Module 5.

Trade in Services: Liberalisation under the WTO's Multilateral Trading System and Integration under the Single Market

ECN 330

Analyzing Economic Integration and Multilateral Trade Liberalization

Glossary of abbreviations

- **BOP** – balance of payments
- **CU** – customs union
- **CVM** – countervailing measures
- **DCs** – developed countries
- **DS** – domestic support
- **DSM** – dispute settlement mechanism
- **EC** – European Commission
- **ECJ** – European Court of Justice
- **ESM** – emergency safeguard mechanism
- **EU** – European Union
- **FDI** – Foreign direct investment
- **GATS** – general agreement on trade in services
- **GATT** – general agreement on trade and tariffs
- **GDP** – gross domestic product
- **IP** – intellectual property
- **LDCs** – less developed countries
- **MA** – market access
- **MFN** – most favoured nation
- **SPS** – Sanitary and phytosanitary measures
- **TBT** – Technical barriers to trade
- **TRIMs** – trade-related investment measures
- **TRIPs** – trade-related intellectual properties
- **UR** – Uruguay Round

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1. The International Services Economy

1.1. Contrasting trade in services and goods

- Exchange more complex
- Intangibility
- Non-storability
- Heterogeneity
- Non-separability

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International Services Economy, continued . . .

1.2. Policy intervention in services

- Wider range of policy/regs on services
  - Internal regulations and controls
  - Involves border measures also
- Regs applied without regard for their trade effects

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International Services Economy, continued . . .

1.3. Economic importance of services - supply

- Predominant domestic economic activity
  - 60% of world GDP, varies by a country's income
  - Low-income: 38% of GDP
  - Middle-income: 56% of GDP
  - High-income: 65% of GDP
- Key drivers: technology and regulatory reform
- Role on the international economy
  - Transport and related services were always important
  - General ↑ in importance reflects new modes of exchange

Source: WTO, 2001

International Services Economy, continued . . .

- Productive factors: sources of comparative advantage
  - Endowment/mobility of human capital (e.g., engineering)
  - Access to better infrastructure and modern technologies
  - Access to widest range of services (e.g. financial)

International Services Economy, continued. . .

1.4. Trends and expectations of services - demand

- High income elasticity of demand
- Services-intensity or content of advanced industrial goods
  - Sophisticated industrial products
  - Require specialized service suppliers

International Services Economy, continued . . .

1.5. Services and employment

- Services important for employment / job creation
- Services are labor intensive
  - Substitution of labor for other factors more difficult
  - Increasing labor productivity in services is more difficult

International Services Economy, continued . . .

1.6. Legal implications and provision of int'al services

- Int'al services contracts more complex
- Depends on economic freedoms (free movement of persons, investment, capital, recognition of diplomas, certificates)
- A parallel implementation of such liberties has not been achieved internationally

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International Services Economy, continued . . .

1.7. International trade in services (TIS)

- Regarded as domestic activity
  - Cross-border services trade ≈ one-fifth of services volume
  - 50% of FDI is services trade
  - Other modes of services trade are possible
- ↑ S+D services as % world GDP is not reflected in ↑ share of world trade (except transport and related)

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International Services Economy, continued . . .

- Factors contributing to non-tradability
  - Policy/regulatory-induced factors
    - Public interest and national security
    - Natural monopolies and network capacity
  - Technical constraints
- How do regulatory reform and tech Δ facilitate TIS? Through transformation of networks
  - Link between supplier and consumer/end user
  - Link between service provider and manufacturer
  - Market structure, efficiency and competition: profits (from innovation) and threat of losses (from complacency)

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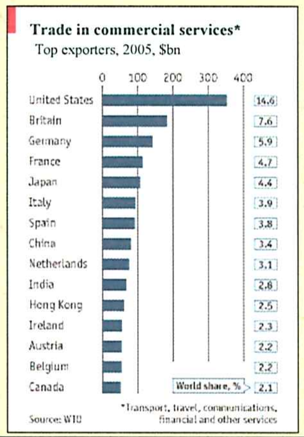
International Services Economy, continued . . .



Economist, 27 April 2006, p. 97

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International Services Economy, continued . . .

1.8. Deregulation and MA liberalization

- Deregulation does not imply ↑ MA
  - Domestic regs are not trade barriers
  - Stds or other regs need not be modified to facilitate foreign competition
- There have been cases when deregulation resulted in unilateral liberalization (even in LDCs)

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2. Multilateral Trade in Services

	Goods	Services	Intellectual property	Trade disputes
Basic principles	GATT	2.1 GATS	TRIPS	DSM
Additional details	Agreements and Annexes			
Specific sectors or issues	Agriculture, textiles, SPS & TBT, investment	Telecoms, financial, tourism, transport, etc		
Market access commitments	Schedule of Commitments			
Country-specific requirements	Listing of MA restrictions and subsidies	Limitations on market access and national treatment		

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Multilateral Trade in Services, continued . . .

2.2. Background on TIS

- US pushed for rules for TIS in early 1980s before the UR-GATT
  - Motivation: perception of a comparative advantage
  - GATT working group formed to study possibility of GATT-type rules on services – no consensus reached
- EU's commitment to free movement of persons, capital and goods requires *freer* movement of services
  - Liberalization / reg reform became a high-profile issue in 1990s
  - Single mkt increasingly involves regs to support TIS

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Multilateral Trade in Services, continued . . .

2.3. Scope of the GAT rules

- TIS covers all services, with exceptions
  - Public service sectors (health, education)
  - Services supplied neither on a commercial basis nor in competition
  - Most of the air transport sector
- MFN exemptions
  - Permitted thru negotiation
  - Subject to review; not to be maintained for more than 10 years

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Multilateral Trade in Services, continued . . .

- GATS: deregulation and MA liberalization
  - Modifying regs to facilitate foreign competition not required
    - Regs are not characterized as MA barriers
    - Were not subject to scheduling or negotiations on MA
  - WTO does not set stds for regs on services
  - No member was interested to set limits on their country's power/right to regulate

Multilateral Trade in Services, continued . . .

2.4. General obligations and trade disciplines

- MFN
- National treatment
- Predictability
- Transparency
- Reciprocity
- Safeguards and exemptions

3. General Agreement on Trade in Services

3.1 Motivation: why an agreement on trade in services?

- Services not affected by tariffs/quotas
- Subsidies are not defined for services
- Services more intangible / less tradable

GATS, continued . . .

3.2. WTO definition of a service

- Mode 1. Cross border trade
- Mode 2. Consumption abroad
- Mode 3. Commercial presence
- Mode 4. Presence of natural persons

GATS, continued . . .

3.3. Country-specific commitments

- Bindings but flexibility
  - Specify conditions limiting extent of MA + nat'al treatment
  - Commit to not make regs more restrictive
  - No minimum access coverage or threshold
- Liberalization takes into account development level
  - Correlation between commitments taken and level of development
  - Members acceding to the WTO pushed much harder than members at similar stage of development who joined during UR-GATT

GATS, continued . . .

- Scheduling MA and national treatment
  - Horizontal commitments
  - Sector-specific commitments

Commitments across service sectors and the modes of supply			
Sector or sub-sector	MA limitations	Limitations on national treatment	Additional commitments
I. Horizontal commitments			
Regulations or legislation that affecting all/many service sectors	(1) None/unbound (2) None/unbound (3) None/unbound (4) None/unbound	(1) None/unbound (2) None/unbound (3) None/unbound (4) None/unbound	Pending regulation or forthcoming changes in regulations
II. Sector-specific commitments			
1. Business A. Professional a. Legal services	(1) – (4)	(1) – (4)	

Note: Schedules of services are in WTO documents beginning with symbols GATS/SC/

GATS, continued . . .

- What is a commitment in the context of services?
- Meaning of commitments
  - "None"
  - "Unbound"
  - Other
- What is a lack of a scheduled commitment?
- "Standstill bindings"

GATS, continued . . .

- MA restrictions: whether or not national treatment is violated
  - Number of service suppliers allowed
  - Number of transactions or assets
  - Total quantity of service output
  - Number of natural persons that may be employed
  - Restrictions on the type of legal entity
  - Participation of foreign capital in sector

GATS, continued . . .

Limitation	Implication or Example of the Limitation
Number of service suppliers	Monopoly supplier, quota on number of firms, fixed number of licenses; exclusive service suppliers; requirement of an economic needs test based on population density
Value of transactions or assets	Value quota; specify that a foreign firm (or subsidiary) maintains some % or share of the total assets of value of the domestic market; economic needs test
Quantity of service output	Quota on number of operations; quota on service output expressed in units; economic needs test
Number of natural persons employed	Quota on number of foreign workers who are able to supply service; specify that foreign labour cannot exceed a certain % of work force or % of total wage bill; economic needs test
Conditions on the legal entity	Measures that restrict or specify types of legal entity, e.g., joint venture, over which service can be provided
Conditions on participation of foreign capital	Value quota in terms of a maximum % of a foreigner's share-holding; volume quota on the total amount of an investment

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GATS, continued . . .

- Limitations on national treatment
  - Nationality or residency requirement for executives and board members
  - Measures requiring an investment in a certain amount of assets in local currency
  - Restrictions on purchase of land by foreign service suppliers
  - Subsidies or tax exemptions granted only to local suppliers
  - Differential capital requirements
  - Operational limits that apply only to foreign suppliers

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GATS, continued . . .

3.4. Sample of service schedule commitments

- Horizontal commitments

Norway – Schedule of Commitments

Sector or sub-sector	MA limitations	Limitations on national treatment	Add'al commit
I. Horizontal commitments			
	(4) *Unbound, except for the temporary presence of natural persons providing services without being employed by a juridical person* who has commercial presence in Norway. Access is subject to the following conditions: A work permit must be obtained. A work *permit must be issued to a natural person who is considered to be a higher-level skilled worker or* to *have special qualifications.* The *competence* of the natural person *must be deemed absolutely necessary* for the recipient of the services.	Unbound except for measures concerning the categories of natural persons referred to in the MA Column	

Note: Schedules of services are in WTO documents beginning with symbols GATS/SC/

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GATS, continued . . .

- Horizontal commitments, continued

Albania – Schedule of commitments

Sector or sub-sector	Limitations on MA	Limitations on national treatment	Add'al commits
Real estate		3) *Foreigners are not permitted to own agricultural land.* Non-Albanians are allowed *only to lease ag land* up to 99 years.	
Privatization	3) The *privatization* process in several sectors *may restrict the total numbers of operators (foreign and local)* and *may limit the shares owned by foreigners* in the enterprise to be privatized.	3) The *privatization of large-scale SOEs may exclude foreign participation* in some sectors.	

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GATS, continued . . .

Horizontal commitments

Albania – Schedule of commitments			
Sector or sub-sector	Limitations on MA	Limitations on national treatment	Add'al commits
Entry and temporary stay of foreign natural persons	*4) Unbound,* except for measures concerning the entry and temporary stay of natural persons in the following categories: business visitors, intra-corporate transferees (executives, managers, specialists) and professionals under service contract.		
Capital outflows / inflows	*All persons must have approval from the Bank of Albania for capital outflows* (foreign exchange) *in excess of $5000*. All persons *must declare the amount in cash/travelers checks in excess of $5,000 or equivalent* in any other currency when leaving or entering the country.		

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GATS, continued . . .

Sector-specific commitments

Norway – Schedule of commitments			
Sector or sub-sector	Limitations on MA	Limitations on national treatment	Add'al commits
Banking and other financial services (excl. insurance)	1) Active *supply of services related to banking*, financing, securities brokers and collective investment funds *requires a commercial presence in Norway.* 2) *Registration of securities*, as stated in the Act relating to the Registry of Securities regulating the book-entry registration system *for paperless securities is subject to a monopoly.* 3) *Commercial banks, securities firms and management companies for collective investment funds must be organized as joint-stock companies.* The same restrictions applies to trading in products derivative to securities, etc.	1) None 2) None 3) *In domestically-owned banks*, ie, banks where Norwegian investors own 2/3 or more, *the board of directors and committees must be Norwegian citizens residing in Norway.*	

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GATS, continued . . .

Sector-specific commitments

Norway – schedule of commitments			
Sector or sub-sector	MA limitations	Limitations on national treatment	Add'al commits
Banking and other financial services (excl. insurance)	3) *One or more foreign banks may be permitted to establish a new Norwegian commercial bank if one single foreign bank owns more than 50%* of the share capital in the new bank. **[conditions on foreign ownership]** *No single or coordinated group of investors may acquire more than 10% of the share capital in an existing Norwegian commercial bank…* Establishment in Norway of bank branches and financing undertakings established abroad is not permitted. . . . (continues)	At least 10 Norwegian citizens residing in Norway must participate in the establishment of a new Norwegian commercial bank. In foreign-owned Norwegian banks up to 1/3 of the members of board of directors and committees may be foreign citizens residing outside Norway. Chairmen must be citizens residing in Norway.	

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GATS, continued . . .

Sector-specific commitments

Norway – Schedule of commitments			
Sector or sub-sector	Limitations on MA	Limitations on national treatment	Add'al commit
9. Tourism and travel-related services			
A. Hotels and restaurants	1) None 2) None 3) None 4) Unbound, except as indicated in the horizontal section	1) None 2) None 3) None 4) Unbound, except as indicated in horizontal section	

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GATS, continued . . .

- MFN exemptions

Norway – List of MFN Exemptions				
Sector or sub-sector	Description of measure indicating its inconsistency with Article II	Countries to which the measure applies	Intended duration	Conditions creating the need for the exemption
Road transport: passenger and freight	Provisions of existing and future road transport agreements with one or more countries to reserve traffic rights for carriage to/from Norway and between 3rd countries.	All countries	Indefinite	Regional specificity of road transport services
Audio-visual services: motion picture and video tape prodn	To confer ***national treatment on audiovisual works thru gov't-to-gov't framework agreements on film co-production***. Such works may ***in some cases receive access to funding*** when this would not otherwise be available…	All countries (existing agreement with the UK)	Indefinite	The aim of such agreements is to *promote cultural links between the countries* concerned.

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GATS, continued . . .

3.5. Sectoral coverage of specific commitments

- Commitments on MA and national treatment

	High-income countries	All other countries	Large developing countries
	MA commitments taken, % of all services		
Weighted avg	40.6	9.4	17.1
No restrictions	30.5	6.7	10.9
Unweighted avg	53.3	15.1	29.6
	National treatment commitments taken, % of all		
Weighted avg	42.4	10.2	18.8
No restrictions	35.3	8.5	14.6

Source: Hoekman, 1996 in Hoekman and Kostecki, 2001

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GATS, continued . . .

- Measures of restrictiveness have limitations
  - Price effects of regs by types are indistinguishable
    - Trade barriers: MA and NT limitations
    - "Non-protective" regs (prudential measures, stds, etc)
  - Absence of commitments cannot be taken as the existence of limitations on MA or national treatment

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GATS, continued . . .

- Number of commitments by members, 2000

No. of committed sectors	No. of members	DCs	EMEs	LDCs
≤ 20	44	0	0	44
21-60	47	0	2	45
≥ 61	45	24	11	10

- All countries that have joined the WTO since 1995 have scheduled more sectors than their member countries at similar income levels

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GATS, continued . . .

- Commitments by sector

Sectors under which most commitments are taken	Reasons for scheduling	Sectors under which least commitments are taken	Reasons for not scheduling
Tourism has most and is most liberal	Not strategic and prudential nature of activity is low	Health and education sectors	Activities usually under the public sector domain
Business services rank second but commitments are not necessarily liberal	Covers a broad range of services under which foreigners could be providers		
Financial services and telecomm services	Sectoral agreements in these sub-sectors were concluded after 1995		

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GATS, continued . . .

- Commitments by mode

Mode 1.	Mode 2.	Mode 3.	Mode 4.
Accounts for 40% of total world value of TIS	20%	40%	0%
Regulatory precaution is greatest.	Most liberal, 50% of entries are "none"	More commitments than under mode 1 because it involves FDI.	Most restrictive mode; stems from horizontal commitments, i.e., immigration law
Gov't has less direct control over such activity. Gov'ts hesitate to allow MA over activities they cannot control.	Mode under which gov'ts can do least to control private activity.	Strong control thru ownership + limits on number of participants. Limits reflect licensing and qualification reqs, which do not need to be schedules FDI hypothesis must be qualified as many sectors remain highly restrictive, e.g., telecomm, banking and insurance	

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GATS, continued . . .

3.6. Services and rules on subsidies

- No disciplines on trade-distorting subsidies (limited empirical info on prevalence/effect)
- Are subsides regulated under GATS framework?
  - Scheduled limitations are essentially exemptions
  - Subsidy would be scheduled as a limitation and by mode
- CVMs do not have proper meaning in TIS
  - Which sectors are supported in services?
  - How do we determine the per unit value?

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GATS, continued . . .

3.7. Services and safeguards

- No specific rules on safeguards
  - National treatment limitations are a proxy
  - Would safeguards under mode 3 make sense?
- Types of safeguard measures: horizontal and sector-specific – What is the policy consideration?

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GATS, continued . . .

- 3.8. Misconceptions of the GATS
  - Members required to open all sectors to competition
  - Members required to abolish public funding
  - Members required to privatize services in public domain
  - GATS opens public services to competition
  - Liberalization means deregulation

Trade in Services, continued . . .

- Hong Kong Ministerial Declaration, adopted on 18 Dec 2005
  - *Para 25 – 27 "Services negotiation":*

    The negotiations on trade in services shall proceed to their conclusion with a ***view to promoting the economic growth of all trading partners and the development of developing and least-developed countries***, and with ***due respect for the right of Members to regulate***......Negotiations shall have regard to the size of economies of individual Members, both overall and in individual sectors.

Trade in Services, continued . . .

- *Para 58. Recently-Acceded Members:*

  We ***recognize*** the special situation of recently-acceded Members who have undertaken ***extensive market access commitments*** at the time of accession. This situation will be taken into account in the negotiations.

4. Economics of Services Trade

4.1. Theory: market failures - case for regs

- Internalities – recall characteristics
  - Non-storable and intangible
  - Quality assessment difficulties and 'asymmetric info'

Result: mkts might not be able to function properly

- Moral hazard
  - Market behavior influenced by imperfectly observable info
  - What can be done to correct mkt failure, apart from regs?
- Adverse selection
  - Problem of asymmetric info by either buyer or seller
  - What can be done to correct mkt failure, apart from regs?

Economics of Services Trade, continued . . .

- Imperfect competition: economies of scale, scope or product differentiation

  Factors to consider:
  - Contestability varies by sectors
  - Barriers to entry/exit
  - Internalities ↔ mkt power
  - Consumer loyalty - cost of switching providers
  - Self-regulation to correct mkt failure → market power

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Economics of Services Trade, continued . . .

- Externalities
  - Negative spillovers
  - Positive spillovers in services networks

  Result: regulate natural monopoly to prevent it from abusing its market power

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Economics of Services Trade, continued . . .

- Concluding comments: markets vs regulatory regimes
  - Regs do not eliminate moral hazard / adverse selection
  - Risks that private sector avoid are transferred to public sector
  - Tug-of-war b/t regulatory agency + competition authority
  - Technological change can make regs obsolete
    - Cost of consumers switching
    - Challenge an existing network
    - Provision of services through different modes

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Economics of Services Trade, continued . . .

4.2. Economics of int'al labor markets and mode 4

- Reasons for transfrontier labor movement
  - Involuntary movement of labor
  - Cheap/available land
  - Wages differ; labor scarcity
  - Skilled labor in search of immobile K/tech vs outsourcing
  - Unskilled labor in search of service employment
- Related issues
  - Labor standards and conditions differ
  - Labor market rigidities: unions, min wages, hiring conditions
  - Market failure: unemployment and domestic wage differentials
  - Labor productivity and its relation to access to capital
  - Remittances and its relation to expatriated labor

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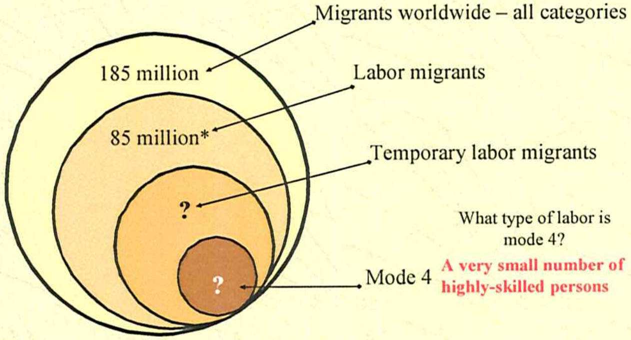
Economics of Services Trade, continued . . .

- Migration of labor in context of mode 4



Source: IOM presentation, Policy and Implementation; * ILO estimate

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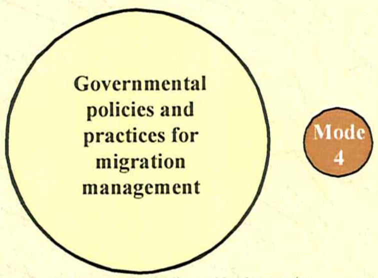
Economics of Services Trade, continued . . .

- Two separate regulatory frameworks
  - Framework for governing migration involve separate issues
  - Mode 4 regulations are about labor for services – not back door migration



Relevant regulatory framework involve tools that:
- Meet demand for labor;
- Protect domestic jobs/wages;
- Manage intra-corporate transferees;
- Provide domestic business access to services (contractual service suppliers);
- Promote business or investment (business visitors)

Source: IOM presentation, Policy and Implementation

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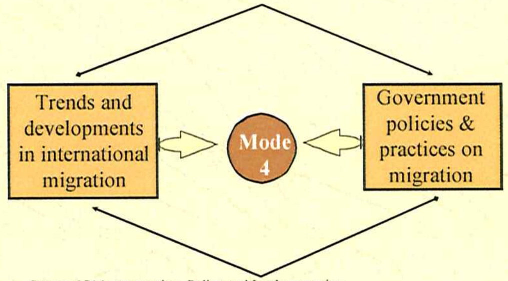
Economics of Services Trade, continued . . .

- Implications for mode 4
  - Better understanding of trends and policies
  - More efficient implementation of mode 4 commitments
  - Further liberalization along mode 4



Source: IOM presentation, Policy and Implementation

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Economics of Services Trade, continued . . .

4.3. Economics of international K-markets and mode 3

- Types of int'al K-flows
  - Loans, portfolio investment – financial services
  - FDI – mode 3
- Reasons for transfrontier movement
  - Capital in search of cheap labor
  - International interest rate differentials; K scarcity
  - Return on investment
  - Inefficient system of lending/borrowing in home mkt
  - Internationalization strategy to circumvent trade policy
  - Strategy to circumvent regulatory restrictions
  - Risk management of portfolio

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Economics of Services Trade, continued . . .

- Case for liberal K markets versus goods market
- Regulatory responses can confuse the effects of liberalization of financial services and K movements
  - Regulate financial services on grounds of risk or social cost of K-flight
  - Regulate foreign K on grounds that some services are a social right
- Case for FDI in services, mode 3, is straightforward for non-financial services

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Economics of Services Trade, continued . . .

- Case for financial services liberalization in LDCs
  - Competition with foreign banks raises the level of efficiency in domestic banking sector
  - Liberalization can trigger much needed capital inflow, particularly cross-border capital flows
- Multilateral vs regional liberalization

  Multilateral is likelier to
  - Result in greater efficiency and more K-inflows
  - Impose high requirements on LDCs' regulations

  Regional is likely to
  - Promote more competition among equals with similar regs
  - Improve the minimum efficient scale of banking

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Economics of Services Trade, continued . . .

- Foreign banks probably operate more efficiently than the local
  - Longer experience in competitive environment
  - Offer more sophisticated financial instruments at better price/quality
  - Used to deal with variable prices (eg., interest rates, fees, commissions)
  - More experience in assessing the risk of projects
  - Able to choose activities in a way to maximise profits
  - Advanced management methods
- Financial regs required for financial markets to function
  - In LDCs, capacity constraints make appropriate regulation and supervision of the financial sector difficult
  - Some argue: LDCs should not liberalise the sector or that they should pursue a restricted level of liberalisation until regulatory agencies are up to the task
  - Others argue: LDCs should regulate the financial sector differently than DCs, e.g. capital controls

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Economics of Services Trade, continued . . .

- Concluding comments on financial services liberalization
  - Technical difficulties are compounded by legal difficulties
    - Significant challenge for regulators in LDCs
    - Which legislative entity can and/or should regulate and supervise banks that operate in more than one country
  - Regionalism as a 1st step to improve the minimum efficient scale in retail banking in LDCs
    - Opens the K-account for regional flows and liberalization across all 4 modes
    - Allowing regional banks without location-specific regulatory costs can improve EOS, risk diversion, and more effective competition on a regional basis

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