Chapter 11

What Behind-the-Border Reforms in Services and Investment are Best Done through Trade Agreements?¹

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11.1 Introduction

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.

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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 ‘second best’ optimal to achieve the other conditions, even though one could not be achieved. Examples of papers that have tried to characterize

¹ This is an edited version of Chapter 5 in Economic and Social Commission for Asia and the Pacific (ESCAP) (2009), *Challenges and Opportunities for Trade and Financial Integration in Asia and the Pacific*, Studies on Trade and Investment 67, ST/ESCAP/2563, Bangkok: ESCAP: 93–109. Available from <http://www.unescap.org/tid/publication/tipub2563.asp>.

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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, 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 Doha Round of non-agricultural market access negotiations under the World Trade Organization (WTO), tariff cuts would take place according to the so-called Swiss formula, which ensures that within each country, the highest tariffs would undergo the greatest percentage cuts. According to this ‘tops down’ formula, the partial reform achieved via the negotiations would reduce both the average level of tariffs, and their dispersion.

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The aim of this chapter is to explore whether there are principles that can be brought to bear in negotiating the services and investment provisions of trade agreements, 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 tops-down principle for tariff reform. It is not the aim to go as far as developing a negotiating modality for services or investment — 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, as exercises in piecemeal reform, with other modes of liberalization. Should countries embrace trade agreements in services and

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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 the chapter). 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 chapter now proceeds with those two levels of analysis in turn.

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11.2 Trade Agreements versus Other Modes of Liberalization²

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 well understood. The key economic benefit is that reciprocity helps to neutralize the negative terms of trade effects of unilateral tariff reform (eg 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 (eg Baldwin and Robert-Nicoud 2008).

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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. But first it must establish exactly what types of partial reforms trade agreements can be expected to achieve in services and investment.

As noted recently (Dee and Findlay 2009):

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

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- when real liberalization of services and investment occurs in trade agreements, it tends to involve the removal of discrimination against foreigners;
- in preferential trade agreements (PTAs), this tends to be on a preferential basis, ie only for the particular partner country;
- 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.

Further, 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. 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. Thus 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, Marchetti and Roy 2008).

Multilateral trade agreements can avoid some of these problems, by opening a market to many foreign players simultaneously. But 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 of Dee (2007) suggests that this latter problem can 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 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.

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The case for reciprocity in services and investment

In this respect, 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).

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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 (see Dee and Findlay 2008 for more details).

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11.3 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.

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*Limits to liberalization*³

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.

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

³ Parts of this section draw on Dee (2009).

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offer shoddy service for ever, 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 government subsidies (through scholarships and the like) to consumers, are also ways in which it is achieved. However, few governments can afford to subsidize everyone. So typically there are limits on who can get government funding, simply for budgetary reasons.

In some services sectors like 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.⁴ 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 entry may be restricted 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.

⁴ Dinh (2013) gives new insights on some of the grey areas in light of the global financial crisis.

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 could not 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 the GATS. Where the rationale for regulation is quality assurance, then the logical way to operationalize this necessity test is to define *minimum acceptable standards* of quality that meet the needs of both sides. To date, there has been little progress in operationalizing a necessity test for any services within the WTO. Arguably, more progress might be made within a PTA among partners whose levels of development were not too dissimilar.

What to liberalize?

As noted, 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:

- the ‘height’ of the trade barrier, that is, the extent to which regulatory restrictions have raised costs or created rents;
- the ‘impact’ of the barrier — whether the impact has been on costs or rents;
- the ‘incidence’ of the barrier — whether it applies only to foreign suppliers, or whether it also applies to domestic operators;
- the size of the affected sector; and
- the nature of its input-output linkages to other sectors.

All these factors will affect the overall economy-wide gains from reform. Some of the evidence on the first three characteristics was surveyed in Chapter 9 of this volume. More recent evidence in these three issues is reported in Dee (2013b).

The 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 (ie wholesale and retail trade) — the height of the barrier in distribution is in fact quite modest. But the distribution sector is bigger, counting 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 once account is taken of the potential productivity boost that could come from greater business-to-business e-commerce (Dee 2008a).

Intersectoral linkages

Finally, a key consideration is which services sectors have strong intersectoral linkages to the sectors where a country's ultimate comparative advantage lies. 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 (eg both ICT services and ICT-enabled services such as back-office professional services).

The services that have strong intersectoral linkages with manufacturing are areas 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 (see Dee 2012b for the most recent evidence on this). South Asia will get relatively large economy-wide gains from liberalizing and improving productivity in most services sectors.

Sectoral priorities — principles of piecemeal reform

One important principle for piecemeal reform of services — the services equivalent of the 'tops 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, 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. And 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. But 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.

11.4 Concluding Comments

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’.

- 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 fall naturally out of that.
- They should not get hung up on ‘negotiating coin’.
- They should worry primarily about productivity in services, and let trade look after itself.