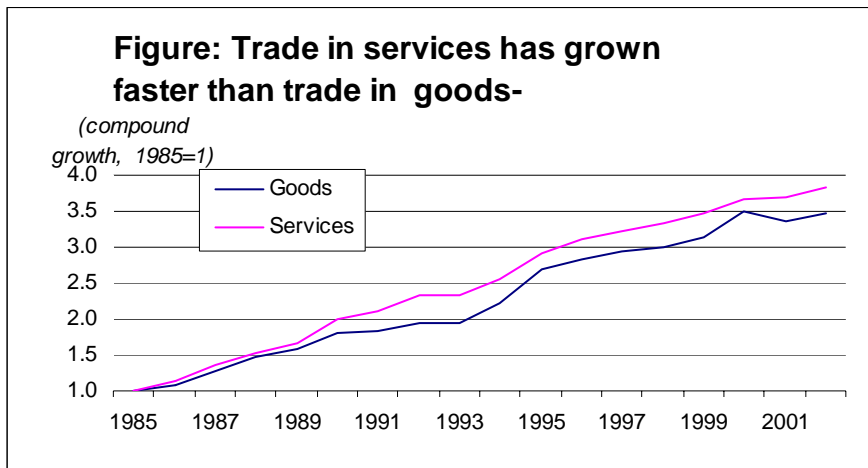
- *Cross-border*: services supplied from the territory of one Member into the territory of another. An example is software services supplied by a supplier in one country through mail or electronic means to consumers in another country.
- *Consumption abroad*: services supplied in the territory of one Member to the consumers of another. Examples are where the consumer moves, e.g. to consume tourism or education services in another country. Also covered are activities such as ship repair abroad, where only the property of the consumer moves.
- *Commercial presence*: services supplied through any type of business or professional establishment of one Member in the territory of another. An example is an insurance company owned by citizens of one country establishing a branch in another country.
- *Presence of natural persons*: services supplied by nationals of one Member in the territory of another. This mode includes both independent service suppliers, and employees of the services supplier of another Member. Examples are a doctor of one country supplying through his physical presence services in another country, or the foreign employees of a foreign bank.<sup>1</sup>

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<sup>1</sup> The GATS does not apply either to measures affecting natural persons seeking access to the employment market of a

It would have been useful if trade statistics for each service sector were available according to each of the modes of supply. This would enable an assessment both of the relative importance of different modes of supply in a particular sector and of the impact of measures affecting each mode of supply.

However, the only services trade statistics available on a global basis are the IMF Balance of Payments (BOP) Statistics, which register transactions between residents and non-residents. According to BOP conventions, if factors of production move to another country for a period longer than one year (sometimes flexibly interpreted), a change in residency has occurred. The output generated by such factors that is sold in the host market is not recorded as trade in the BOP. Therefore, transactions involving commercial presence and stay of natural persons for durations of more than one year are not covered by the BOP statistics. The limitations of the existing statistical domains in providing information on trade by different modes of supply are listed in Table 1.




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Member, or to measures regarding citizenship, residence or employment on a permanent basis.

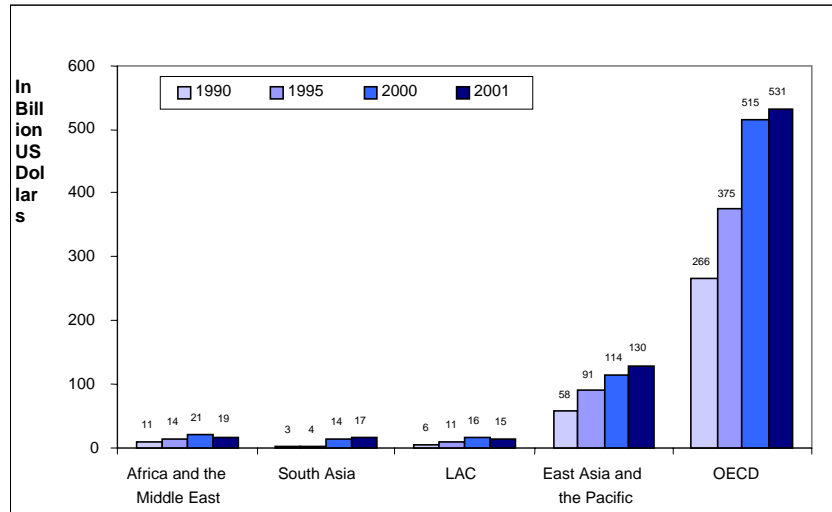
**Table 1: Inadequacies of Statistical Domains with regard to Modes of Supply**

Mode of Supply	Relevant Data Source	Inadequacies
Cross border supply	BOP service statistics (categories other than <i>travel</i> )	- BOP does not distinguish among <i>cross border supply</i> , <i>commercial presence</i> (firms) and <i>presence of natural persons</i> (individuals) for less than one year
Consumption abroad	BOP Statistics (mainly the <i>travel</i> category)	- <i>Travel</i> also contains goods, and is not subdivided into the different categories of services consumed by travellers - Some transactions related to this mode of supply are also in other BOP categories
Commercial presence	FDI and foreign affiliates trade (FAT) statistics	- FDI statistics do not provide data on output (or sales); FDI definition does not match the definition of <i>commercial presence</i> - Until recently, FAT statistics only existed for the United States. Now other OECD countries have also started collecting such statistics using basic concepts and definitions contained in the Manual of Statistics on International Trade in Services ( <a href="http://www.oecd.org/dataoecd/32/45/2404428.pdf">http://www.oecd.org/dataoecd/32/45/2404428.pdf</a> ).
Presence of natural persons (independent)	BOP Statistics (mostly categories other than <i>transport</i> and <i>travel</i> )	- BOP do not distinguish between <i>cross border supply</i> , <i>presence of natural persons</i> (individuals) and <i>commercial presence</i> for less than one year - natural persons who are residents are not covered
Presence of natural persons (employees)	Employment data from FAT statistics	- not yet available

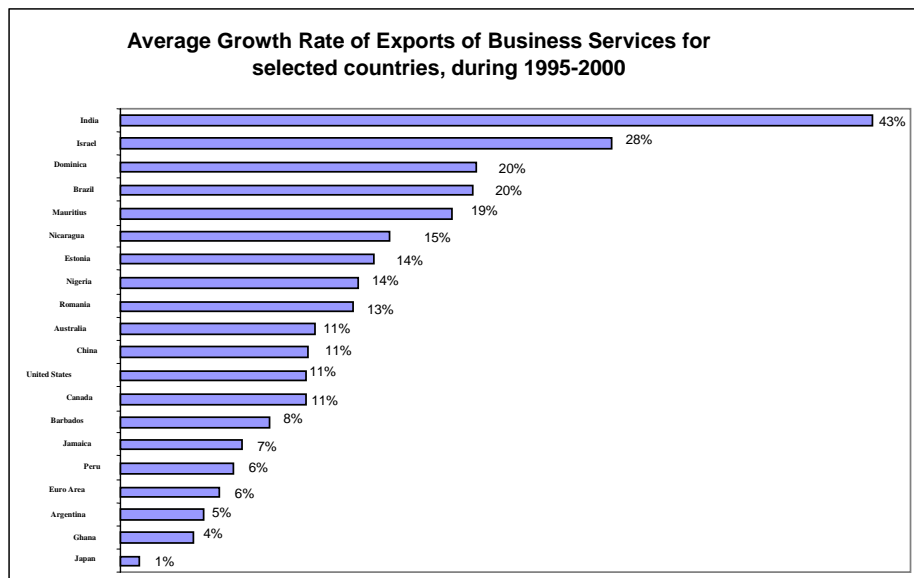
Nevertheless, available evidence suggests that developing countries are becoming players in exporting services. While some developing countries are increasingly investing in other countries to export services—e.g. Malaysia in environmental services, and South Africa in telecommunications—most supply services via cross border sales (e.g. data processing), to visiting foreign consumers (e.g. tourism), and through the movement abroad of individual services providers (e.g. professional services). Developments in information and communication technology have dramatically increased the scope for cross-border exports of services, ranging from software development in the Philippines to data processing in Barbados. The IMF Balance of Payments category *business services* covers trade in all services other than *transport* and *travel* services. As Figure shows, most exports of business services still originate in OECD countries. But Figure reveals that while the exports of the European Union and the United States have grown at respectively 6 and 11 per cent per annum in the second half of the 1990s, the exports of countries like India, Israel, Dominica and Brazil have grown at rates above 20 per cent

per annum. Moreover, many other developing countries – including Mauritius, Nicaragua, Barbados and China – have witnessed high rates of growth.

### Regional Distribution of Business Services Exports



Source: IMF Balance of Payments Statistics; Note: -The “Business Services” category includes Total Services minus Transportation, Travel and Government Services. Alternatively, Business Services consist of: Communication, Construction, Insurance, Financial, Computer & info, Other business, Personal, cultural and recreational services, as well as Royalties and License fees.



Source: IMF Balance of Payments Statistics

### III. SERVICE REFORMS CAN PROMOTE EFFICIENCY AND GROWTH

Liberalization of trade in services, accompanied by the reform of complementary policies, can lead to sectoral and economy-wide improvements in performance.

#### *At the sectoral level—*

Removing barriers to trade in services in a particular sector is likely to lead to lower prices, improved quality and greater variety. As in the case of trade in goods, restrictions on trade reduce welfare because they create a wedge between domestic and foreign prices, leading to a loss to consumers that is greater than the increase in producers surplus and government revenue. Several empirical sectoral studies support this contention. Since many services are inputs into production the inefficient supply of such services acts as a tax on production, and prevents the realization of significant gains in productivity. As countries reduce tariffs and other barriers to trade, effective rates of protection for manufacturing industries may become negative if they continue to be confronted with input prices that are higher than they would be if services markets were competitive.

A major benefit of liberalization is likely to be access to a wider variety of services whose production is subject to economies of scale. Consumers derive not only a direct benefit from diversity in services such as restaurants and entertainment, but also an indirect benefit because a wider variety of more specialized producer services, such as telecommunications and finance, can lower the costs of both goods and services production (Ethier, 1982, Copeland, 2001). In such circumstances, smaller markets can be shown to have a strong interest in liberalizing trade in producer services, since this can offset some of the incentives that firms have to locate in larger markets (Markusen, 1989).

#### **Box: Why do Services Matter for Development?**

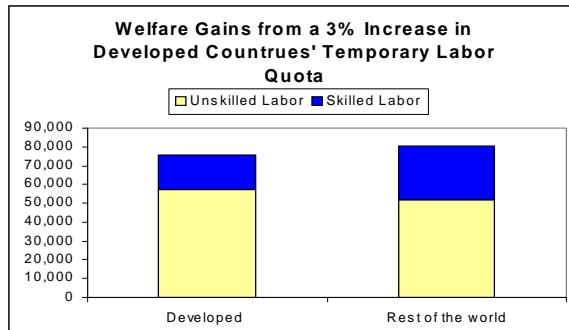
In developing countries, the average share of services in GDP increased from around 40 percent in 1965 to around 50 percent in 1999, while the OECD countries, the average share increased over the same period from 54 percent to over 60 percent. Among the fastest growing sectors in many countries are services like telecommunications, software, and finance. Efficient services not only provide a direct benefit to consumers, but also help shape overall economic performance. An efficient and well-regulated financial sector leads to the efficient transformation of savings to investment, ensuring that resources are deployed wherever they have the highest returns; and facilitates better risk-sharing in the economy. Improved efficiency in telecommunications generates economy-wide benefits as this service is a vital intermediate input and also crucial to the dissemination and diffusion of knowledge—the spread of the internet and the dynamism that that has lent to economies around the world is telling testimony to the importance of telecommunications services. Similarly, transport services contribute to the efficient distribution of goods within a country, and are particularly important in influencing a

country's ability to participate in global trade. Although these are the more prominent services, others are also crucial. Business services such as accounting and legal services are important in reducing transaction costs—the high level of which is considered one of the most significant impediment to economic growth in Africa. Education and health services are necessary in building up the stock of human capital. Retail and wholesale services are a vital link between producers and consumers, and influence the efficiency with which resources are allocated to meet consumer needs. Software development is the foundation of the modern knowledge-based economy. Environmental services contribute to sustainable development by helping alleviate the negative impact of economic activity on the environment.

—*and economy-wide*—

Estimates of benefits vary for individual countries—from under 1 per cent to over 50 per cent of GDP—depending on the initial levels of protection and the assumed reduction in barriers. In simulations of global service trade liberalization, developed countries gain more in absolute terms – which is not surprising given the relative size of their economies – but developing countries also see significant increases in their GDP. One model predicts gains of between 1.6 per cent of GDP (for India) to 4.2 per cent of GDP (for Thailand) if tariff-equivalents of protection were cut by one-third in all countries (Chadha, et al., 2000). The gains from liberalizing services may be substantially greater than those from liberalizing trade in goods, because current levels of protection are higher and because liberalization would also create spillover benefits from the required movement of capital and labor. For instance, one model finds that the welfare gains from a 50 per cent cut in services sector protection would be five times larger than those from non-services sector trade liberalization (Robinson et al., 1999). These results are particularly striking because they are derived from models that do not fully allow for the temporary movement of individual service suppliers – potentially a major source of gain.

Temporary movement offers arguably the neatest solution to the dilemma of how international migration is best managed, enabling the realization of gains from trade while averting social and political costs in host countries and brain drain from poor countries. Recent research finds that if OECD countries were to allow temporary access to foreign service providers equal to just 3 per cent of their labor force, the global gains would be over \$150 billion – more than the gains from the complete liberalization of all trade in goods (Winters et al, 2002). Both developed and developing countries would share in these gains, and they would be largest if both high-skilled mobility and low-skilled mobility were permitted.

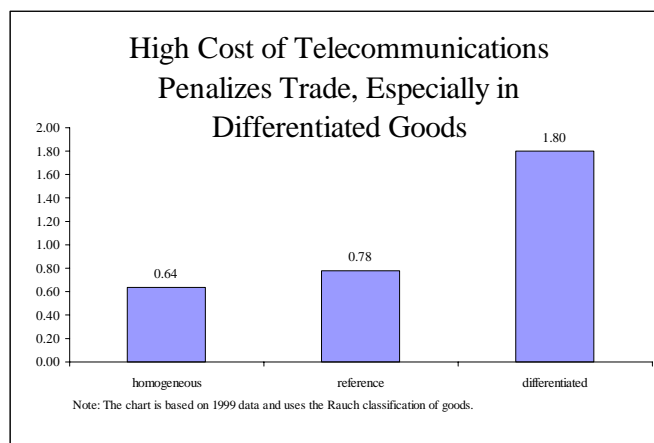


Note: Data in million US\$  
Source: Walmsley and Winters (2002)

**Box: Services reform and impact on comparative advantage**

Reform of services policy has an impact not only on overall economic activity but also on its composition. The profound effect transport costs have on trade and the distribution of economic activity across regions is increasingly well-documented. The impact of communication costs on trade costs has received less attention. Fink et al (2002) tested this relationship by incorporating alternative measures of communication costs in a model of bilateral trade. They find that international variations in communication costs indeed have a significant influence on trade patterns. More interestingly, estimates using disaggregated data reveal that the impact of communication costs on trade in differentiated products is larger than on trade in homogenous products - by as much as one-third (Figure). The implication is that lower communication costs can shift a country's comparative advantage towards more sophisticated communication-intensive differentiated goods and away from more standardized primary goods.

Source: Fink, Mattoo and Neagu (2002)



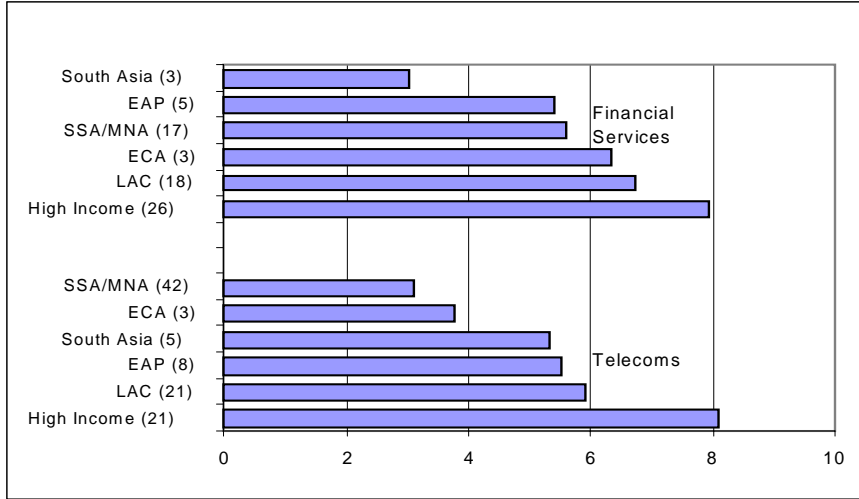
Note: The chart is based on 1999 data and uses the Rauch classification of goods.

because sunk costs have commitment value and can be used strategically (Bos and Nett, 1990). Second, allowing privileged access creates vested interests that may then resist further reform or seek to dilute its impact. For example, in South Africa, private shareholders (national and foreign) in the incumbent successfully lobbied to reduce the number of entrants that the government was planning to allow from two to one (Lamont, 2001).

—*with accelerator effects on growth*

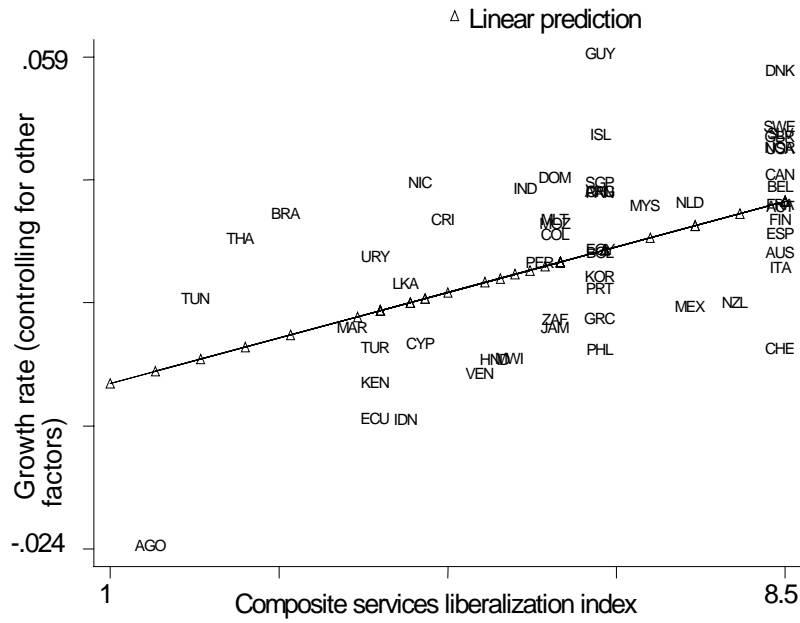
Certain services industries clearly possess growth generating characteristics (see box). Furthermore, barriers to entry in a number of services sectors, ranging from telecommunications to professional services, are maintained not only against foreign suppliers but also against new domestic suppliers. Full liberalization can, therefore, lead to enhanced competition from both domestic and foreign suppliers. Greater foreign factor participation and increased competition together imply a larger scale of activity, and hence greater scope for generating the special growth-enhancing effects. Even without scale effects, the import of foreign factors that characterizes services sector liberalization could still have positive effects because they are likely to bring technology with them. If greater technology transfer accompanies services liberalization— either embodied in foreign direct investment or disembodied—the growth effect will be stronger.

**Figure 1: Services liberalization indices: Telecoms and financial services**



Source: Mattoo, Rathindran & Subramanian. (2001).

**Greater liberalization in services is associated with more rapid growth**



Source: Mattoo, Rathindran and Subramanian (2001)

Econometric evidence—relatively strong for the financial sector and less strong but nevertheless statistically significant for the telecommunications sector—that openness in services influences long run growth performance (see Figure). After controlling for other determinants of growth, countries that fully liberalized the financial services sector (in terms of the three dimensions noted above) grew, on average, about 1.0 percentage point faster than other countries. An even greater impetus on growth was found to come from fully liberalizing both the telecommunications and the financial services sectors. Estimates suggest that countries which fully liberalized both sectors grew, on average, about 1.5 percentage points faster than other countries. While these estimates indicate that there are substantial gains from liberalizing key services sectors, it would be wrong to infer that these gains can be realized by a mechanical opening up of services markets. A flawed reform program can undermine the benefits of liberalization.

***Flaws in reform programs in services can substantially undercut the benefits of liberalization.***

For example, if privatization of state monopolies to private owners (sometimes foreigners) is conducted without concern to creating conditions of competition, the result may be merely transfers of monopoly rents to private owners. Similarly, if increased entry into financial sectors is not accompanied by adequate prudential supervision and full competition, the result may be insider lending and poor investment decisions. Also, if policies to ensure universal service are not put in place, liberalization need not improve access to essential services for the poor. Managing reforms of services markets therefore require integrating trade opening with a careful combination of competition and regulation.

South Africa's experience with liberalizing telecommunications services is instructive. The Government recognized the need for a more efficient supply of services. It decided to sell 30 percent equity stake of the public incumbent, Telkom, to a strategic investor and to grant the newly privatized entity a five year monopoly period for fixed-line telephone services. It was hoped that market exclusivity would facilitate rapid infrastructure rollout to previously under-serviced areas. But the program has had mixed results. Even though network growth picked up, Telkom did not meet its rollout obligations and sought to renegotiate the targets specified in its monopoly license. The cost of the fixed-line monopoly was also reflected in Telkom's rising price-cost margin, with gains in productivity leading to higher margins rather than lower prices (Hodge, 1999). Finally, despite some improvement, labor productivity was only a quarter that of leading international operators, with the lack of competition in the domestic market identified as a major contributing factor. Continued restrictions on domestic and foreign entry appear to have prevented the realization of the full benefits of competitive markets.

In addition to competition, the institutional and regulatory framework plays a critical role. For example, in the 1990s, financial reforms were introduced in many African countries but have been less successful than expected (World Bank, 2001). Some of the reasons for the disappointing results are directly related to the financial system, while others

pertain to the more general economic environment. The restructuring of state-owned banks was not sufficient to change the behavior of the financial institutions. Public authorities still pressured these institutions to lend money to loss making public enterprises. Liberalization failed to trigger competition in the banking sector and governments were mostly reluctant to close down distressed state banks. Furthermore, liberalization of interest rates in a setting characterized by uncontrolled fiscal deficits had a pernicious effect on domestic public debt, which in turn led to larger deficits. Finally, and crucially, there was a lack of an adequate regulation and supervision mechanisms to monitor the functioning of the financial system.

The collapse of the Korean economy in 1997 also reveals the precariousness of financial liberalization in an imperfect policy environment. Korea did liberalize its financial markets substantially, but it encouraged the development of a highly fragile financial structure. By liberalizing short-term (but not long-term) foreign borrowing, the Korean authorities made it possible for the larger and better-known banks and chaebols to assume heavy indebtedness in short-term foreign currency debt. Meanwhile, the second tier of large chaebols greatly increased their short-term indebtedness in the domestic financial markets (funded indirectly through foreign borrowing of the banks). The funds borrowed were being invested in over-expansion of productive capacity. At the same time, financial regulation and supervision were fragmented with responsibilities spread unclearly between the Bank of Korea and several parts of the Ministry of Finance. In addition, Korea had a restrictive regime in terms of foreign bank entry. Until the 1997 crisis, the Korean banking system was virtually closed to foreign banks, in contrast to some other East Asian countries, such as Hong Kong, which was almost completely open for all financial services. This restrictive regime impeded the development of the local institutions and may have contributed to the large capital outflows as foreign creditors refused to rollover their loans.

***Liberalization could increase prices of some services for the poor—***

Opening up essential services to foreign or domestic competition could have an adverse effect on the poor—which is often cited as a reason for the persistence of public monopolies. However, a more efficient solution is to have regulations with a social purpose.

If a country is a relatively inefficient producer of a service, liberalization and the resultant foreign competition are likely to lead to a decline in domestic prices and improvement in quality. But there is a twist. Frequently, the prices pre-liberalization are not determined by the market but set administratively, and are kept artificially low for certain categories of end-users and/or types of services products. Thus, rural borrowers may pay lower interest rates than urban borrowers, and prices of local telephone calls and public transport may be kept lower than cost of provision. This structure of prices is often sustained through cross-subsidization within public monopolies or through government financial support.

Liberalization threatens these arrangements. Elimination of restrictions on entry imply an end to cross-subsidization because it is no longer possible for firms to make extra-normal profits in certain market segments. New entrants may focus on the most profitable market segments (“cream-skimming”), such as urban areas, where network costs are lower and incomes higher. And privatization could mean the end of government support. The result is that even though the sector becomes more efficient and average prices decline, the prices for certain end-users may actually increase and/or availability decline.

The evidence on the relationship between competitive market structures and wider access to services is mixed. In some cases, a positive relationship has been observed in services like basic telecommunications, especially in countries where initial conditions are feeble, as exemplified by a low tele-density or service rationing (long waiting lists for obtaining connections). However, there is also evidence that financial services liberalization in some countries has had an adverse effect on access to credit for rural areas and the poor. These point to the need to create mechanisms to ensure that the poor have adequate access to services in liberalized markets.

—*and entail adjustment costs*

Different modes of supply have different effects on factor markets. Cross-border trade and consumption abroad resemble goods trade in their implications. The impact of the movement of factors depend critically on whether they are substitutes or complements for domestic factor services. Given the structure of factor prices in poor countries, we would typically expect liberalization to lead to an inflow of capital and skilled workers. Such inflows would tend to be to the advantage of the unskilled poor—increasing employment opportunities and wages. Interestingly, it has been shown that even when foreigners compete with local skilled workers in a services sector, the productivity boost to the sector from allowing foreigners access could lead to an increase in the demand for domestic skilled workers – the scale effect could outweigh the substitution effect (Markusen, Rutherford, and Tarr, 2000). Given these predictions, why are workers in developing countries sometimes skeptical about the benefits of liberalization? One concern is the possible reduction in employment in formerly public monopolies which have frequently employed surplus labor. For example, Alexander and Estache (1999) find that the privatization of electricity distribution in Argentina led to a 40 per cent reduction in the workforce after privatization.

But there is also evidence that pessimism may not always be justified. For example, a number of developing countries have managed to maintain or even increase employment in their liberalized telecommunications sectors. Since many developing countries have low teledensities (in the vicinity of 5 lines per 100 people), roughly 70% of telecom investment in developing countries is directed towards building wire line and mobile networks which are labor intensive and hence help maintain or raise employment levels. Petrazzini and Lovelock (1996) find in a study of 26 Latin American and Asian economies that telecom markets with competition were the only ones that consistently increased employment levels, while two thirds of the countries with monopolies saw considerable declines in their telecom work force.

#### **IV. DOMESTIC POLICY: EMPHASIZING COMPETITION AND REGULATION**

##### *Increasing competition is the first order of business*

Many developing countries have moved away from public monopolies in sectors such as communications, financial and transport services, but are still reluctant to allow unrestricted new entry. Privatization does not axiomatically mean greater competition. Restrictions on foreign presence assume particular significance in the case of services where cross-border delivery is not possible, because consumer prices then depend completely on the domestic market structure. Several studies have concluded that larger welfare gains arise from an increase in competition than from simply a change in ownership from public to private hands (Armstrong, et al. 1994). Foreign investment clearly brings benefits even in situations where it does not lead to enhanced competition. Foreign equity may relax a capital constraint, can help ensure that weak domestic firms are bolstered (e.g. via re-capitalizing financial institutions), and serve as a vehicle for transferring technology and know-how, including improved management. However, if restrictions on competition artificially inflate the returns on investment, the net returns to the host country may be negative.

Are there good reasons to limit entry? In some cases, technical limitations may prevent competition, such as those imposed by the scarcity of radio spectrum needed for the provision of mobile telecommunications services, and scarcity of space for department stores or airports in a city. More generally, entry restrictions might be justified by the existence of significant economies of scale, e.g. if there are substantial fixed costs of networks, competitive entry could lead to inefficient network duplication. However, entry restrictions are increasingly hard to defend in principle, in the face of technological change and in the face of mounting evidence that competition works.

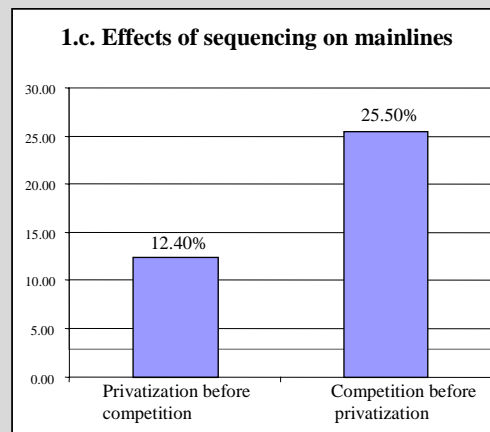
First of all, entry restrictions change the nature of interaction between incumbents and may well make collusion more likely. Secondly, such restrictions dampen the impact of competition on productive efficiency. Third, the regulator is usually not better placed than the competitive process to determine the optimal number of firms in the market, especially given the difficulty of obtaining information about the cost structure of firms and other sources of regulatory failure. Furthermore, technological advances have significantly lowered network costs in a unisector like telecommunications, and vertical separation (e.g. through network unbundling) has widened the scope for competitive entry (Smith, 1995). Therefore, inefficiencies introduced by duplication of networks may be small compared to operational inefficiencies that can result from a lack of competitive pressure. For example, even in telecommunications, a sector where fixed costs are significant, countries in Latin America that granted monopoly privileges to telecom operators of six to ten years to the privatized state enterprises saw connections grow at 1.5 times the rate achieved under state monopolies but only half the rate in Chile, where the government retained the right to issue competing licenses at any time (Wellenius, 1997).

### Box: The Sequence of Reform Matters

Fink et al. (2003) analyzed the impact of policy reform in basic telecommunications on sectoral performance using a new panel data set for 86 developing countries across Africa, Asia, the Middle East, Latin America and the Caribbean in the period 1985 to 1999. We found that both privatization and competition can independently lead to significant improvements in performance. But a comprehensive reform program, involving both policies and the support of an independent regulator, produced the largest gains: an 8 percent higher level of mainlines and a 21 percent higher level of labor productivity compared to years of partial and no reform.

Interestingly, the sequence of reform matters: mainline penetration is lower if competition is introduced after privatization, rather than at the same time. This result suggests that delays in the introduction of competition – for example due to market exclusivity guarantees granted to newly privatized entities – may adversely affect performance even after competition is eventually introduced. This could happen for three reasons. First, the importance of location-specific sunk costs in basic telecommunications suggests that allowing one provider privileged access may have durable consequences

**Figure 3. Sequences matter**



Source: World Bank/ITU Telecommunications Policy Database & Fink, Mattoo, Rathindran (2001), forthcoming

because sunk costs have commitment value and can be used strategically (Bos and Nett, 1990). Second, allowing privileged access creates vested interests that may then resist further reform or seek to dilute its impact. For example, in South Africa, private shareholders (national and foreign) in the incumbent successfully lobbied to reduce the number of entrants that the government was planning to allow from two to one (Lamont, 2001).

Finally, sequences matter because of the implied changes in the regulatory environment: in one case, the incumbent is a relatively inefficient public operator and the regulator is well informed about the cost structure, in the other case, the incumbent is a relatively efficient private operator and the regulator is less well informed. It could be argued that new entry is easier to accomplish in the former situation.

Regulation in services, as in goods, arises essentially from market failure attributable to three kinds of problems: natural monopoly; inadequate consumer information; and considerations of equity and protecting the poor.

*Efficient regulation: Making competition work*

The existence of natural monopoly or oligopoly is a feature of the so-called "locational services". Such services require specialized distribution networks: roads and rails for land transport, cables and satellites for communications, and pipes for sewage and energy distribution (UNCTAD and World Bank, 1994).

Many countries have instituted independent regulators for basic telecommunications services to ensure that monopolistic suppliers do not undermine market access by charging prohibitive rates for interconnection to their established networks. A similar approach is being taken in a variety of other network services, including transport (terminals and infrastructure), and energy services (distribution networks).

Regulation of the interconnection price may not, however, be sufficient. Small markets may not be able to create conditions for effective competition in the supplies of certain telecommunications, transport and financial services, even if they eliminate all barriers to entry. For two related reasons. First, unlike in the case of goods, national markets are often segmented from the international market due to the infeasibility of cross-border delivery. Secondly, changing technologies may have reduced the optimal scale of operation as well as sunk costs in these sectors, but not enough for small markets to sustain competitive market structures. Some form of final price regulation may, therefore, be unavoidable. In some cases, such regulation can, at least in principle, be implemented at the national level though, in practice, many developing countries today lack the means to do so. In other cases, the limited enforcement capacity of small states strengthens the case for multilateral initiatives..

*Regulation to remedy inadequate consumer information*

In many intermediation and knowledge-based services, consumers have difficulty securing full information about the quality of service they are buying (UNCTAD and World Bank, 1994). Consumers cannot easily assess the competence of professionals such as doctors and lawyers, the safety of transport services or the soundness of banks and insurance companies. When such information is costly to obtain and disseminate, and consumers have similar preferences about the relevant attributes of the service supplier, the regulation of entry and operations in a sector could increase social welfare. However, the establishment of institutions competent to regulate well is a serious challenge, as is revealed by the difficulties in the financial sector—not only in a number of developing countries but also in the U.S., Sweden and Finland in the 1980s and 1990s. The fact that regulatory inadequacies cannot be quickly remedied raises the issue of how different elements of reform—particularly prudential strengthening and trade and investment liberalization – are best sequenced.

A separate problem is that domestic regulations to deal with the market failure may themselves become impediments to competition and trade, as a result of differences across jurisdictions in technical standards, prudential regulations, and qualification requirements in professional, financial and numerous other services. In many cases, the impact on trade is an incidental consequence of the pursuit of a legitimate objective, but in some cases regulation can be a particularly attractive means of protecting domestic suppliers from foreign competition. The issue of how multilateral trade rules might sift the legitimate from the protectionist is an issue to which we return in the final section.

### *Regulation to ensure universal service*

Reform programs can accommodate universal service obligations by imposing this requirement on new entrants in a non-discriminatory way. Thus, such obligations were part of the license conditions for new entrants into fixed network telephony and transport in several countries. However, subsidies have often proved more successful than direct regulation in ensuring universal access (Estache et al., 2001). In 1999, Peru adopted a universal service levy of one percent to finance a fund dedicated to providing universal access in remote areas. Funds were allocated through a competitive bidding process that encouraged operators to adopt the best technology and other cost-savings practices at minimum subsidy. The Chilean government adopted a similar scheme that permitted it to leverage over \$2 million in public funds into \$40 million in private investment; this resulted in installation of telephones in 1,000 localities at about ten percent of the costs of direct public provision. Household ownership of a telephone in Chile increased from 16 percent to 74 percent 1988-2000 and all but one percent of the remaining households were provided with public access to telephone.

Public subsidies also be directed to the consumer rather than the provider (Cowhey and Klimenko, 1999). Governments have experimented with various forms of vouchers from education to energy services. This last instrument has at least three advantages: first, it can be targeted more directly at those who need the service and cannot afford it; secondly, it avoids the distortions that arise from artificially low pricing of services to ensure access; and finally, it is an instrument that does not discriminate in any way between providers.

## **V. MULTILATERAL ENGAGEMENT: BUTTRESSING DOMESTIC REFORMS**

In principle, a country can liberalize its markets and strengthen its regulatory institutions unilaterally. But four types of issues create benefits from multilateral engagement. First, liberalization may be constrained by domestic opposition from those who benefit from protection. Second, a country cannot on its own improve access for its exports to foreign markets. Third, a small country may not be able to deal adequately with anti-competitive practices by foreign suppliers. Finally, a country may lack the expertise and resources to devise and implement optimal policy, especially in the area of domestic regulation.

International the natural forum to pit the first two elements –opposition to reform at home and barriers to access abroad -against each other constructively through the process of mercantilist negotiations. But there is also a need for complementary multilateral efforts to ensure that the gains from liberalization are not undermined by inadequacies in policy choice and regulation.

### **Box: The Main GATS Rules**

The GATS rules operate at two levels. First, there is a set of general rules that apply across the board to measures affecting trade in services, and then there is a set of sector-specific commitments that determine the extent of liberalisation undertaken by individual countries. The most important of the general rules are *transparency* and the *most-favoured-nation* (MFN) principle. The former requires that all measures of general application affecting trade in services be published by a Member, and that other Members be informed of significant changes in trade policy. The latter prevents Members from discriminating between their trading partners.

The specific commitments on market access and national treatment are the core of the GATS, and the impact of the Agreement depends to a large extent on the commitments made by Members.<sup>2</sup> Both types of commitments are made for each of the four modes of delivery of service transactions.

#### (i) Market access

Article XVI stipulates that measures restrictive of *market access* which a WTO Member cannot maintain or adopt, unless specified in its schedule, include limitations on :

- (a) the number of service suppliers;
- (b) the total value of services transactions or assets;
- (c) the total number of services operations or the total quantity of service output;
- (d) the total number of natural persons that may be employed in a particular sector;
- (e) specific types of legal entity through which a service can be supplied; and
- (f) foreign equity participation (e.g. maximum equity participation).

With the exception of (e), the measures covered by Article XVI all take the form of quantitative restrictions.

Three aspects of Article XVI are important. First, the Article XVI list does not include all measures which could restrict market access. Perhaps most significantly, fiscal measures are not covered. Thus, a Member could maintain, without being obliged to schedule, a high non-discriminatory tax on a particular service which severely limits market access.

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<sup>2</sup>Both the market access and national treatment provided for in the schedules must be extended to all foreign service suppliers on a non-discriminatory basis, irrespective of whether a country has listed any MFN exemptions.

Second, Article XVI has been interpreted to cover both discriminatory and non-discriminatory measures, i.e. measures of the type "only five new *foreign* banks will be granted licenses" and also measures such as "only ten new [*foreign and domestic*] banks will be granted licenses". Finally, the limitations must be read as "minimum guarantees" rather than "maximum quotas", i.e. a country which has promised to allow five foreign banks entry is free to grant entry to more than five.

(ii) National treatment

Article XVII:1 states the basic *national treatment* obligation:

"In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers."

Unlike Article XVI, Article XVII provides no exhaustive list of measures inconsistent with national treatment. Nevertheless, Article XVII:2 makes it clear that limitations on national treatment cover cases of both *de jure* and *de facto* discrimination.

Consider two examples of limitations on national treatment. If domestic suppliers of audiovisual services are given preference in the allocation of frequencies for transmission within the national territory, such a measure discriminates explicitly on the basis of origin of the service supplier and thus constitutes formal or *de jure* denial of national treatment. Alternatively, consider a measure stipulating that prior residency is required for the issuing of a license to supply a service. Although the measure does not formally distinguish service suppliers on the basis of national origin, it *de facto* offers less favourable treatment for foreign suppliers because they are less likely to be able to meet a prior residency requirement than like service suppliers of national.

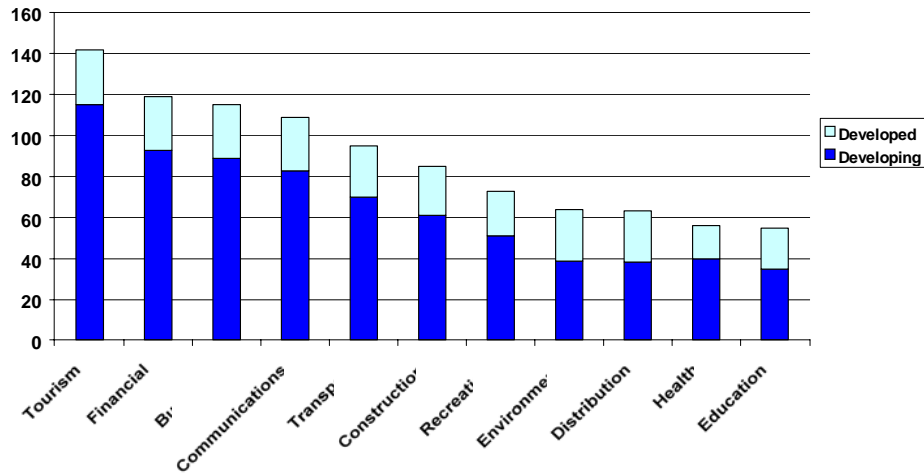
A Member's specific commitments can be seen as the outcome of a two-step decision. Each Member first decides which service sectors will be subject to the GATS market access and national treatment disciplines. It then decides which measures violating market access and/or national treatment respectively will be kept in place for each mode in that sector. Granting unrestricted market access with full national treatment would be equivalent to establishing free trade, and the flexible structure of rules reflects the desire of most governments to adopt a gradual and conditioned approach to opening up their markets.

Virtually all existing GATS commitments – with the exception of those for acceding countries - reflect a binding of the status quo rather than liberalization.

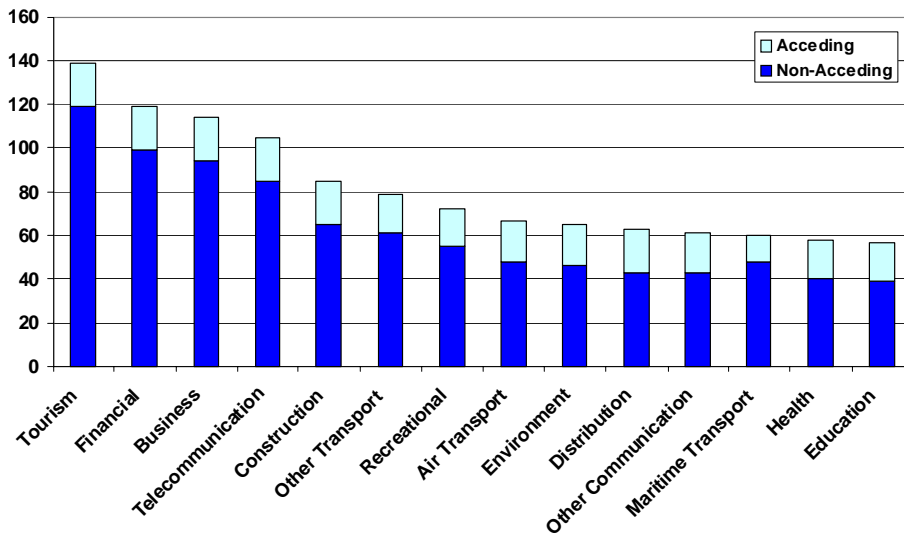
Acceding Members (20):

Albania, Armenia, Bulgaria, Cambodia, China, Chinese Taipei, Croatia, Ecuador, Estonia, Georgia, Jordan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Mongolia, Nepal, Oman, Panama

**Sector focus of current commitments**  
(Developed/Developing Country Members, August 2003)



**Sector focus of current commitments**  
(Acceding/Non-Acceding Members)



Acceding Members (20):

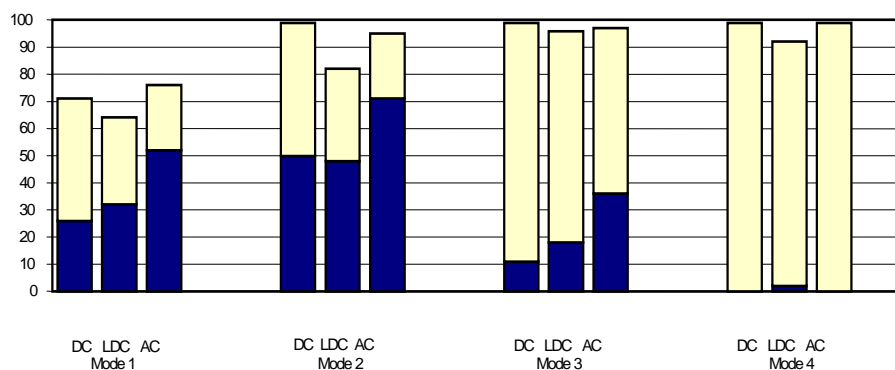
Albania, Armenia, Bulgaria, Cambodia, China, Chinese Taipei, Croatia, Ecuador, Estonia, Georgia, Jordan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Mongolia, Nepal, Oman, Panama

***Using the current round of GATS negotiations to deliver liberalization at home and access to markets abroad***

The General Agreement on Trade in Services (GATS) had a deliberately symmetric structure, encompassing the movement of both capital and labor for services provision. In theory, developed and developing countries could indeed bargain to exploit their modal comparative advantage: improved access for capital from developed countries being exchanged for improved temporary access for individual service providers from developing countries. In practice, all countries have been unwilling to grant greater access for foreign individuals (except for the limited class of skilled intra-corporate transferees), and a trade-off between modes of delivery simply has not occurred (Figure). Moreover, even the negotiating links across services sectors and between services and goods sectors do not seem to have been particularly fruitful. And so, since governments could not demonstrate improved access to foreign markets as a payoff for domestic reform, GATS commitments reflect for the most part the existing levels of unilaterally determined policy - rather than liberalization achieved through a reciprocal exchange of “concessions”. The only exception are the acceding countries, which were induced to make far reaching commitments to current and future liberalization as part of their accession negotiations – on both a sectoral basis (Chart) and a modal basis (Chart). But even for these countries, commitments on the movement of individuals remain thin.

The overall negotiating context may change with time. With severe shortages of skilled labor in the US and Europe and the powerful constituency of high-technology companies lobbying for relaxation of visa limits, the prospects for serious inter-modal trade-offs - such as obtaining temporary labor movement in return for allowing greater commercial presence for foreign service providers - are now greater. The challenge is to devise mechanisms that provide credible assurance that movement is temporary, rather than a stepping stone to migration.

Figure. WTO Members' have been reluctant to make market access commitments on the movement of natural persons (Mode 4)



<sup>a</sup> Calculated on the basis of a sample of 37 sectors deemed representative for various services sectors.  
(See WTO Document S/C/W/99, 2 March 1999)

**Legend**

The upper part of each bar represents partial commitments, the lower part full commitments.  
DC = Developed countries  
LDC = Developing and transition economies  
AC = Acceding countries

***Strengthening GATS rules and commitments***

In line with the WTO's central concern with securing market access, it would also be natural to use the GATS to enhance the credibility of policy at home and security of access to markets abroad through legally binding commitments; to ensure that domestic regulations support trade liberalization; and to prevent discrimination between trading partners by ensuring effective application of the most-favored-nations principle.

First, the GATS could help secure access to markets that are already open. Trade in electronically delivered products, in which more and more developing countries are beginning to participate, must continue to remain free of explicit barriers – should they ever become feasible. It would be far more effective to widen and deepen commitments under the GATS on cross-border trade.

**Box: Ensuring Barrier-Free Trade in Electronically Delivered Products**

Trade in electronically delivered products, in which more and more developing countries are beginning to participate, and offers an increasingly viable alternative to the movement of individuals, is today largely free of explicit barriers. The main concern should be preventing the introduction of new barriers which the dramatic expansion of exports is showing signs of provoking.. What is the best route to preventing the imposition of explicit restrictions?

WTO Members have so far focused on prohibiting the imposition of customs duties on electronically delivered products. It is ironic that considerable negotiation energy has been invested in prohibiting the economically superior (and infeasible) instrument of protection whereas little attention has been devoted to inferior (and possibly more feasible) instruments such as quotas and discriminatory internal taxation. In any case, since the bulk of such commerce concerns services, open trading conditions are more effectively secured through deeper and wider commitments under the GATS on cross-border trade regarding market access (which would preclude quantitative restrictions) and national treatment (which would preclude all forms of discriminatory taxation).

There is considerable scope for an improvement in such commitments. For instance, in data processing, of the total WTO Membership of over 130, only 66 Members have made commitments; and only around two-thirds of these commitments guarantee unrestricted market access. Many developing countries have not made sectoral commitments, but the commitments of those who have is frequently superior to those of developed countries. It is particularly striking that in some of the core financial services, about a third of the developing countries which have made commitments guarantee unrestricted cross-border supply whereas none of the 26 developed countries does so. Developing countries have also been more forthcoming than developed countries in audiovisual and entertainment services. One possible approach to improving commitments would be for all Members to agree that no restrictions would be imposed on cross-border delivery, either of all services or of a bundle of whose composition could be negotiated.

At home, policies that are believed are most likely to succeed. Developing countries themselves could take greater advantage of the opportunity offered by the GATS to lend credibility to reform by committing to maintain current levels of openness or to greater levels of future openness. In basic telecommunications, the one sector where countries have been willing to make such commitments, there is evidence that the commitments have facilitated reform (Table)

Developing countries have much to gain from stronger multilateral rules on domestic regulations. Such rules can play a role in promoting and consolidating domestic regulatory reform, as happened to some degree in the telecommunications negotiations. The rules are also needed to equip developing country exporters to address regulatory barriers in foreign markets in the form of burdensome licensing and qualification requirements for professionals, or restrictive standards in electronic commerce.

It is desirable also to remedy the current weaknesses in the application of the MFN principle in the GATS. One obvious problem is the explicit departure from the MFN obligation through numerous MFN exemptions listed by countries. Less visible, but potentially more serious, is the possibility of implicit discrimination through preferential recognition agreements and allocation of quotas. Rules in these areas need to be clarified and strengthened to protect developing countries both from discrimination in their export markets and from pressure to grant particular foreign suppliers privileged access to their

markets – as, for instance, is reported to be happening in the Chinese insurance market. Dealing with anti-competitive practices

<b>COUNTRY</b>	<b><u>PRECOMMITMENT TO LIBERALIZATION</u></b>
<b><u>LATIN AMERICA</u></b>	
<b>Argentina</b>	No restrictions as of November 8, 2000
<b>Grenada</b>	Reserved for exclusive supply until 2006. No restrictions thereafter.
<b>Venezuela</b>	No restrictions as of November 27, 2000.
<b><u>AFRICA</u></b>	
<b>Cote d'Ivoire</b>	Monopoly until 2005, no restrictions thereafter,
<b>Mauritius</b>	Monopoly until 2004, no restrictions thereafter.
<b>South Africa</b>	Monopoly until 31 December 2003: thereafter duopoly and authorities will consider the feasibility of more licenses
<b><u>ASIA</u></b>	
<b>India</b>	Review the subject of opening up of national long-distance service in 1999, and international services in 2004.
<b>Korea</b>	Will raise foreign equity participation in facilities based suppliers.
<b>Pakistan</b>	Proposes to divest 26% to a strategic investor who will have an exclusive license for the operation of basic telephonic services for seven years.
<b>Thailand</b>	Will introduce revised commitments in 2006, conditional upon the passage and coming into force of new communication acts.

Anti-competitive practices that fall outside the jurisdiction of national competition law may be important in sectors like maritime, air transport and communication services. The current GATS provision in this area provides only for information exchange and consultation. Strengthened multilateral rules are needed to reassure small countries with weak enforcement capacity that the gains from liberalization will not be appropriated by international cartels. For instance, the United States and the European Union could begin by ending the exemption of collusive practices in maritime transport from the scope of their competition law. It would also be desirable to create a right for foreign consumers to challenge anti-competitive practices by services firms in the national courts of countries whose citizens own or control these firms- a variant of the precedent in the WTO rules on intellectual property and government procurement.

### *Global cooperation to support liberalization*

Beyond WTO negotiations multilateral support is needed at four levels: in devising sound policy, strengthening the regulatory environment, enhancing developing country participation in the development of international standards and ensuring access to essential services in the poorest areas.

While there is growing consensus on the benefits of liberalization, there is less agreement on the precise route to liberalization. Certain issues have prompted differing strategies. Should all barriers to entry be eliminated in sectors with significant economies of scale? How far should trade and investment liberalization be conditioned on strengthened prudential regulation? Developing countries in particular could benefit from the experience of other countries on these issues – but the experience with electricity in California and rail transport in Britain suggest that there is scope for learning in all countries. More work is needed at the national and international levels to take stock of individual and cross country experience to identify the areas where there are clear prescriptions for policy and those where there is need for further research, and therefore, for humility in policy advice and formulation.

Sound domestic regulation – ranging from prudential regulation in financial and professional services to pro-competitive regulation in a variety of network-based services -is critical to realizing the benefits of services liberalization. We have also seen that devising and implementing such regulation is not easy and there are acute regulatory problems in many developing countries. Regulatory institutions can be costly and may require sophisticated skills. To some extent such costs can be recovered through fees or regional cooperation—but external assistance could help ensure that adequate regulation is in place. Some technical assistance is already being provided, but often on an ad hoc basis either bilaterally or through international organizations. More systematic efforts – along the lines of the Integrated Framework for least developed countries-are needed to assess the needs of individual developing countries and to ensure that the most appropriate assistance is provided in key sectors.

Improvements in domestic standards and qualifications are also needed in order to be able to export services. For example, in the case of professional services, low standards and disparities in domestic training and examinations can become a major impediment to obtaining foreign recognition. Thus, inadequacies in domestic regulation can legitimize external barriers to trade. At the same time, developing countries need to participate more actively in the development of international regulations and standards, especially in new areas like electronic commerce. Otherwise, standards could evolve to reflect the concerns only of developed countries and impede the participation of developing countries in services trade.

There will remain certain poor countries, or certain regions within poor countries, where improvements in services policy and regulation will not be sufficient to ensure access to essential services. The criterion for determining whether assistance is needed could be the absence of private sector provision despite comprehensive policy reform. The

effectiveness of international assistance could be maximized by allocating it in a manner similar to that used domestically by countries like Chile and Peru to achieve universal service. For instance, once a country (or a region within a country) has been selected for assistance, funds – such as those provided by certain countries to bridge the digital divide – could be pooled and allocated through international competitive tenders to the firm which offers to provide the necessary infrastructure at least cost. Providing international assistance in meeting the costs of the required subsidy programs could increase the benefits of, and facilitate, liberalization by ensuring that the needs of the poor would be met.

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