

Multilateral Liberalisation of Services Trade and Investment in a Globalising World: Scope and Limitations¹

Christopher Findlay

Asia Pacific School of Economics and Management

The Australian National University

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¹ This presentation draws on material in Findlay and McGuire (2002) which is available on request. Email christopher.findlay@anu.edu.au.

Introduction – the growth in services trade and investment

The United States recently made a proposal for a tariff free world. It proposed a formula for cutting tariffs to zero by 2015. The proposal also made mention of non-tariff barriers. But it made no mention of services where substantial impediments to trade exist. Working on goods alone leaves out a very important part of the story of liberalisation. Clearly, however, there are some extra complications in the case of services trade and investment.

In the trade mode, services trade grew at the same rate as goods trade over the 1990s, at about 6.5 per cent. In 2001, the value of goods trade fell by 4.5 per cent, while services trade declined by half a percentage point. The value of services trade declined in all cases except for the transition economies. The value of services trade in 2001 was about 24 per cent of the value of merchandise trade. The share of 'other commercial services' in world services trade is rising as the share of travel and transportation is falling.²

Services trade tends to be intense between developed countries. Developed countries dominate the lists of both leading exporters and importers, although now India and China sometimes appear.

On the investment side, services are relatively more important. It has been estimated that services account for about 43% of world investment stocks (as of the mid 1990s) and that services transactions associated with FDI are 70 per cent higher than the value of exports as recorded in the balance of payments statistics.³

It is well understood now how special are services transactions. They involve, generally, a higher degree of direct contact between buyer and seller. This is because services are about adding value to things belonging to others, or adding to the capacity or changing the features of those people themselves. There is a number of ways this transactions can be organised (these are the so-called modes of supply in the GATS) including one or other party moving. Under the investment mode, the foreign supplier establishes near the customers, as a supplier of utility services must do if it wants to invest in water or power services. Or in the trade mode, the customer might move to the supplier, as a student moves to study abroad. A supplier might move temporarily to do business offshore, as could a management consultant. In some cases, the transaction can take place through the intermediation of some sort of communications system, as might occur in markets for architectural services. Overall, though, a services transactions is much more 'up-front and personal' than a goods transactions.

A number of factors have contributed to the growth in trade and investment of services. In part they are the same as those contributing to a larger service sector, including the effects of income on demand, and the willingness of firms to look at the way they organise themselves, so that they buy in more services that once they did in-house. Logistics is probably the best example of this trend. This is a much broader

² These data are found in WTO (2002).

³ Dee and Hanslow (2000) prepared data sets of services fdi and transactions by various modes.

activity than just distribution, as defined in the GATS. These trends are driving the relative rapid growth of trade in business services.

Another contributor is regulatory reform which is opening up more of the public sector to private provision and to trade and investment. In Australia, already the energy and water sectors are populated by foreign investors and operators. The postal sector remains closed but in other countries (New Zealand for example) the market is competitive.

Other contributors to the capacity to operate internationally include lower costs of travel and communications. Contributors to that outcome include international trade and investment in those sectors.

Services are special in some ways but familiar in others. The propositions about comparative advantage and the gains from trade apply to services. Impediments to trade lead to the loss of economic welfare. While the impediments are difficult to measure, the preliminary evidence is that they are significant.

Services transactions penetrate much deeper into an economy than do goods transactions, because of the nature of the interaction between buyer and seller. The depth of the interaction raises many issues, including concerns among some groups about the implications for national sovereignty. The requirements for contacts, and the new ways in which information and financial transactions can be organised, are also important issues in the context of policy on national security. At the same time, and because of the depth of interaction, trade and investment in services adds to the capacity of an economy to adjust faster and gain more quickly from greater participation in world markets. Trade in education, transport, infrastructure and financial services, as well as capacity building at government level (another form of a service transaction), are all contributors to this effect.

The focus here is the nature of the impediments to trade and investment in services, their significance, the impact of their reform and the design of reform strategies. The scope of the multilateral route to support reform is discussed and, in a later section, some mention is made of some its immediate challenges and limitations.

Impediments to trade and investment in services

The range of modes of supply and the nature of the transaction mean that the scope of possible impediments is large. They are diverse and difficult to assess, often being the result of regulatory processes which operate behind the border. Service transactions trigger substantial regulatory activity, because of the problems of lack of information and the difficulty of reversing a process which it has been applied. You can't have your haircut taken back or your operation reversed.

It is difficult to apply a form of protection that is familiar in goods trade, like a border tax, since what moves generally is either the capacity to provide a service, or the item being serviced. In the latter case, defining the value-added as a result of the international movement is difficult – imagine trying to tax tourism on this basis! More common are rules on how to operate and rules on whether and when a foreign supplier can establish. Services sector impediments inevitably are less transparent than those applying to goods.

It is also much easier for a country to regulate or impede transactions which take place on their own soil, or which involve foreign suppliers moving into and operating within their territory. When the consumer travels to the foreign supplier, it is much more difficult to impede the trade. When new technology provides new ways of getting buyers and sellers together it is also much more difficult for governments to get in the way of international business.

The GATS covers all modes, so there is actually already in place an international agreement in place which covers more than 40% of the global fdi stock. The issue now is whether negotiations on investment that might apply to goods will deliver approaches consistent with those already established in services.

While an agreement exists, the GATS does not necessarily add much to the transparency of policy. The GATS is based on a positive list approach. Countries are bound only in sectors in which they make commitments, and according to the exceptions noted. Where no commitment is made, the GATS provides no detail of the policy operating. Also actual policy can differ from that which is bound. There is role for further research, some of which is discussed below, to add to our understanding of policy and its impact.

Assessments of impediments and the impact of liberalisation

While difficult to measure, impediments to services trade and investment can still be assessed and compared. A common methodology is to identify and list all the possible impediments, assess their impacts (maybe through a scoring system) and then relate different degrees of impediment to market outcomes. Sometimes its possible to come up with a price effect that is equivalent to the impact of the policy. A substantial body of work of this type has been done here in a joint ANU-Productivity Commission research project. Also at the OECD there is a growing body of work applying this methodology.

It is useful to distinguish between impediments that affect establishment and those that affect operations. Also there is a distinction between impediments that apply to all potential suppliers and those that affect only foreigners. Bearing in mind this distinction, then work of this type completed to date finds that:

- There are significant impediments to trade in services, particularly in telecommunications, banking and transport as well as some of the professional services. High levels of impediments in these fields are likely to have significant effects on other goods and services exporters;
- In policy applying to the services sector, there is usually significant discrimination against foreign suppliers, and observed at levels higher than expected in banking and in maritime and distribution services.
- The relative importance of barriers to establishment and operation vary between sectors, with establishment barriers being regarded as more important in the professions;
- In general, impediments to international services transactions tends to fall as income rises, except in some professional service activities.

The development of these measures of policy impact facilitates the identification of negotiating priorities and it provides some benchmarks for monitoring the progress of reform. It also facilitates the application of large scale modelling to services reform and the results highlight a number of interesting aspects of the policy choices in a services reform program.

a) large gains to services reform, particularly to developing countries.

Work by the Productivity Commission⁴ (completed in 2000) found that that the world as a whole is projected to be better off by more than US\$260 billion annually as a result of eliminating all post-Uruguay Round trade restrictions. About US\$130 billion would come from liberalising services trade, US\$50 billion would come from agricultural liberalisation, and US\$80 billion from liberalisation of

⁴ See Dee and Hanslow (2000).

manufactures. These are the projected gains in real income about 10 years after the liberalisation has occurred and the associated resource adjustments have taken place.

Other studies generally indicate that economies with significant restrictions gain the most in terms of percentage changes in real GDP from liberalising trade in services. Thus, the major benefits from liberalisation accrue to developing economies because their restrictions on services are higher than those of developed economies.

For some economies — the European Union, the United States, Canada, Singapore and Taiwan — the contribution of multilateral services trade liberalisation is projected in this modelling work to be negative. There are a number of reasons that contribute to this result, but generally, after the restrictions on FDI in foreign economies are removed, the owners of foreign capital receive a lower return from investment in those economies. However these results also depend on assumptions made about the extent to which restrictions add to profits compared to the extent to which they add to costs.

b) partial liberalisation should be avoided and tackling non-discriminatory impediments is a priority

This modelling work also projected the benefits of *partially* liberalising services trade. The results show that the greatest global benefits will come from liberalising *non-discriminatory* or *market access* restrictions rather than *discriminatory* or *national treatment* restrictions.

Reducing *non-discriminatory* restrictions on all service suppliers together is a better approach than only reducing *discriminatory* restrictions on foreign service suppliers because reducing *discriminatory* restrictions on foreigners alone can have a negative impact on the level of services supplied by domestic firms. Removing restrictions of that type will result in lower prices and higher total sales, but domestic service suppliers will end up with an even smaller share of this market. However, if restrictions that affect foreign and domestic service suppliers equally are reduced, all service suppliers will have the same opportunities to increase the amount of services they supply in an expanding market.

It was found that removing all restrictions on *establishment* would yield a larger total benefit than removing all restrictions on *ongoing operations*.

When reform involves removing only one class of restriction (*market access*, *national treatment*, *establishment* or *ongoing operations*), it is difficult to find an outcome where at least some economies gain and none lose from partial liberalisation. The best strategy for liberalisation is to negotiate gradual reductions in *all* types of restrictions simultaneously.

c) intersectoral impacts are important

This work also looked at the question of which sectors can gain from multilateral services trade liberalisation. A service sector may not lose from liberalisation because there are competing forces at work.

- Not all services trade barriers discriminate against foreign services suppliers, so a service sector could expand because of new entry by domestic services suppliers.
- Some services trade barriers restrict inward FDI, so a service sector could expand because of new foreign entry.
- Some services barriers discriminate against foreign services delivered cross-border, so a service sector could contract in the face of additional import competition.
- Services trade liberalisation may benefit downstream using industries, and a service sector may lose out in the competition for domestic resources (eg labour).

These points are also important for debate about the effects of reform. For example a higher degree of openness does not necessarily mean that the domestic sector shrinks, although it might mean a much larger foreign presence.

The modelling results do not necessarily capture all the effects of reform, including the longer run effects on productivity.

The Australian experience of productivity growth in the 1990s illustrates the scope for high productivity growth in services and the impact of policy change on productivity growth. Since the early 1990s total factor productivity in Australia accelerated by one percentage point. There are three possible explanations: a response to policy reforms; increases in workforce skill; use of more advanced information and communications technologies (ICTs). Parham (200) reports that the data do not support a connection with a change in workforce skill and he then argues that 0.2 or at most 0.3 percentage points are attributable to the use of ICTs. This leaves 0.8 percentage points which are attributed to policy reforms.

Relevant policy reforms which had been introduced since the mid-1980s included deregulation of access to finance; floating the currency; reductions in barriers to trade and foreign direct investment; government business enterprise reform; and increasing labour market flexibility. These policy reforms added to competition in the domestic market, increased the incentives to operate efficiently and removed impediments to adjustments to production processes and the organisation of the firm.

Also of interest here is the sectors in which more rapid productivity growth was observed in Australia. In the late 1980s and early 1990s, agriculture, mining and manufacturing showed relatively strong productivity growth. Over this period there was strong productivity growth in the infrastructure sectors of electricity, gas, water and communications. Parham (2002) attributes this contribution to the effects of reform on the efficiency of government-owned enterprises as well as technological changes. In the latter part of 1990s, productivity growth in this set of industries remained strong, except for manufacturing. Other industries in the service sector made a greater contribution to productivity growth, especially industries such as wholesale trade but also construction, and transport and storage.

Routes to reform

Unilateral action can deliver the benefits just outlined, but clearly the scope of the task is large if the gains are to be maximised, and the extent of domestic adjustment will be substantial. Strong resistance to unilateral action can be expected. An approach in which a number of countries move at once provides an environment in which countervailing political resources can be mobilised in each home economy.

Multilateral

The loss of rents among incumbents is an obvious source of resistance. Services markets are likely to be imperfectly competitive. Items are not standard, they can easily be differentiated, since what lies in stock is the capacity to provide a service, not the service itself. Each transaction can be tailor-made, and this feature combined with the nature of the transactions creates greater scope for complex pricing schemes to be applied. These features plus the incumbents' control of a block of capacity mean that markets are not easy to enter. Rents can be earned and sustained, although depending on ownership structures or regulatory rules, the rents are not necessarily taken out as profits but maybe as higher costs.

Loss of these rents is one reason why reform of the service sector faces substantial resistance. Incumbent suppliers lose a privileged position and must compete with a wider range of competitors, both domestic and foreign.

In this context, the multilateral approach provides an opportunity to mobilise countervailing political support for reform, either from downstream services exporters or from other sectors whose market access is tied up in the single undertaking of the multilateral negotiation.

Another issue in services sector reform is the management of government and their institutions. Generally many agencies are involved. Also sometimes governments below national level impose the key impediments. Mobilising all these interests to accept change, including change established in an international agreement, is a challenge.

Yet another set of domestic interests are opposed to the GATS on the grounds of what they see as its intrusion into domestic policy making. These groups assert (incorrectly) that the GATS will force governments to open up service sectors to foreign competition, that it will undermine the capacity of governments to regulate, and that it will take away the prerogative of governments to decide which services are to be provided in the public sector.⁵ The Australian government has issued a fact sheet to respond to each of these claims.

In terms of the engagement of all the parties in a multilateral approach, the modelling results also highlight the mutual interest of developed and developing countries in the services negotiations. The gains from liberalisation are large according to measures of impediments. There are also downstream sectors which can be identified which might be expected to grow faster in developing economies as a

⁵ See for example <http://www.aftinet.org.au/campaigns/AFTINETfactsheet0702.pdf>

result of opening up key inputs like telecommunications, transport and banking. Furthermore, and not covered in the modelling work so far outlined, are the impacts of restrictions on the movement of people. This mode of supply is a key interest to both developed and developing countries and further comment on that mode is offered below.

Smaller groups

Regional approaches to reform are also being pursued actively, with many negotiations in progress in the western Pacific region. Part of the motivation for these negotiations is greater market access for services exporters.

It might be expected that given the nature of the impediments it would be easier to negotiate around these in a smaller group setting. Some arguments for the use of this approach are also based on the benefits of being a first mover, establishing a position of incumbency in a foreign market and capturing some of the rents available. However, the preferential route runs a number of risks.

The agreements negotiated are likely to be compatible in terms of their architecture and so it will be difficult to combine them to form a larger group of countries committed to free trade. Another risk is linked to the dynamic effects on the political economy of reform.⁶ A preferential agreement by putting some suppliers in a preferred position can stall the momentum to further liberalisation. Furthermore, a preferential approach by some countries will invite retaliation by others, to offset the effects of trade diversion and to join the pursuit of rents in the same partially open markets.

Even in services agreements, there is a risk of diversion of trade and of a loss of rents through preferential allocation of access to foreign suppliers. Mattoo and Fink (2002) compare the effects of “sequential entry” to “simultaneous entry”. When entry is costly (in terms of the presence of sunk costs) the incumbents may be able to deter further entry. The first mover advantage in an FTA negotiation might be given to a supplier who is not operating on the frontier in terms of global technology and technical efficiency. The preferential trading arrangement strategy runs the risk, therefore, of saddling a country with less than first-class suppliers.

One option for managing these risks is to announce a commitment to multilateralise, according to an agreed and credible timetable, any preferential terms of access provided in the FTA negotiations. Whether the existing WTO rules can be reviewed is a topic under discussion in this Round of negotiations. But these observations bring us back to the value of the multilateralism as a way of helping to manage the domestic political economy reactions to the reforms and then locking in that policy to avoid backsliding at a later date.

⁶ See for instance, see Findlay, 2002 and Mattoo and Fink, 2002.

Challenges in the multilateral route

The multilateral approach when applied to services faces many challenges, some of which are the following. This list does not exhaust the current agenda of such issues.

a) Starting points

A common assessment of the original GATS negotiations is that while they established a framework, they did not actually achieve much liberalisation, and that many commitments were significantly less open than actual policy. The challenge in this Round is to go further. As negotiations proceed, however, policy continues to shift, often driven by market forces including technological change. A recent review of telecommunications policy in APEC, for example, found there was significant adjustment even over the last 4 years. Another key question therefore will be how to deal with such policy change. There are various proposals on the table for providing 'credit' for those who have already made policy changes since the Uruguay Round and there is no agreement yet on whether a common rule will be adopted (rather than the matter being left to the outcome of the bilateral discussions). But at least recent policy changes should be bound in the current negotiations.

b) Classification

A related issue is the classification of services sectors and whether groups of sectors might be handled in 'clusters'. Some of the classifications used do not match the business models of supplier firms. Logistics provides a good example. Energy is another, where generating the power is only one part of a package of services provided by an energy utility in a deregulated system. Transport operators are generally not interested in just one mode, but in access to all the feeder and other complementary services, so that they can offer customers an integrated package of door-to-door arrangements.

There is debate about whether new categories should be created to deal with these evolving business models. The application of model sets of commitments or even check lists of sectors would work just as well, without the problem of proliferation of sectors and the subsequent uncertainties that might create. In any case, the business models will continue to evolve and as long as classifications exist for the basic building blocks, relevant commitments to reform should be able to be designed.

c) Competition policy

As noted, the discussion of liberalisation of trade and investment in services necessarily triggers attention on domestic regulation. Within that category, competition policy is going to be important, especially because of the nature of services production and its implications for market structure.

Domestic competition policy certainly affects the business environment, and the terms under which entry into a market takes place. For example, there is debate in Australia not just about the rules that apply to new entrants into the infrastructure sectors, but also to the manner in which the procedures are applied.

There is discussion of whether current regulatory practices raise the risk of regulatory error (deeming some action to be anti-competitive when it is not).

Furthermore, a decision on competition policy in one country can affect the market structure in another country. For example, a competition authority may permit two service providers to merge without a substantial reduction in competition in a market in its jurisdiction. But in a smaller foreign market, the consequence could be a reduction in the number of suppliers. The smaller market might re-examine its entry policy, but at its size, and in spite of its GATS commitments, further credible entry (at least, within the existing technology) may be unlikely. Depending on the behaviour of the incumbents, prices may rise. There is a number of steps and qualifications in the sequence leading to this conclusion, but it does illustrate the possibility that the extent of market power of incumbents in one market need not be independent of policy choices applying to others.

Fink et al (2001) offer interesting suggestions relevant to this circumstance: they argue for a) an end to the exemption from national competitive law of collusive agreements that affect only foreign markets and b) create the right for foreign consumers to take action in the courts of countries whose citizens own companies that abuse their market power. These procedures could also be added to the GATS provisions.

It is implausible to expect harmonisation of competition policies. Even developed countries make different decisions on similar cases because of the application of different principles. Countries at different stages of development will also make different choices about the same issues, depending on the costs of the regulatory process and the contribution to efficiency of any action taken.

More useful will be a focus on some key issues where there are clearly more common interests, such as price fixing arrangements, or mergers leading to the risk of the abuse of market power, as illustrated above. Another complementary method to help align regulatory practices that apply to these issues is to work on new reference papers for other sectors, like that applied to telecommunications. A review of the experience in that application of the telecommunications paper would be useful.

Finally, competition policy is a valuable area for capacity building work, in sharing experience about the design of institutions and about rules on decision making in those institutions.

d) Safeguards

Whether or not to develop a set of safeguards mechanisms is a key issue in the services negotiations. Already the negotiating deadline has been extended a number of times. The apparent lack of discipline from the GATT on these measures in goods trade leads to the immediate reaction that such a proposal has many problems.

Sauve (2002) reviews the economic issues associated with the specification of safeguards arrangements, designed to provide short-term import relief to domestic industry. He notes the difficulty of defining the boundaries of domestic industry (given the presence of foreign investors), of defining the 'like services' from which the problem arises, and of finding the data to make a case about a surge of imports. Another issue is how to apply a mechanism to each mode of supply, and whether such measures are even able to be implemented, given the scope to supply via other electronic means.

At the same time Sauve notes that a large number of developing countries are expecting some rules of this type will be put in place. There is an argument that a 'safety valve' of this type will help the process of liberalisation.

If such a regime is required to reach agreement on services, then the challenge as Sauve says will be to ensure that it makes economic sense. He reviews three options, one a wide-ranging mechanism, another a mechanism applying only to sectors where specific commitments are made and a third option which is to experiment with mechanisms for sectors where the concerns are greatest. Sauve nominates financial services for this purpose.

Whatever approach is applied, it will be important to adopt principles such as mfn application, the use of objective measures as a trigger, reporting obligations, and limited duration. Sauve also notes that while developing countries might seek such rules, those rules could also end up being applied to mode IV (the movement of people) which could disadvantage the proponents of the mechanism. Other commentators have also observed that the positive list approach of the GATS itself provides a safeguard mechanism.

Conclusion

There are substantial gains, all round, from liberalisation of services trade and investment. International transactions in services tend to be concentrated among developed economies and as, the Australian experience of reform demonstrate, the service sector can provide new sources of productivity growth in higher income economies. There is much to gain from further rounds of deregulation and liberalisation.

The modelling results also point to the size of the impediments and the gains to developing countries, from the more efficient internal allocation of resources. At the same time, a number of market access opportunities would arise for developing countries, some of whom already appear on the list of the big exporters and importers.

The size of the gains, the scope for both developed and developing countries to gain, the potential for better market access to underpin domestic reform and change, and the intersectoral impacts, all provide the basis for progress in negotiations.

There is evidence of significant unilateral policy change in some sectors. The multilateral process helps avoid backsliding on that policy, helps develop multilateral norms on some difficult impediments including regulatory practices (without undermining national sovereignty) and, through the joint action by a number of countries, helps deal with the domestic resistances to policy change. Some of its immediate challenges are various aspects of the negotiating process such as its starting points, as well as the treatment of regulatory policy (including competition policy) and the treatment of safeguards.

A critical component of any undertaking on services is likely to be commitments in relation to the fourth mode of supply – the movement of people. Commitments in the GATS to this mode are few, and multilateral norms on the important regulatory issues that affect the movement of natural persons are valuable. Additional commitments and the adoption of norms complement each other, since otherwise some commitments could be undone by domestic regulatory practices. Key components are recognition of qualifications, the treatment of temporary migrants and the taxation of income flows. People movement questions, however, are now more complicated to discuss because of the greater weight on national security in policy agendas.

New modelling work suggests the gains to including this mode in the liberalisation process will be high. While this mode is often associated with developing country interests, developed countries too will be expected to make requests relating to this mode. Its significance and the mutual interest of many countries in the outcome make progress on mode IV a key component of the final bargain in this Round of negotiations.⁷

⁷ The WTO held a symposium on this mode in April 2002: see http://www.wto.org/english/tratop_e/serv_e/symp_mov_natur_perso_april02_e.htm

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