



The Law and Economics of Trade in Services

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What role will services play in addressing major societal challenges?

- Human capital enhancement $Y = f(K, L, (T))$
- Mitigating climate change, green energies and their financing
- Designing intelligent cities and work places
- Nurturing the revolution in life sciences
- Inventing intelligent forms of mobility (transportation)
- Investing in the digital society – E-commerce, E-governance, E-health

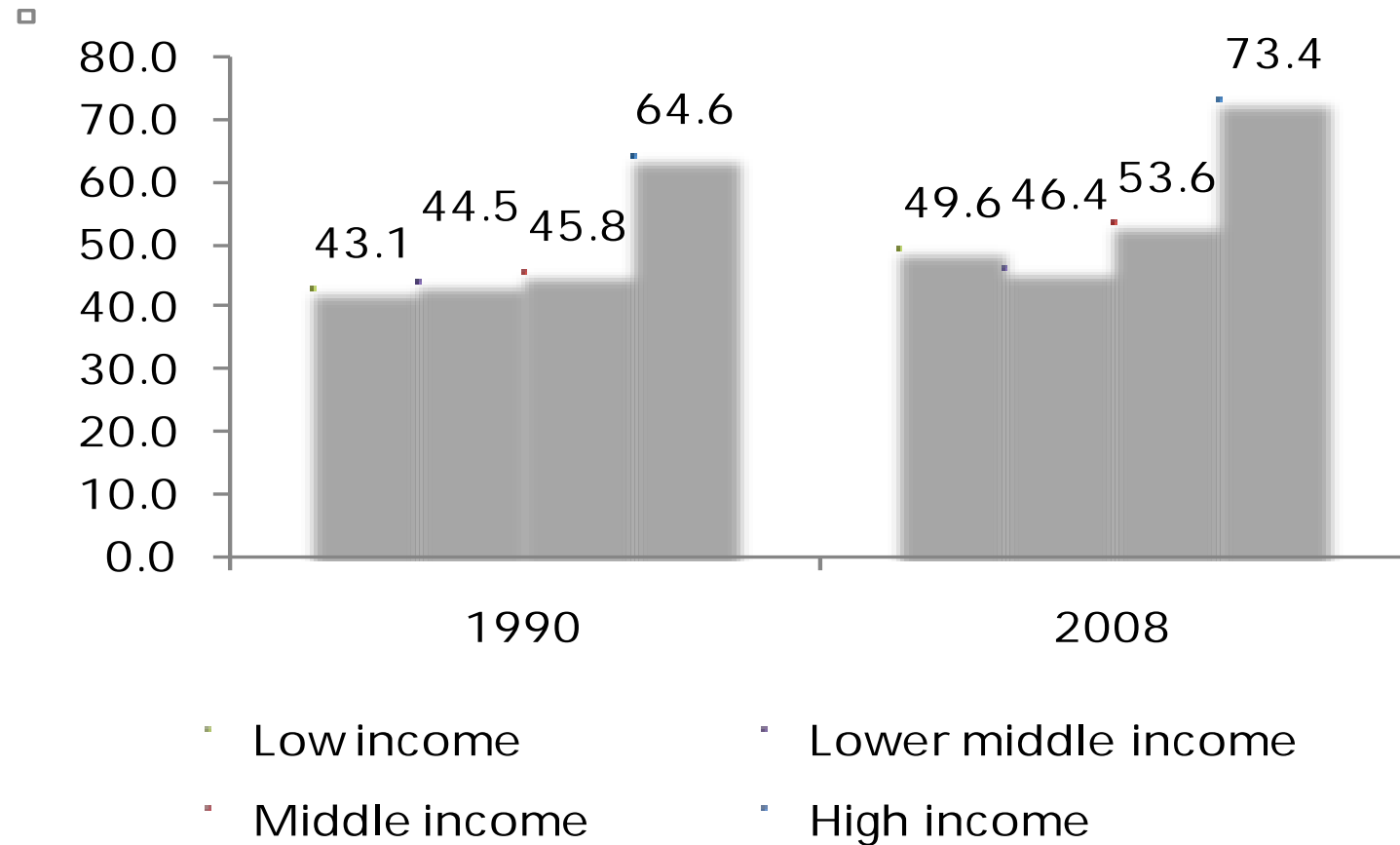
Each one of these meta challenges will require major doses of innovation in product design and delivery platforms, and the efficiency with which services – finance, ICT, business services, architecture, engineering, design, R&D, education – are delivered will be key in addressing these challenges

Responding to these challenges will also create vast new trade and investment opportunities, with or without trade agreements.

Key trends

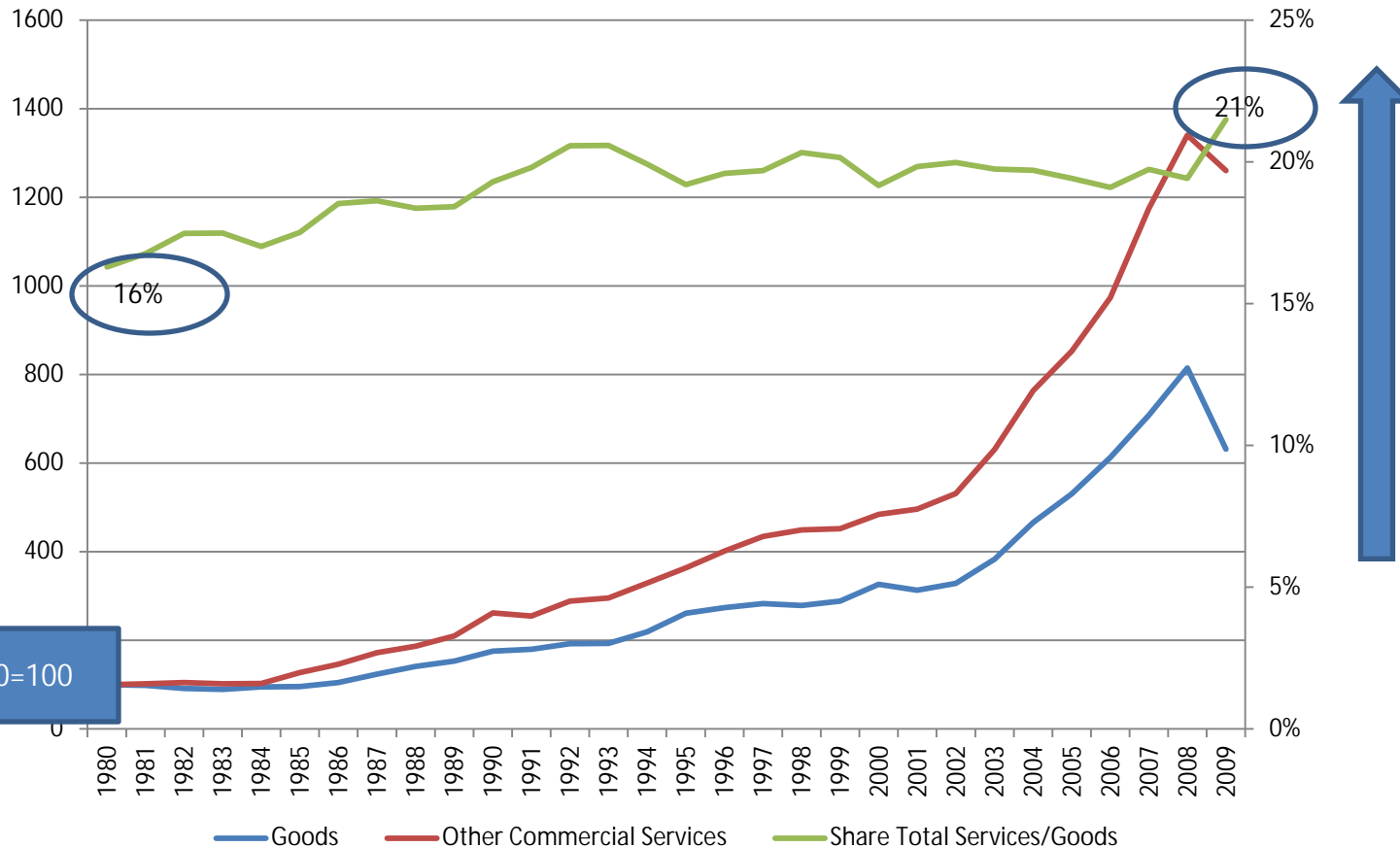
- Services trade offers enormous potential for welfare gains; in the area of temporary labour movement alone, possibly greater benefits than those flowing from the liberalization of all barriers to trade in goods
- Yet, limited *negotiating* traction so far, especially in the WTO (alongside far-reaching unilateral reforms and deeper PTA commitments)
- The political economy of novelty...even after 25 years, we are still in discovery mode and the Uruguay Round is not yet finished in services
- Novelty breeds precaution, especially in a world where many stakeholders seek the protection of regulatory sovereignty

On the rise: Services to GDP ratios



Source: World Bank, World Development Indicators

INTERNATIONAL TRADE IS NO LONGER EXCLUSIVELY ABOUT GOODS CROSSING BORDERS

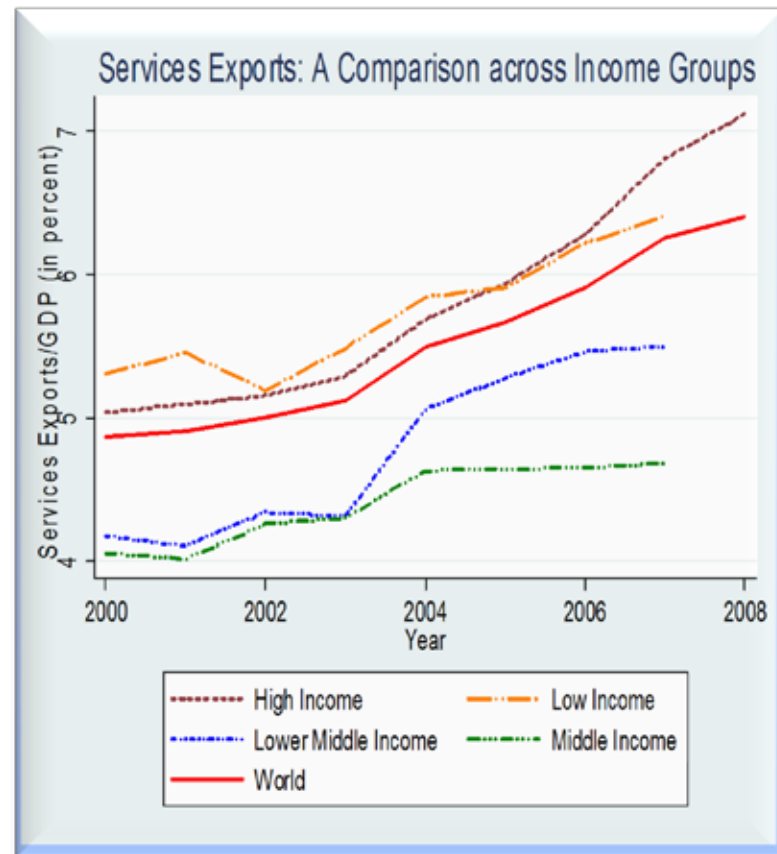


1980=100

Source: World Bank, World Development Indicators

INTERNATIONAL TRADE IS NO LONGER EXCLUSIVELY ABOUT GOODS CROSSING BORDERS

- India's success is well known, but not unique
- Developing countries are exporting a wide range of services



Source: World Bank, World Development Indicators

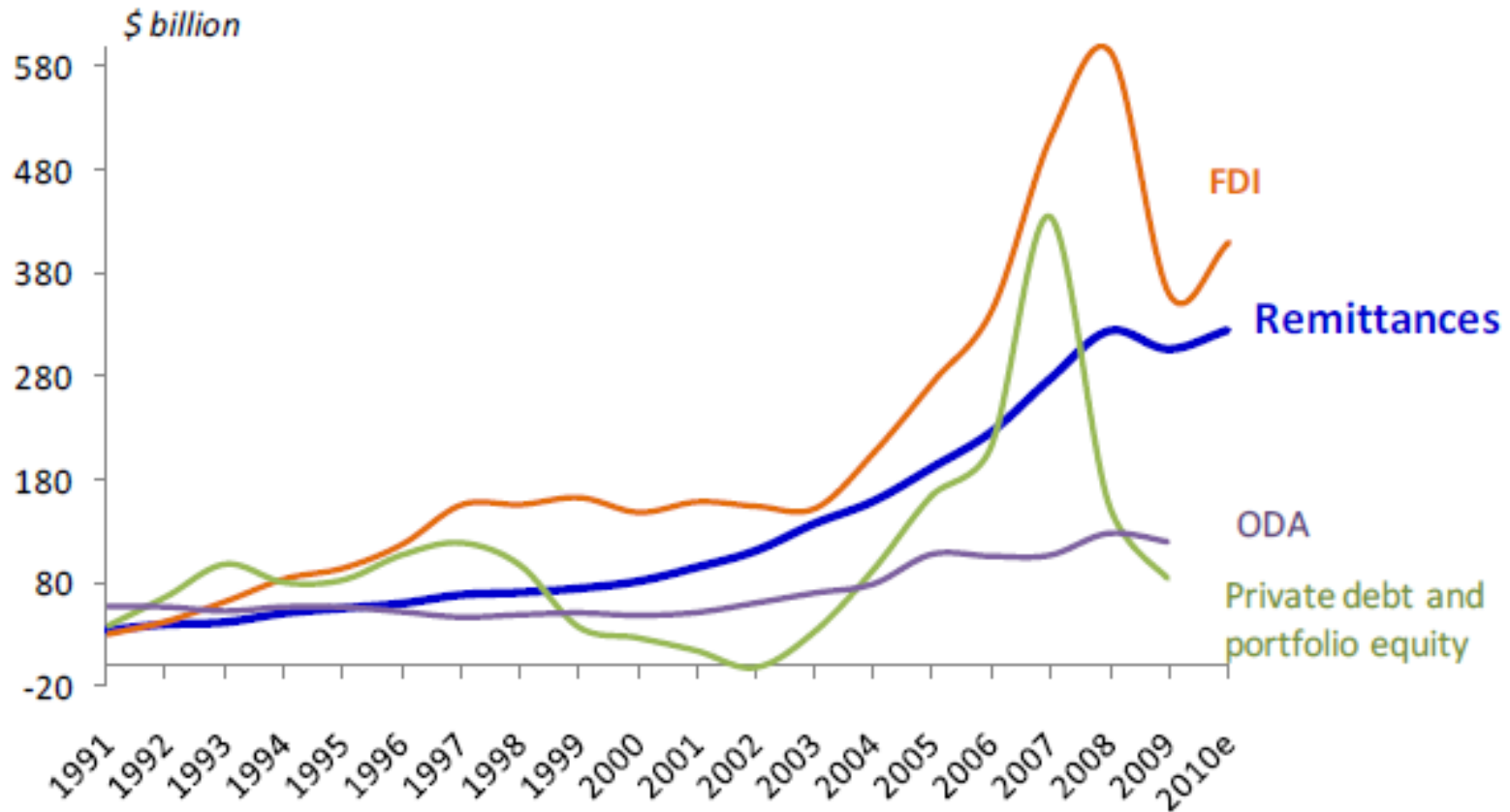
Services trade is expanding fast

Service Exports/GDP

A priori expectations about service sector reforms

- Ø The gains from liberalising services may be substantially greater than those from liberalising trade in goods.
- Ø This is so because:
 - Ø current levels of protection are higher in services and
 - Ø spill-over benefits from the oft-required movement of capital and labour
- Ø Infrastructural services (“producer services”) such as telecoms, finance and transport are crucial determinants of overall economic efficiency and growth.

FDI and remittances predominate as sources of developing country finance



A priori expectations (2)

- Ø Additional gains are associated with the fact that services protection tends to rely on *quota*-type restrictions, which tend to be:
 - Ø Less-transparent
 - Ø More distortive of competition and
 - Ø Less economically efficient (mostly non-revenue bearing) than tariffs in merchandise trade.

Key determinants of service sector growth

Q: What *meta* factors influencing the structure of the world economy account for the trends we have just depicted?

A: ?

Key Determinants

Technological change

Changes in the organization
of production

The growth of FDI

The supply of human capital

Changes in demand patterns

Ideology

Technological change

- Ø Technological innovation, especially (but not only) in information and communication technologies, was instrumental in:
 - Ø Contributing to dramatic cost reductions in information processing; and
 - Ø Increasing the tradability of services transactions.

- Ø Technological developments have allowed a large and growing number of developing countries:
 - Ø To insert themselves into the new international division of labour in services;
 - Ø To exploit new sources of comparative advantage; and
 - Ø To leapfrog entire stages of infrastructural development, notably through the spread and rapid adoption of mobile technologies (telephony and internet).

Changes in the organisation of production

- Ø The fragmentation of production and the intensification of competitive pressures have altered the manufacturing process.
- Ø Key service functions, e.g. design, accounting, after sales services, human resource management, that used to be performed within manufacturing firms, are today outsourced, including on a cross-border basis.
- Ø This has led to a secular drop in the share of manufacturing in GDP and employment and a commensurate rise in the share of services.
- Ø The rising strategic importance of logistics in the management of supply chains in just in time delivery patterns is illustrative of the key role of services in manufacturing efficiency.
- Ø Similar patterns of fragmentation and outsourcing are today at play in service industries, e.g. professional services, finance, travel and tourism, are increasingly relying on remotely supplied services.

The growth of foreign direct investment

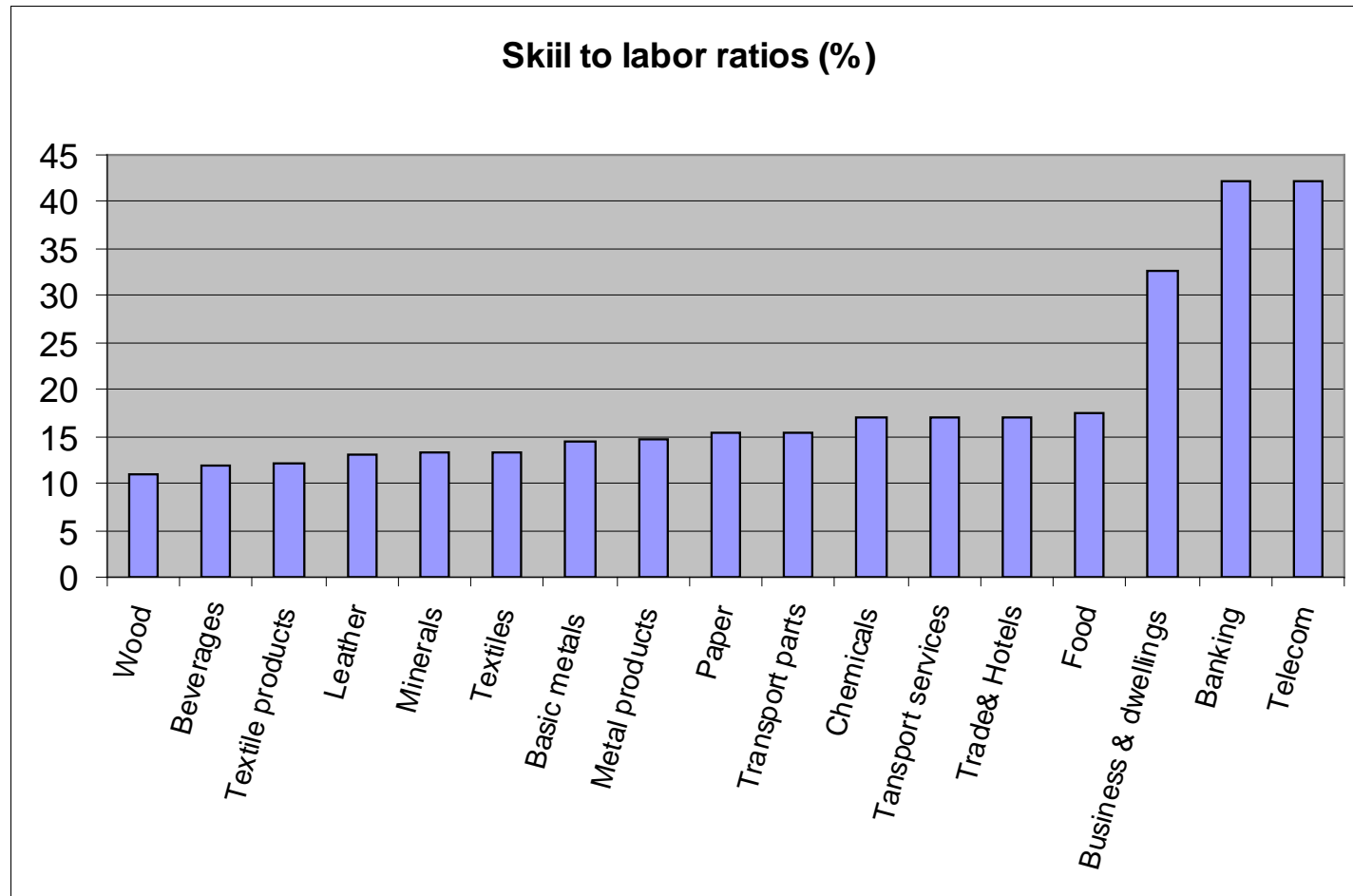
- Ø The growth FDI has far outstripped that of domestic output and international trade in recent decades, making cross-border investment the most powerful vector of globalisation.
- Ø Two successive FDI waves have contributed to the internationalisation of the service economy:
 - Ø Starting in the late 1950's, the rise of the multinational firm encouraged service suppliers to follow their manufacturing clients abroad (pull factors); and
 - Ø More recently, service industries have been pursuing their own (endogenous) internationalisation strategies in an environment characterised by trade and investment liberalisation, privatisation and pro-competitive regulatory reforms (push factors).

The supply of human capital

- Ø Service activities typically imply physical (human) contact and proximity between suppliers and consumers.
- Ø The service economy is diverse with segments of low-skill and low pay activities alongside (more important) segments of high-skill and high pay activities. The world's richest economies are all service economies.
- Ø Services liberalization typically entails a rise in the demand for high-skilled workers, driving up wages in these sectors and affecting overall income distribution (strong returns to higher education)
- Ø To sustain high productivity growth, service-driven economies need to devote increasing attention to the quality of human capital and to life-long learning.
- Ø This has fed strong growth in cross-border trade and investment in education and training services. More MILE students needed, please!

The supply of human capital (2)

Inter-sectoral skill intensities



Source: Amin and Mattoo (2006)

The supply of human capital (3)

- Ø Through international labour arbitrage, the increasing supply of skilled workers from developing countries has vastly increased competitive pressures in what is becoming a global labour market in many sectors.
- Ø In turn, this has increased the importance of managing human mobility, particularly skilled labour movement, including via trade agreements (through commitments on temporary labour mobility).
- Ø It has also raised controversy linked to migration and white-collar job displacement in many advanced industrialized countries, raising concerns of a service sector race to the bottom (e.g. Polish plumbers and Indian software engineers).

Changes in demand patterns

- Ø Services are highly income elastic.
- Ø Rising incomes are closely associated with a rising demand for various services – education, health, travel, entertainment
- Ø The globalisation of trade and investment leads to an increasing degree of convergence in consumer tastes (and hence demand) via the emergence of global brands and their advertising.

Ideological shifts

- Ø The collapse of centrally-planned economies and the rise of the “Washington consensus” emphasising market-friendly trade and investment policies resulted in a marked shift in attitudes towards the boundary between the market and the state.
- Ø The period since the late 1980’s has witnessed a sustained withdrawal of the state as owner-supplier of many services and its emergence as a regulator of services, responding to market failures and assuming the role of competition police in newly-competitive markets.

Ideological shifts (2)

- Ø The profound reassertion of governmental conduct in service industries led, in turn, to a worldwide wave of privatisation, investment liberalisation and the emergence of pro-competitive regulatory regimes in key service industries.
- Ø All of the above developments have contributed to the internationalisation of the service economy.
- Ø An interesting question for the future is whether and to what extent the recent financial crisis and the strongly interventionist forces it has unleashed constitute a cyclical or structural reversal of the above trends.

Why negotiate on services?

The promise (and limits) of autonomous liberalisation

Ø Most of the potential gains from services policy reforms can be secured through *autonomous* actions by the governments of developed and developing countries.

Why pursue services trade negotiations?

- Ø Unilateral liberalisation, while genuine and widespread, is far from even across regions, countries, sectors and modes of supply.
- Ø Prohibitive barriers remain, particularly in areas of greatest interest to developing countries (Mode 4).

Supporting domestic policy reforms

Services negotiations can help support domestic reform efforts:

- 1) Reciprocity-based bargaining can help governments overcome domestic opposition to reform;
- 2) Domestic (autonomous) reforms *cannot* address barriers in foreign markets;
- 3) A binding commitment is more difficult (and costly) to reverse in future and can strengthen the credibility of domestic policies, contributing to an improved investment climate;

Supporting domestic policy reforms (2)

- 4) Services agreements offer the possibility of pre-committing to future liberalisation with a view to instilling a greater sense of urgency to needed domestic regulatory reforms whilst promoting orderly adjustment; and
- 5) Additional commitments on transparency and regulatory principles can be important complements to the removal of explicit services trade barriers under services agreements.

Engaging in trade

- Ø Securing better access to imports of services can significantly improve overall economic performance by bringing:
 - Ø Higher quality services;
 - Ø Improved performance and competitiveness of domestic firms;
 - Ø International best practices, particularly in matters of domestic regulation;
 - Ø Better skills and technologies;
 - Ø Access to distribution networks; and
 - Ø For many developing countries, needed investment capital otherwise difficult to secure due to budget constraints and limited access to international capital markets.

Engaging in trade (2)

Services trade and FDI

- Ø The bulk of services trade occurs via an established presence (commercial presence - Mode 3).
- Ø Services account for almost half of the global *stock* of FDI and for more than 60% of FDI *flows* in recent years.
- Ø Services is also where 4 in 5 (80%) barriers to cross-border investment are found.
- Ø The strong contribution that key infrastructural services can make to overall economic performance means that developing countries have much to gain from autonomous FDI liberalization and from scheduling deeper commitments on Mode 3 (*e.g.* finance, energy, telecommunications and transport).
- Ø Scheduling commitments forms part of a signalling strategy vis-à-vis the foreign investment community.

Summing Up: Three core benefits

- **Deeper liberalization** through the reciprocal exchange of concessions
- **Enhanced Credibility** through binding commitments
- **Greater Regulatory cooperation** given the behind the border nature of protection in services markets

Defining characteristics of services

Intangible

Non-storable

Intermediates

Protected behind borders

Highly regulated

Diverse

Intangible

- Ø What is the value of a service? This is arguably harder to assign and measure than for “physical” goods.
- Ø Data limitations at both the national and international levels are pervasive in the services field.
- Ø Weak data means that the predictive value of economic models of services reforms is itself weaker.
- Ø Can you negotiate what you cannot properly measure? Weak data induces negotiating precaution, especially on the part of developing countries.
- Ø Negotiating implications: lack of precise data inhibits the quest for workable emergency safeguards provisions in services trade (need to document import surges and establish causation/injury).

Non storable

- Ø Unlike goods, the simultaneity of production and consumption distinguishes many services transactions.
- Ø Yet, we observe the increasing commoditization of many services that are embedded in goods or stored and delivered electronically.
- Ø There remains, nonetheless, a critical need for factor mobility, and its complex political economy in home and host countries:
 - Ø Movement of capital remains controversial in many host countries, especially developing countries; and
 - Ø Movement of labour (for work purposes) is resisted in most recipient countries, especially (but not only) in developed countries.
- Ø Definitional and negotiating implications: non-storability alerts us to the need to adopt a modal approach to defining services trade, with two modes of supply “Modes 3 and 4” focusing specifically on factor movements.

Intermediates

- Ø Services are inputs into all that a nation produces, brings to market, trades or invests in.
- Ø This is arguably the most central insight by far, with far-reaching implications for policy design and engagement in trade negotiations.
- Ø An inefficient service sector acts like a prohibitive tax on economy-wide performance.
- Ø Services trade policy should thus be designed like that affecting imports of capital goods.
- Ø Gains from trade come from both imports and exports, such that countries may have an incentive to engage in negotiations to secure access to (or reduce the price of) key inputs that may be lacking or that are inefficiently produced at home.

Protected behind borders

- Ø Domestic regulation, not tariffs, is the main instrument of protection in services.
- Ø Services negotiations are thus akin to dismantling non-tariff barriers: experience teaches us that this is slow and ponderous.
- Ø Absent a tariff/border tax, national treatment could not be a general obligation in services trade (i.e. applied without exceptions as in the GATT).
- Ø While a general obligation under GATS, even MFN is subject to exceptions in services trade (unlike in GATT).
- Ø Competition in services markets is very often *quantitatively* constrained: the maintenance of quantitative restrictions is allowed under GATS whereas it is outlawed under the GATT.
- Ø The regulatory intensity of services trade heightens the importance of disciplines on transparency.

Highly regulated

- Ø The ubiquity of market failure in the provision of services justifies the high level of domestic regulation found in services markets.
- Ø There are four main types of market failure in services trade:
 - Ø Monopolies and oligopolies (especially prevalent in network-based industries);
 - Ø Information asymmetries (finance/prudential standards and professional licensing regimes);
 - Ø Externalities (transportation and environmental services, cultural diversity); and
 - Ø Universal services/public goods (health, education).

Highly regulated (2)

- Ø The trade effects of the domestic regulatory response will vary depending on the type of market failure:
 - Ø Oligopolies/monopolies: need to correct the scope for access inhibiting conduct at the source, *e.g.* Reference Paper on Basic Telecommunications;
 - Ø For the three other types of market failure: need to ensure that legitimate regulatory objectives are achieved in the least trade-restrictive manner whenever possible, so-called “efficient regulation”;
 - Ø A key aim of trade disciplines is thus to ensure proportionality between regulatory objectives and the means to achieve them:
 - Ø Example: examination rather than re-qualification in professional licensing; and
 - Ø Importance – and controversial nature - of the GATS Article VI:4 work programme on the development of a necessity test for services trade.

Diverse

- Ø Complex political economy: industry is usually closer to sectoral regulators than to trade ministries; regulatory agencies can be powerful political actors.
- Ø Limits to reciprocal bargaining as a result of cross-country differences in specialization patterns.
- Ø Services negotiations entail the need to master many different regulatory languages and bureaucratic cultures (challenge of inter-agency coordination).
- Ø Building user coalitions may also be needed to overcome producer resistance to market opening:
 - Ø Financial industry lobbied hard for telecommunications liberalisation in Uruguay Round; and
 - Ø Manufacturers/distributors lobby for more liberal logistical/transportation services.
- Ø Acknowledging the need for sectoral specificity – dual architecture of GATS: horizontal disciplines and annexes addressing sectoral specificities.

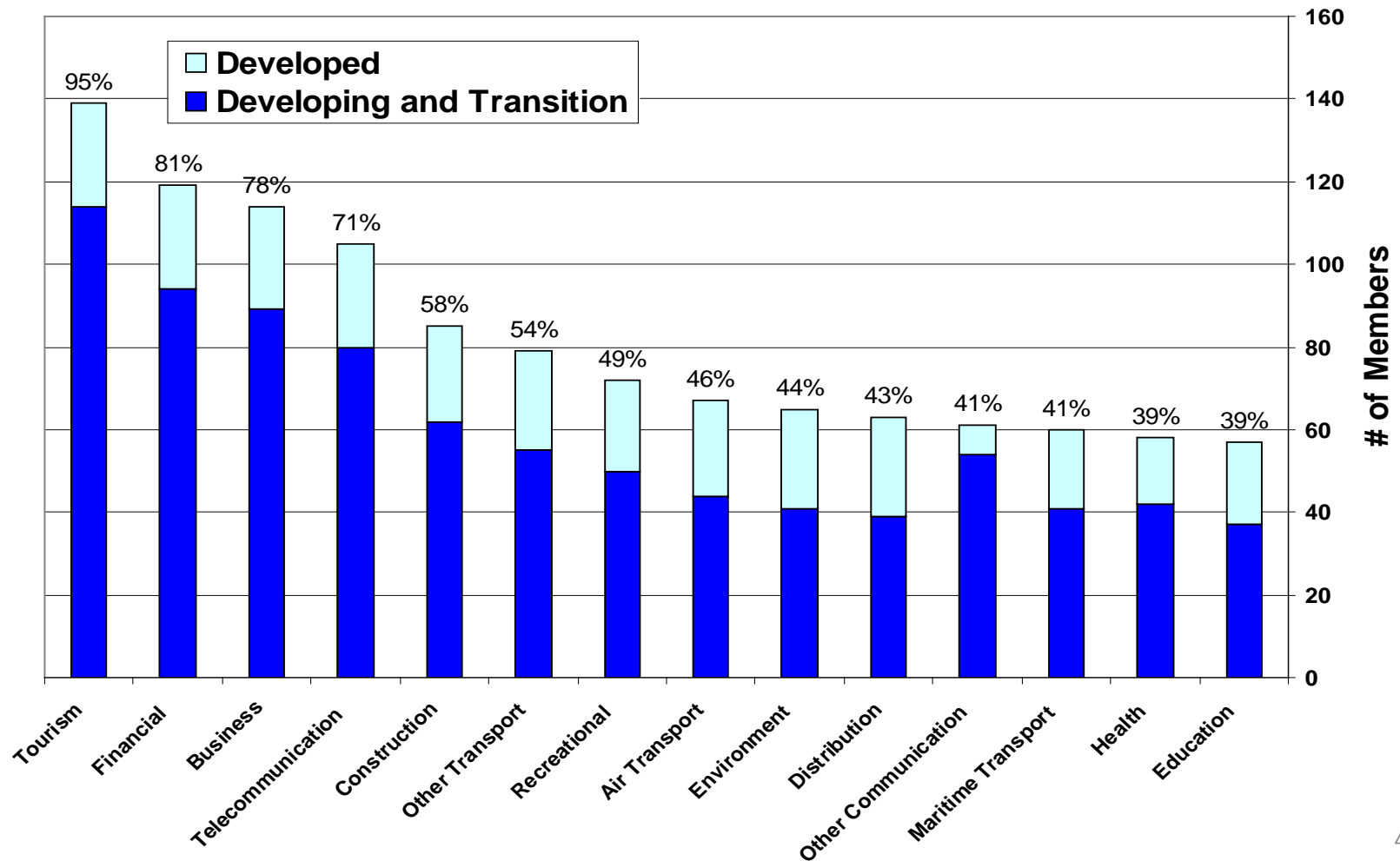
Negotiating issue	Treatment in GATT	Treatment in GATS
Modes of supply	Cross-border ; limited coverage of investment matters (TRIMs); no inherent need for factor mobility in goods trade	Inherent need for addressing factor mobility in services trade; reliance on four modes of supply: cross-border supply; consumption abroad; commercial presence; movement of natural persons
Quality of data, measurement, modelling	Comprehensive, disaggregated robust	Partial, aggregated, weak
National treatment	General obligation, no exceptions	A la carte in scheduled sectors and modes, subject to limitations; right to not schedule
Most-favoured nation treatment	General obligation without exception	General exception subject to one time exception upon GATS' entry into force or accession; with a weak/non-credible sunset clause
Quantitative restrictions	Prohibited; per se offense	Allowed, subject to listing in scheduled sectors and modes
Diversity	One size fits all; common rules to all sectors subject to goods disciplines	Co-existence of horizontal and sector-specific disciplines in annexes

Sales of Services by GATS Modes of Supply: 2005 Statistical Approximation

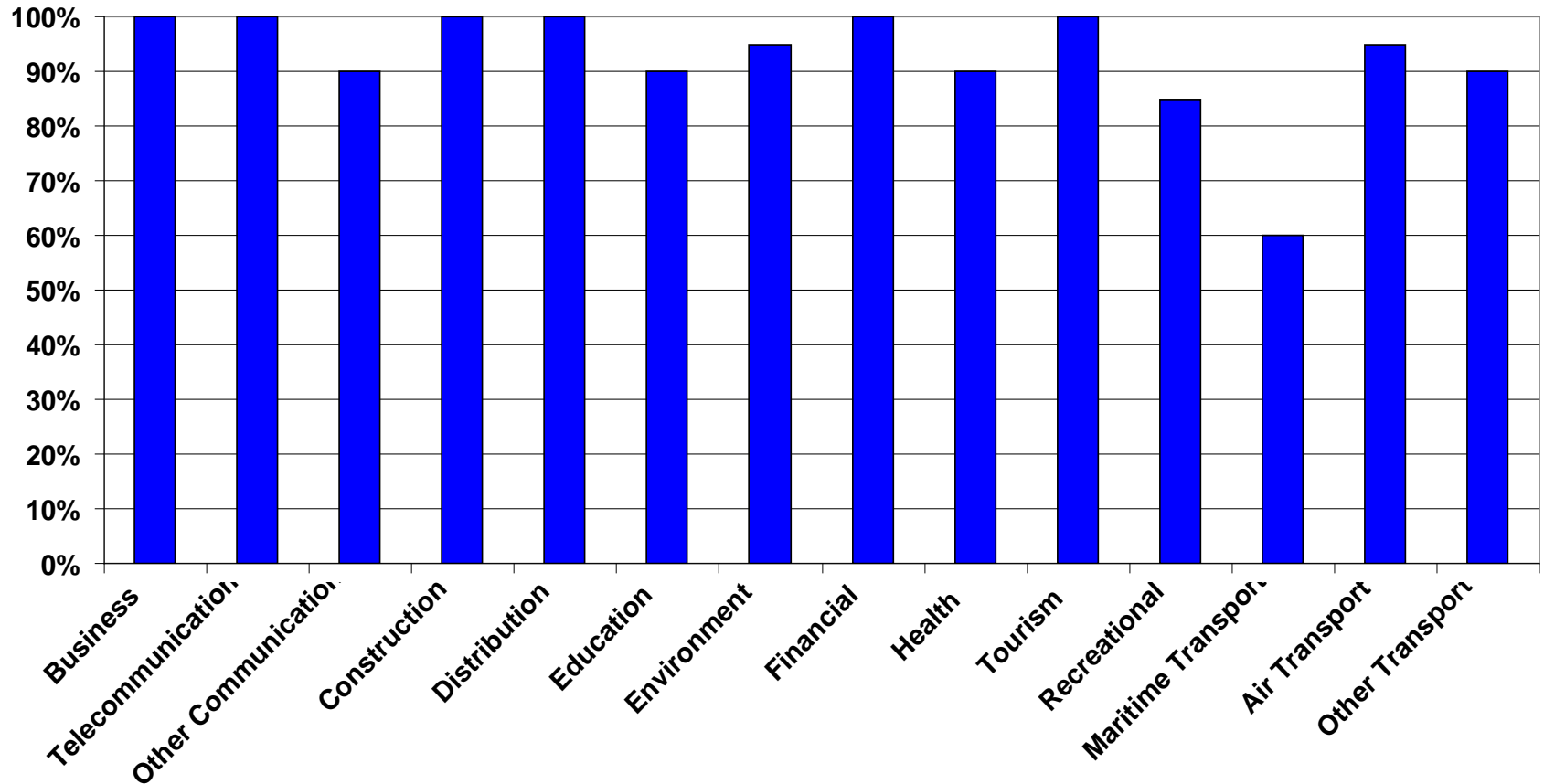
Mode of Supply	Estimated share
1 - cross-border supply	25 - 30 %
2 - consumption abroad	10 – 15 %
3 - commercial presence	55 - 60 %
4 – presence of natural persons	less than 5% (Approx. 150 billion USD)

**Key patterns in commitments and
negotiating offers
under GATS**

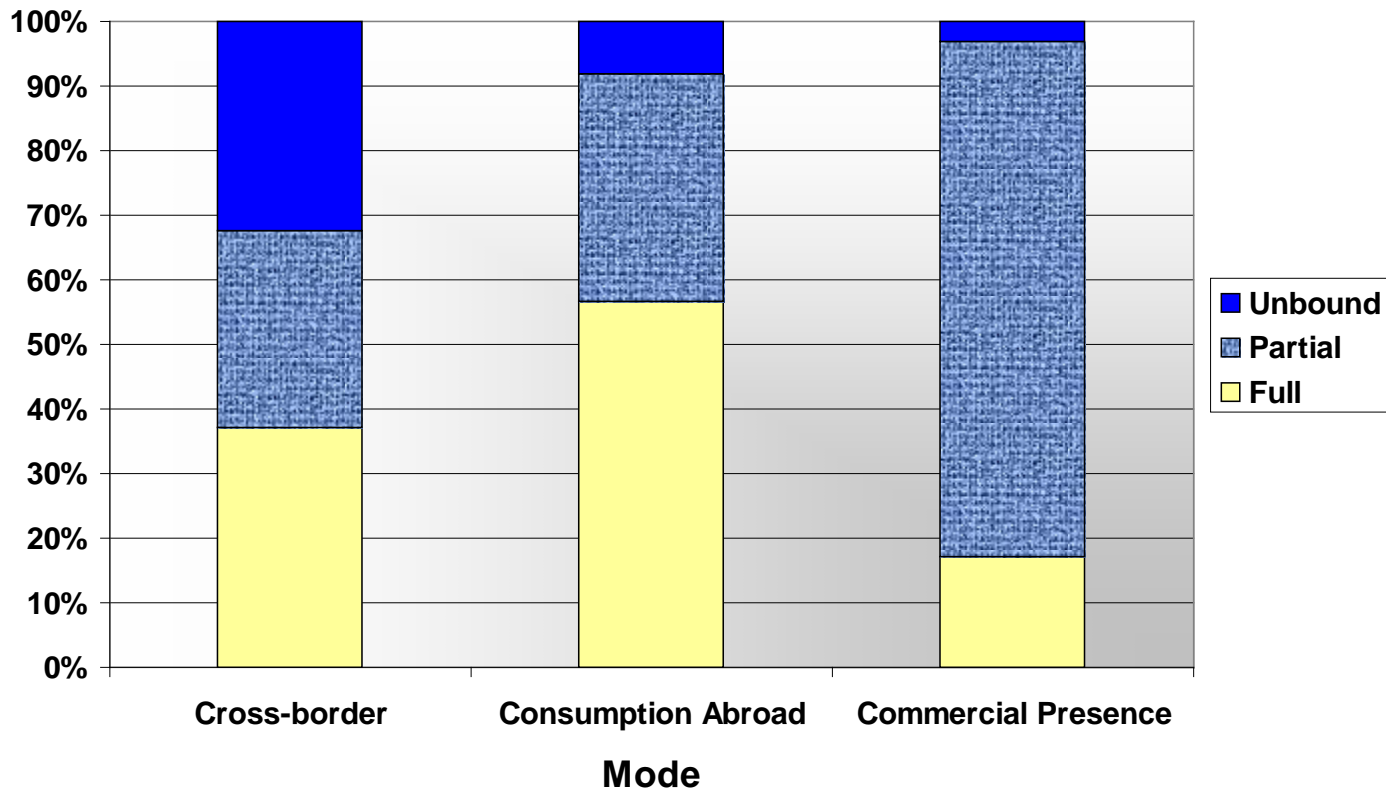
Sectoral distribution of current GATS commitments (current)



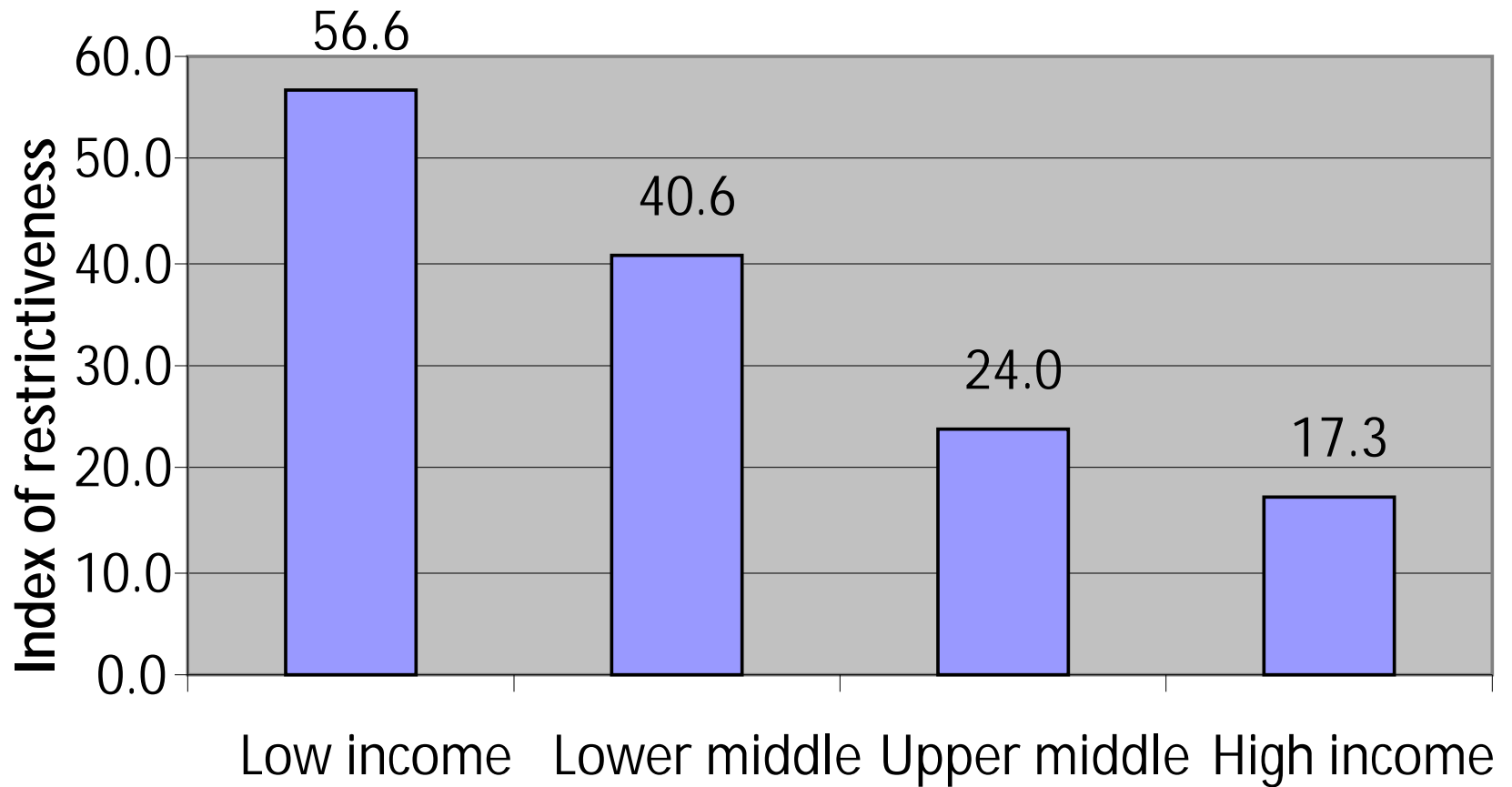
Proportion of Acceding Members with Commitments in Selected Service Sectors



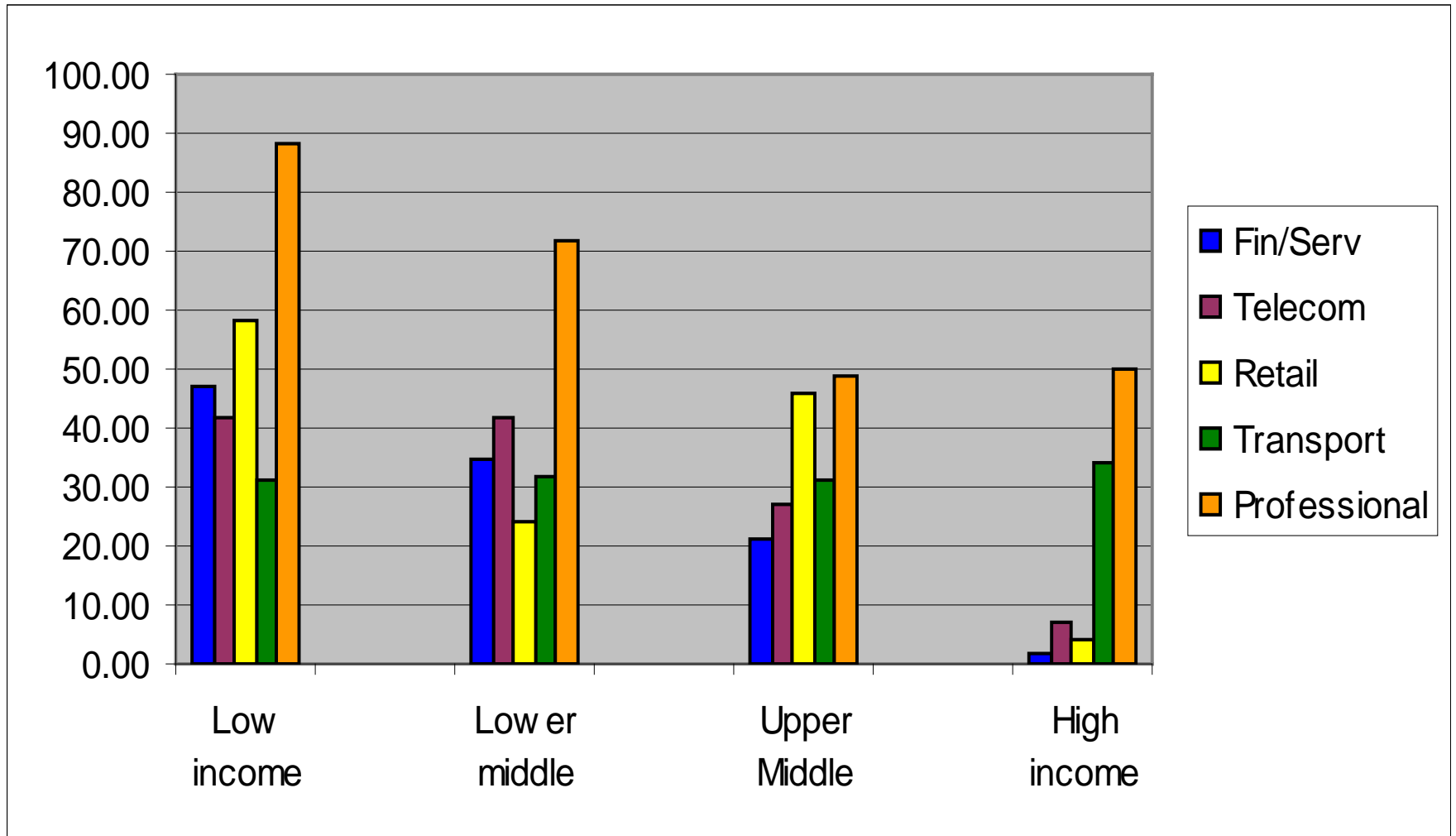
Nature of GATS Market access commitments (all Members)



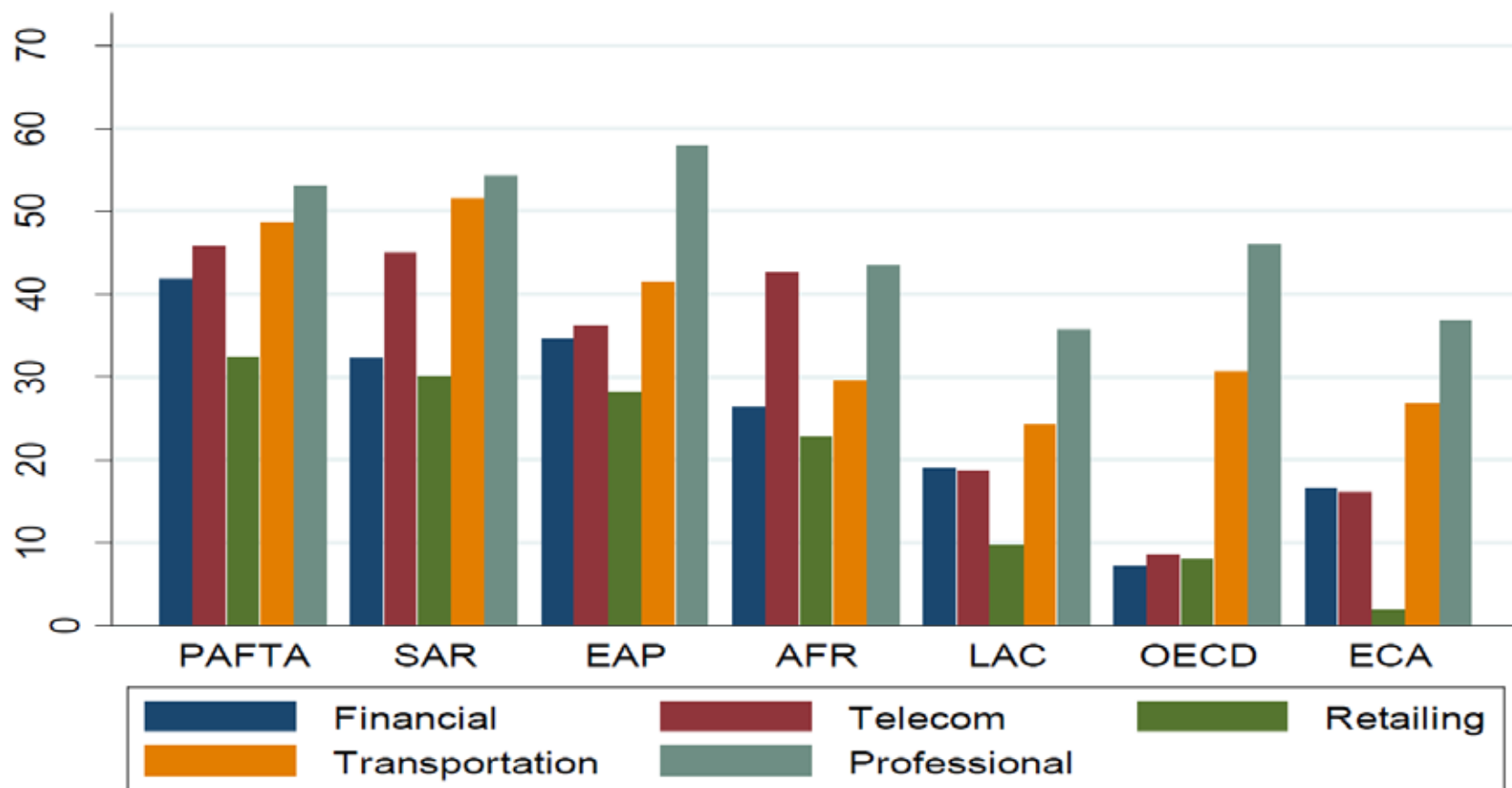
Restrictiveness of service trade/FDI policies by income groups



Restrictiveness by sector

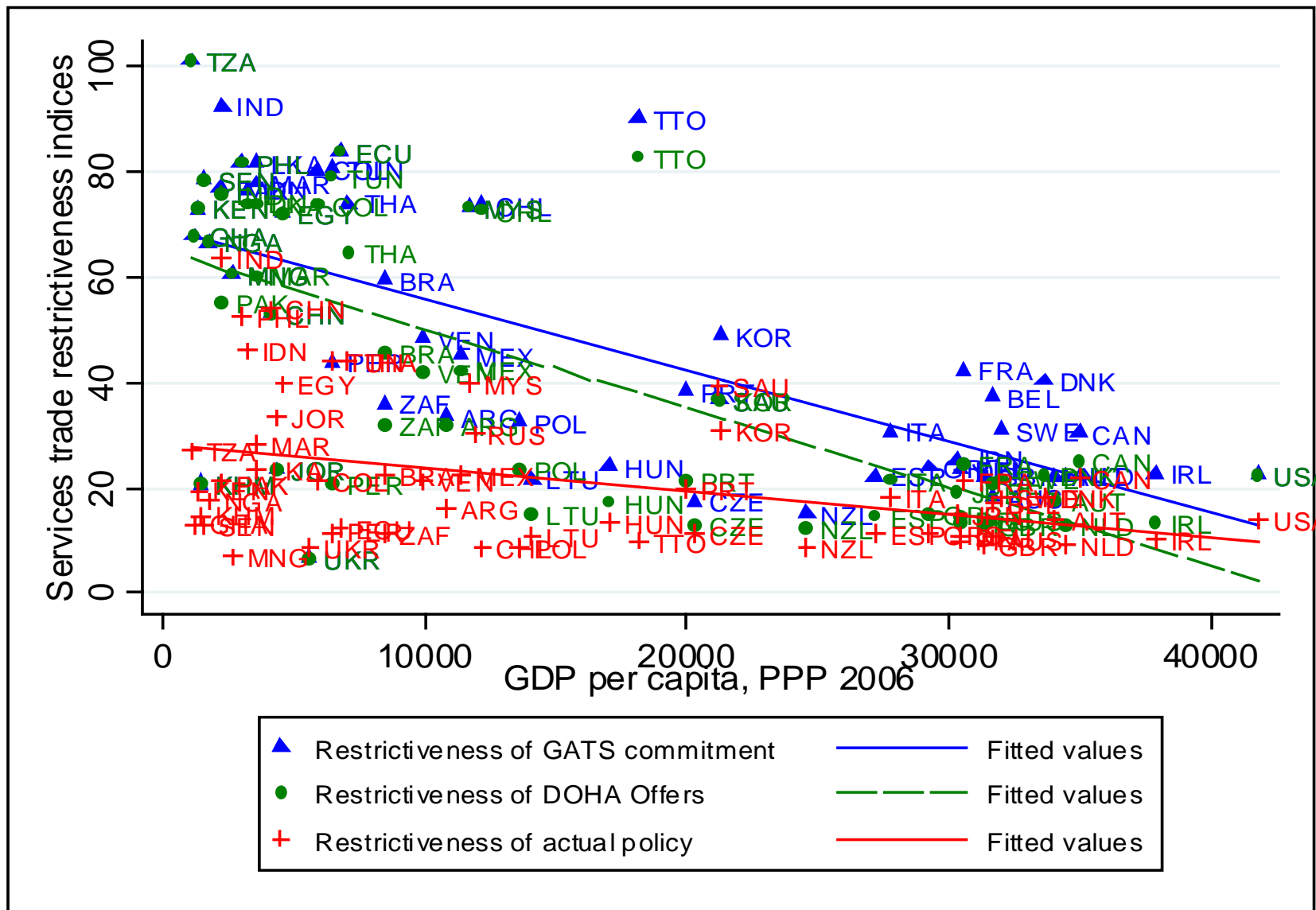


Services Trade Restrictiveness by Sector and Region



Note: Based on 100 countries (Algeria and Iran excluded);
Except for PAFTA, countries' regional affiliation follows WB classification.

GATS schedules, Doha offers and actual policy



Thank you!

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