

## CHAPTER 2

# The Contribution of Services to Development

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### Key Learning Objectives

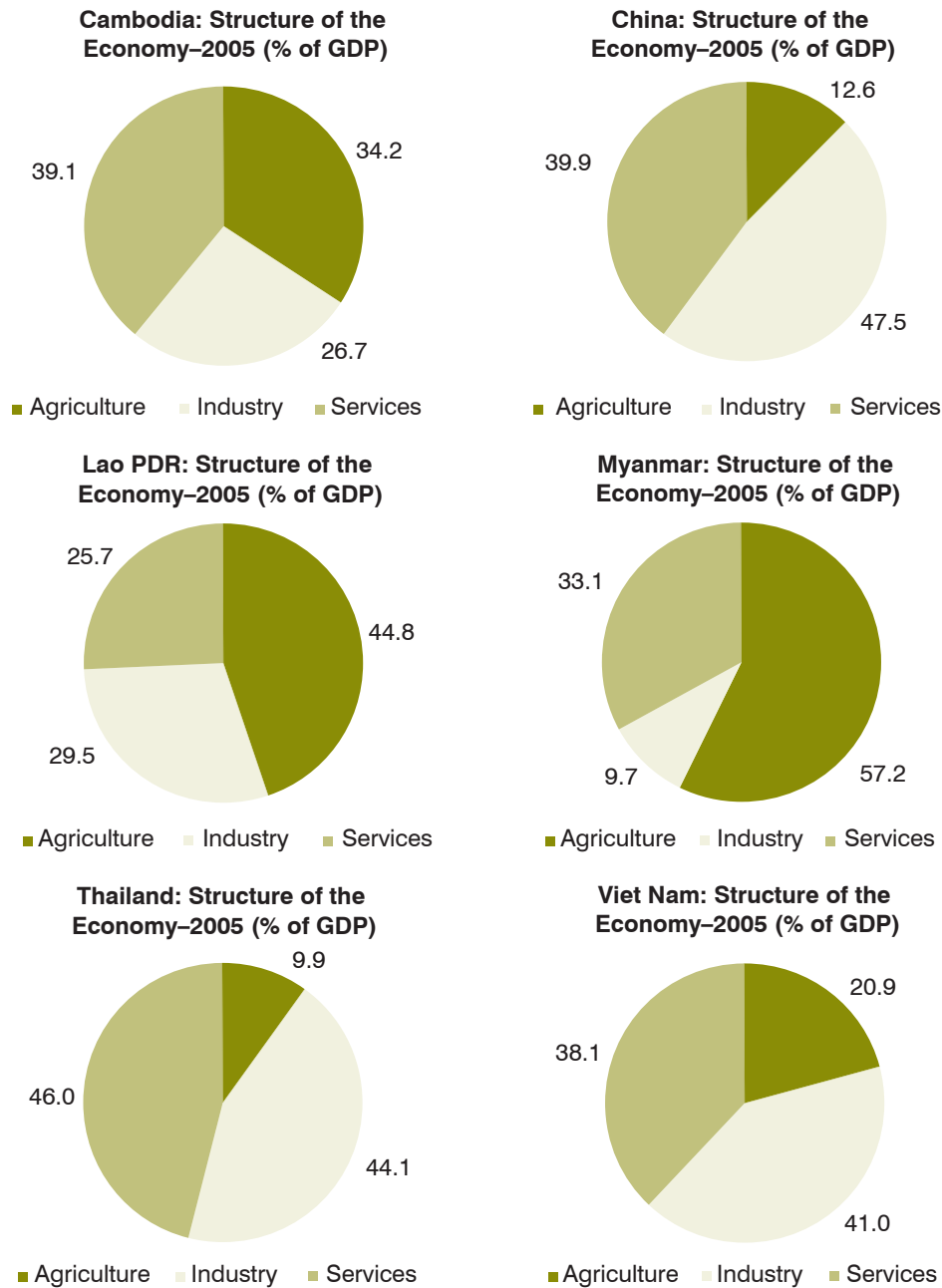
- Appreciating that services exert significant economy-wide effects and can affect investment climates;
- Understanding how the economic cost of protecting inefficient service sector is arguably greater overall than that of protectionism in the goods sector;
- Acknowledging that policy reforms to increase international competition in service industries can boost growth prospects and enhance welfare;
- Understanding the forces that have shaped the rise of services in domestic output and international trade in recent decades;
- Appreciating how services and services trade differ from goods and goods trade, and why such differences matter for purposes of trade regulation and the conduct of negotiations; and
- Understanding that despite the clear potential from greater engagement in services negotiations, services trade liberalization also carries risks and potential costs that need to be anticipated and properly addressed during and after negotiations, notably through appropriate adjustment policies.

The service sector is an important component of any country's economy. It makes a direct and significant contribution to gross domestic product (GDP) and job creation, and provides crucial inputs for the rest of the economy. In the process, services exert significant effects on economy-wide performance and on the overall investment climate. Some service sectors, such as health, education, water, and sanitation, are also directly relevant to achieving important social development objectives.

The trends depicted above can readily be observed in the Greater Mekong Subregion (GMS). Services account for a significant share of the subregion's GDP, ranging from 25.7% in the Lao People's Democratic Republic (Lao PDR) to 39.1% in Cambodia and 46.0% in Thailand according to recent figures (Figure 1). For both Cambodia and Thailand, services already represent the largest share



**Figure 1: The Share of Services in the GMS Economies**  
(Services as % of GDP)



GDP = gross domestic product, GMS = Greater Mekong Subregion, Lao PDR = Lao People's Democratic Republic.

Source: Tiranutti, V. 2008. Trade in Services in the GMS Countries: An Overview. Presentation to the ADB-ITD Training Course on Trade and Investment in Services, International Institute for Trade and Development. Bangkok. 11 February.



of their economies and their leading source of export earnings. The recent rapid liberalization of trade in services in the GMS countries has resulted from a confluence of factors, including regional integration efforts among members of the Association of Southeast Asian Nations (ASEAN), notably through the ASEAN Framework Agreement on Services (AFAS). In addition, the signing of free trade agreements (FTAs) between ASEAN and other economies such as the People's Republic of China (PRC) and the Republic of Korea, along with other FTA initiatives currently underway with Australia, India, Japan, and New Zealand, have given much greater prominence to services trade policy throughout the region.<sup>5</sup>

The importance of policy in the service sector goes beyond the sector itself. Services are essential inputs into virtually all production, and producers depend on services to deliver their output to end users. Because the price and quality of the services available in an economy have major impacts on all sectors, service-sector policies and efficiency-enhancing reforms, including regulatory and institutional changes, can exert major effects on overall economic performance.

An inefficient service sector acts like a prohibitive tax on a national economy. For this reason, the economic cost of protecting an inefficient service sector is arguably greater overall than that of protectionism in the goods sector. Countries are increasingly adopting an open trade and investment regime and a pro-competitive regulatory stance in key infrastructural service sectors—telecommunications, finance, transport, logistics, energy—to maximize benefits from the internationalization of services markets.

Countries able to exploit these opportunities have generally contributed to, and benefited from international economic convergence. In contrast, countries that fail to establish conditions conducive to the efficient provision of key infrastructural services run the very serious risk of falling further behind.

Policy reforms to increase international competition in services industries can boost growth prospects and enhance welfare. Countries with open financial and infrastructure service sectors have been found to experience a growth dividend estimated at 1.5 percentage points of GDP or more.<sup>6</sup> Country- and sector-specific

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<sup>5</sup> For a fuller discussion of trends in regional integration in Southeast Asia, see Section IV.

<sup>6</sup> Hoekman, B. 2006. *Liberalizing Trade in Services: A Survey*. *Policy Research Working Paper 4030*. Washington, DC: World Bank; Mattoo, A., R. Rathindran, and A. Subramanian. 2006. *Measuring Services Trade Liberalization and its Impact on Economic Growth: An Illustration*. *Journal of Economic Integration* 21, pp. 64–98; Eschenbach, F. and B. Hoekman. 2006. *Services Policy Reform and Economic Growth in Transition Economies, 1990–2004* *Review of World Economics*, 142(4), pp. 746–64.



analyses of services liberalization document the relationship between more open and competitive service sectors and productivity performance in services-intensive sectors such as domestic manufacturing, extractive industries, agriculture, and fisheries.<sup>7</sup> Foreign direct investment (FDI) in services is a major means through which “best practices” and knowledge are diffused to host countries and linkages to regional and production networks established.

Services such as telecommunications, transport, banking and insurance, logistics, and distribution constitute much of the infrastructure that is required for trade. They are used intensively in all production, making up 10%–20%, and sometimes more (an estimated 20%–25% in some countries’ ready-made garments industry), of production costs in both manufacturing and agriculture.<sup>8</sup> These figures and observations attest to the economic and commercial significance of the service sector and of negotiations aimed at progressively rolling back impediments to trade and investment in it.

In many countries, the development process typically coincides with growth of the service sector alongside a steadily reduced share for agriculture in employment and output (Figure 2). The question is thus not whether or not to embrace a more service-centered development path—a process of structural transformation that tends to occur spontaneously as incomes rise and economic development proceeds—but rather how to pursue it and at what pace? A further question is how trade and investment policy, hence engagement in trade and investment negotiations, should accompany such structural adjustment to ensure that it proceeds in an orderly, predictable manner.

### Key Determinants of Service Sector Growth

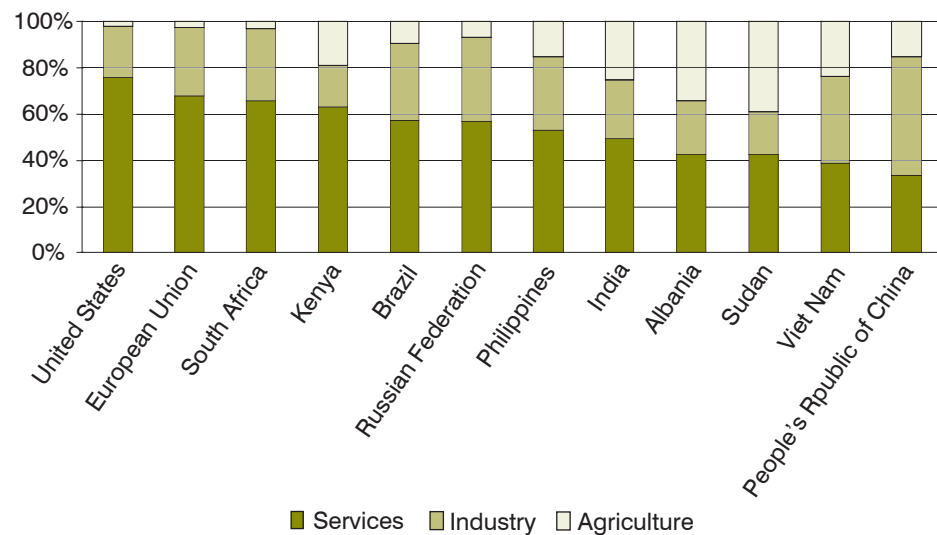
The rising importance of the service sector in domestic economies and its growing contribution to international trade and investment can be traced to a number of structural forces shaping global integration. Five such forces can be identified as contributing most to the increasingly service-centered nature of worldwide production and exchange patterns.

<sup>7</sup> Arnold, J., B. Javorcik, and A. Mattoo. 2007. *The Productivity Effects of Services Liberalization: Evidence from the Czech Republic. Policy Research Working Paper 4109*. Washington, DC: World Bank; Arnold, J., A. Mattoo, and M. Narcisco. 2006. *Services Inputs and Firm Productivity in Sub-Saharan Africa: Evidence from Firm-Level Data. Policy Research Working Paper 4048*. Washington DC: World Bank.

<sup>8</sup> Zedillo, E., and P. Messerlin with J. Nielson. 2005. *Trade for Development. Background report for United Nations Millennium Project*. New York. Chapter 4. Also available: [www.unmillenniumproject.org](http://www.unmillenniumproject.org)



**Figure 2: Share of Services in GDP, Selected Countries, 2006**  
(%)



GDP = gross domestic product.  
Source: World Bank.

### Technology

Technological innovation has vastly increased the tradability of services transactions while contributing to dramatic cost reductions in information processing in recent decades. In particular, the revolution in information and communication technology (ICT) has allowed the digitization of data, giving birth to e-commerce and the possibility of remotely supplying an ever more dizzying array of business services—the most tangible manifestations of technology’s contribution to the service economy. Such developments have allowed a large and growing number of developing countries to interpose themselves into the new international division of labor in services trade and to exploit new sources of comparative advantage. It has also allowed developing countries to leapfrog entire stages of infrastructural development, notably through the spread and rapid adoption of mobile technologies (telephony and internet). The service sector-enhancing properties of technology are being felt much more widely than in just the ICT sector; they can be seen in applications as diverse as containerized shipping, the design of long-distance aircraft, and energy storage, reducing costs and facilitating trade with similar far-reaching results.



### Changes in the Organization of Production

The fragmentation of production, the creation of regional and global production networks, and the intensification of competitive pressures that have come in globalization's wake have fundamentally altered the manufacturing process. One important consequence has been the rising strategic importance of logistics management in servicing just-in-time delivery patterns. The growing recourse made to outsourcing services functions—from design to accounting to after-sales services and human resource management—that used to be performed inside manufacturing firms and computed as such in national income accounts has been just as fundamental.

A similar process of fragmentation is under way today in service industries themselves. Making powerful use of the ICT revolution, firms in transportation, banking, insurance, telecommunications, utilities, health care, and various professions and business services are increasingly relying on—and providing—remotely supplied services. In the process, an entirely new geography of services trade has emerged.

### The Growth of Foreign Direct Investment (FDI)

During the past few decades, the growth of foreign direct investment (FDI) has far outstripped that of GDP and international trade, creating ever-tighter links of production and exchange between countries. FDI has arguably been the most powerful vector of globalization, and two successive waves of cross-border investment activity have contributed to the internationalization of the service economy.

A first wave, reaching as far back as the 1960s and continuing today, was led by the spread of manufacturing firms in search of new markets or export platforms. In expanding globally, such firms encouraged the internationalization of home-country service suppliers, which followed their corporate clients abroad in sectors as diverse as construction and engineering, professional and business services, banking and insurance, telecommunications and information services.

A second, more recent, wave of FDI-induced internationalization of the service economy has displayed more endogenous patterns. Major firms in all key service sectors are pursuing their own internationalization strategies in an environment characterized by far greater host-country openness in the wake of pro-competitive regulatory reforms, privatization, and investment liberalization. This second wave has been spawned by the fragmentation of services production and the creation



of ICT-dependent production networks in services, with investors from developing countries becoming increasingly active players in cross-border merger and acquisition activity.

### **The Supply of Human Capital**

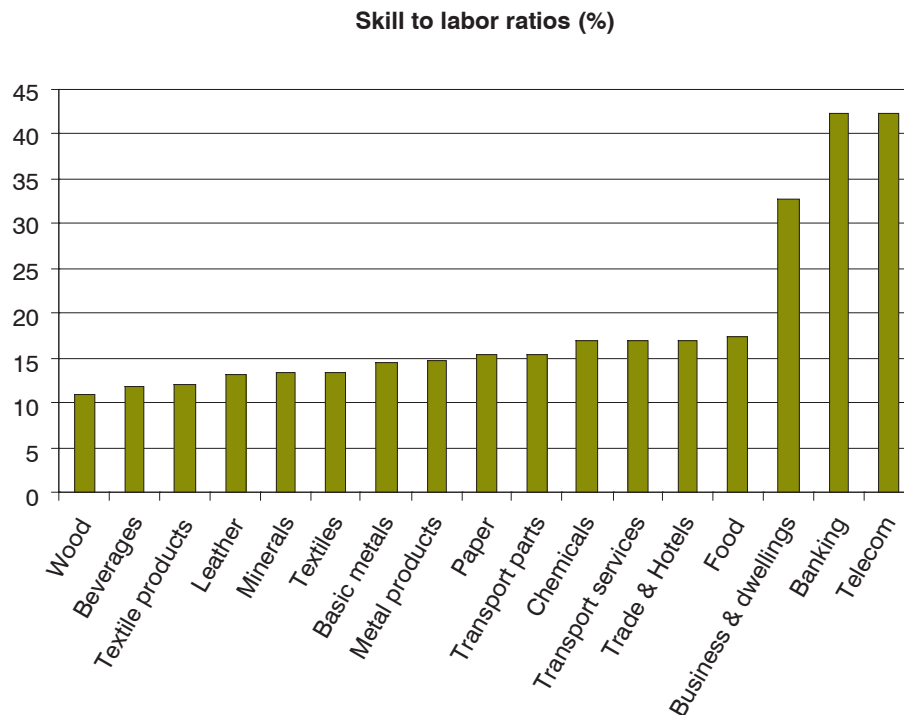
Service industries everywhere make abundant use of labor, and the very nature of many service activities, from haircuts to medical services, often implies physical contact and proximity between suppliers and consumers. The scope for adopting labor-saving production methods is generally more limited in services than it is in agriculture, extractive industries, or manufacturing, though cross-border labor arbitrage in the performance of certain labor-intensive service activities has become increasingly possible through ICT applications. While the service economy includes pockets of low-qualified, low-skill, low-pay activities, it also comprises many segments that require above-average skill levels. As Figure 3 reveals, service sectors such as finance, engineering, ICT, health, education, and energy rank among the highest in skill-to-labor ratios. It is hardly a coincidence that the world's richest economies, where average wages and labor productivity levels are highest, are precisely those with the highest shares of services in output and employment. Yet to maintain income and productivity growth, service-centered economies need to devote increased attention to the quality of human capital and its lifelong training. The latter challenges are ones that cross-border trade and investment in services can help meet.

Several developing countries, including some in the GMS, have experienced strong increases in the supply of human capital in recent years as a result of determined efforts at improving overall education and training standards. In some instances, such as the PRC, Viet Nam, and Singapore, those efforts have included trade and investment liberalization aimed at attracting top-ranking foreign providers of higher education.

The supply of skilled workers from developing countries, which by some accounts has increased by a factor of four since the early 1990s, has vastly intensified competitive pressures in a growing global labor market—at times provoking fears among blue- and white-collar workers in rich countries over job displacement arising from the fragmentation of manufacturing and services. At the same time, rising skill levels have made workers more mobile, creating strong demand for managing so-called Mode 4 trade, or the temporary movement of service suppliers, including via trade agreements, in the interests of sending and receiving countries alike.



**Figure 3: Intersector Skill Intensities**



Source: Amin, M., and A. Mattoo. 2006. Do institutions matter more for services? *Policy Research Working Paper 4032*. Washington, DC: World Bank.

### Ideology

Few structural transformations in the world economy are immune from the political, economic, regulatory, or ideological context within which they occur, and the growth of the service economy and the advent of rules governing cross-border trade and investment in services are clearly no exception. The last few decades have witnessed nothing short of a revolution in thinking in political circles about the proper boundaries between the market and the state, notably with regard to ownership and supply of critical service activities such as telecommunications, finance, transportation, and energy. This revolution has been induced in large measure by the four previous key determinants and their interaction.

The collapse of Soviet communism in the late 1980s and the rise of the so-called Washington consensus that ensued, with its emphasis on market-friendly trade



and investment policies, resulted in a marked shift in government attitudes toward service sector regulation. The result in most countries, developed and developing, has been the steady withdrawal of the state as owner-supplier and its emergence as a regulator of services, responding to market failures and officiating in newly competitive markets. Such a profound realignment of government conduct in services led, in turn, to a worldwide wave of privatization, investment liberalization, and the emergence of pro-competitive regulatory regimes and strengthened enforcement of competition policy in important service industries. All of these developments contributed to the internationalization of the service economy, prompting calls, including in trade policy circles, for collective action and for creating rules of the game at the regional and multilateral levels to further the internationalization process and to ensure that the quest for greater market contestability will proceed in a transparent, predictable, and nondiscriminatory manner.

### Defining Characteristics of Services and Why They Matter for Trade Regulation

While services and services trade share many properties with goods and goods trade, goods and services differ in a number of ways that matter significantly for policy design and rule-making. Six distinguishing characteristics appear most important and worthy of analytical attention. Table 1 offers a synthesis of key differences between General Agreement on Tariffs and Trade (GATT) and General Agreement on Trade in Services (GATS) in the light of these characteristics.

**Table 1: Characterizing Differences Between Goods and Services in Trade Law: A Synthesis**

Negotiating Issue	Treatment in GATT	Treatment in GATS
<b>Modes of supply</b>	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
<b>Quality of data, measurement, modelling</b>	Comprehensive, disaggregated robust	Partial, aggregated, weak

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Table 1: continued

Negotiating Issue	Treatment in GATT	Treatment in GATS
<b>National treatment</b>	General obligation, no exceptions	A la carte in scheduled sectors and modes, subject to limitations; right not to schedule
<b>Most-favored nation treatment</b>	General obligation, no exceptions	General obligation subject to one time exception upon GATS' entry into force or accession; with a weak/non-credible sunset clause
<b>Quantitative restrictions</b>	Prohibited; per se offense	Allowed, subject to listing in scheduled sectors and modes
<b>Diversity</b>	One size fits all; common rules to all sectors subject to goods disciplines	Co-existence of horizontal and sector-specific disciplines in annexes

GATS=General Agreement on Trade in Services, GATT=General Agreement on Tariff and Trade, TRIM=Trade-Related Investment Measures.

Source: Author.

## Intangibility

Unlike goods and the inputs required to produce them, which are tangible by their very nature, many services involve the application and transformation of intangible knowledge into intangible value-adding outputs that are harder to measure in almost all instances, particularly when supplied across borders. This difficulty of measurement largely explains why data on the production and exchange of services remain so weak and highly aggregated, lessening the ability of governments to measure the full contribution of services to output, trade, and development. It also generates economic models with considerably weaker predictive power, confronting governments with greater uncertainty over the likely consequences of alternative policy or negotiating approaches. The result is once again a propensity toward greater precaution in negotiated outcomes and toward legally binding commitments often scheduled at a level below prevailing regulatory and market-access conditions.

The paucity and highly aggregated nature of services trade statistics also hinder attempts at designing an emergency safeguard mechanism (ESM) for services trade under Article X of GATS, or under the services chapters of preferential trade agreements (PTAs). This is so because the current state of services trade data



does not allow us to determine the origin and value of potential import surges in specific service sectors precisely, or to establish credible causal links between such surges and the potential injury faced by “like” domestic service providers. For this reason, a GATS ESM remains elusive a decade and a half after the GATS Article X negotiating mandate was agreed.

### **Nonstorability**

Unlike goods, whose production is typically wholly removed from final consumption, and which can be produced in a plant, stored in a wholesale warehouse, and then shipped to a retail distributor for final purchase, many services can only be consumed at the point of purchase, and therefore require simultaneous production and consumption. It is true that technology now makes it possible to store certain services digitally for deferred consumption. Still, the vast majority of services—from haircuts to real-time medical interventions to phone conversations to consulting services—remain nonstorable. This means that factors of production—capital and labor, each of which has its own complex political economy—must be mobile for most service transactions to occur.

The nonstorable character of many services explains why the definition of trade in services needed to look beyond so-called Mode 1 trade (goods-like cross-border transactions where only the service itself crosses a border) and cover transactions involving the movement of people, either as consumers (Mode 2 trade) or as service providers (Mode 4 trade), as well as services sold via the establishment of a commercial presence in a host country market (so-called Mode 3 trade).

Adding factor mobility to the negotiating equation in services introduces layers of complexity that are simply not present in goods negotiations. Neither are the policy sensitivities that arise over migration-related matters and foreign ownership and control of sensitive economic sectors, which trade in services necessarily implicates.

After they had waged and ultimately won a protracted battle to keep investment issues off the Uruguay Round agenda, developing countries, reluctant to deal with investment-related forms of trade, argued at the outset of the [Uruguay] Round that services negotiations should focus solely on cross-border transactions. However, they quickly came to recognize that such a limitation would involve liberalizing transactions over which host countries had no jurisdictional reach. The result would be that potentially significant differences in regulation could not easily be addressed under a regime based on national treatment. Acknowledging that foreign investment in services could bring significant economic benefits and allow



foreign suppliers to be fully subject to host-country regulatory control, developing countries progressively embraced an approach to defining services under which trade in services comprise four distinct modes of supply. As a negotiating quid pro quo, parallels were established between capital and labor mobility under GATS. The incorporation of Mode 4 trade, an area in which many developing countries enjoy a clear comparative advantage and where Organisation for Economic Co-operation and Development (OECD) countries tend to be more defensive, also allowed developing countries to compensate for the fact that Mode 3 trade was a form of services trade of almost exclusive interest to developed country suppliers at the time of the Uruguay Round (though no longer today).

However, the functional (and legal) equivalence established between Modes 3 and 4 under GATS, which is replicated in many PTAs, cannot mask the stark differences that characterize these modes' respective political attractiveness. To date, Mode 3 remains by far the most significant mode for trading services, accounting for an estimated 60% of transactions and a commensurate share of binding commitments under the GATS, whereas Mode 4 trade (with the exception of labor mobility linked to the operation of foreign investments—so-called intracorporate transferees) accounts for a negligible share both of total services trade and of services commitments (1%–2% in both cases), thanks to onerous restrictions maintained against labor mobility in developed and developing countries alike.

### Intermediation

Perhaps the single most important economic insight that flows from a consideration of the differences between goods and services is that nearly all of services-provision has a dual purpose: it is an important economic activity in its own right and, critically, provides inputs into the production of other goods and services. Services such as telecommunications, finance, energy, transportation, and logistics are always and everywhere embedded into all a nation produces, brings to market, or exports.

For this reason, trade policy for services can be likened to trade policy for capital goods imports. Simply put, the aim of policy should be to progressively reduce the economy-wide tax that service sector inefficiency represents. Regardless of where a country's comparative advantage may happen to lie—and for many developing countries it may not lie in the export of many types of services—it can be magnified if firms can secure access to services of higher quality and lower price. This implies that all countries, not only those that are the leading suppliers of services, have a stake in services negotiations.



The central intermediation task services perform—the fact for instance that telecommunications or finance are used pervasively in almost any economic transaction—recalls how imports can expose domestic suppliers to potentially more efficient products, producers, and production methods, or even to a range of services that are not available locally. While this claim runs against the mercantilistic instincts that predominate in trade negotiations, it is critically important to policy to look at services negotiations as a means of helping an economy attain a higher growth and efficiency. The far-reaching degree of unilateral liberalization in services policy that developing countries have pursued in recent decades attests to their growing recognition of the key intermediation role services play in the development process.

### **Protection Behind Borders**

Again unlike goods, the border is arguably of marginal significance to trade in services, except for Mode 4 trade (temporary movement of service providers), because trade and investment protection in services takes the form of domestic regulation, rather than border measures such as tariffs. The negotiating agenda in services may thus be likened to that characterizing nontariff measures (NTMs) negotiations in goods trade. If several decades of NTM negotiations have taught trade officials anything, it is that such talks are slow, ponderous, and typically protracted, involving differences in regulatory regimes that are often deeply entrenched politically and that offer conveniently subtle and often disguised forms of trade and investment discrimination to home-country governments and firms. The nontariff-like nature of services negotiations offers one more explanation of why progress tends to be snail-paced.

In goods trade under GATT, once a tariff is levied at the border, “like” domestic and foreign goods must be accorded national treatment without exception. The relative irrelevance of the border as a locus of trade regulation explains why this core nondiscrimination principle of national treatment cannot be applied across the board (i.e., as a general obligation) to all services transactions. Rather, under GATS, national treatment commitments are the expression of voluntary scheduling decisions in those sectors, subsectors and modes of supply of interest to World Trade Organization (WTO) members, and are subject to the right to maintain any limitations thereto (so long as the latter are scheduled in committed sectors and modes of supply).

The diverse nature of potentially restrictive service sector regulations—rooted in measures that are overtly discriminatory (and thus in violation of national treatment), that quantitatively constrain the level of competition in the marketplace (for example, by limiting the number of competitors or transactions or their value),



or that result from unduly burdensome nondiscriminatory domestic regulatory conduct—further illustrates the range of policy measures, regulatory interests, and policy sensitivities likely to be at play in services negotiations.

Historical reliance on sector-specific forms of reciprocity in sectors such as banking, aviation and other transport modes, and audiovisual services further explains why, unlike GATT, GATS allows WTO members to deviate from the core principle of most-favored-nation (MFN) treatment, arguably indefinitely.<sup>9</sup>

### High Regulatory Intensity

The transparency obligations found in services agreements tend to be quite detailed and generally more onerous than those applicable to goods trade; they often involve extensive notification requirements, the creation of “one-stop shop” inquiry points, the establishment of administrative tribunals, the speedy rendering of administrative decisions, recognition of prior comment rights to foreign suppliers and investors on proposed laws and changes to existing legislative and regulatory measures, and similar conditions. The explanation is heavy reliance on behind-the-border regulatory measures as instruments of protection in services trade, combined with the extensive degree of regulation found in major service sectors.

State intervention tends to be pervasive in light of the high incidence of market failure in services markets. Four main types of market failure affecting service industries can be identified, with differing effects on trade (Table 2). First is the tendency of many services markets, particularly those characterized by network properties—such as telecommunications, energy distribution (pipelines, electricity), sanitation services, railways, and airports—to be highly concentrated and characterized by monopoly or oligopoly. In such circumstances, incumbents can easily deter new market entry—a monopoly can prevent it completely—or abuse their dominance by engaging in anticompetitive cross-subsidization between competitive and noncompetitive market segments, or by maintaining unduly burdensome conditions of access to their networks for the purpose of supplying services competitively. The impact on trade is obvious: dominant firms can easily nullify or impair the value of market-opening commitments. This must prompt a deliberate response in the form of pro-competitive safeguards directed at market failure. One example in the trade field is the Reference Paper on Pro-Competitive Regulatory Principles appended to the WTO’s 1997 Agreement on Basic Telecommunications, which imposed a number of competition policy-like disciplines on dominant firms with a view to ensuring that commitments to promote

<sup>9</sup> The obligation to sunset MFN exemptions listed under Annex II of GATS after a period of 10 years only applies “in principle.”



competition in basic telecommunications services would not be frustrated by abusive interconnection charges by firms with market power.<sup>10</sup>

**Table 2: Dealing with Domestic Regulation: Domestic and International Policy Responses**

Market Failures	Service Sectors Concerned	Possible Trade Policy Response (GATS or PTAs)	Possible National Policy Responses
<b>Monopoly/Oligopoly</b>	Network services: telecommunications; transport (terminals and infrastructure); environmental services (sewage); energy services (distribution networks)	Generalizing key disciplines in telecommunications reference paper <sup>10</sup> to ensure cost-based access to essential facilities, such as roads, rail tracks, terminals, sewers, networks or pipelines.  Strengthening disciplines to deal with anticompetitive conduct	Developing pro-competitive regulation to protect consumer interests where competitive market structures do not exist
<b>Asymmetric Information</b>	Intermediation and knowledge-based services: financial services, professional services, etc.	Implementing nondiscrimination; possibly applying a “necessity” test	Strengthening domestic regulation to remedy market failure in an economically efficient manner
<b>Externalities</b>	Transport, tourism, etc.		
<b>Social Objectives:</b> <b>Universal Service</b>	Transport, telecommunications, financial, education, health		Devising economically efficient means of achieving social objectives in competitive markets

GATS=General Agreement on Trade in Services, PTA=preferential trade agreement.

Source: Mattoo, A., and P. Sauvé. 2003. *Domestic Regulation and Services Trade Liberalization*. Washington, DC: Oxford University Press.

<sup>10</sup> “The Reference paper on Pro-Competitive Regulatory Disciplines is a set of additional, voluntary, competition-promoting disciplines agreed in the context of the WTO’s 1997 Agreement on Basic Telecommunications.”



Three other types of market failure are prominent in services markets: information asymmetries, which provide the rationale for licensing regimes in professional services or for prudential regulation in financial markets; (negative) externalities, which are typically associated with pollution (noise, air, water) or environmental damage stemming from transportation or tourism, especially ecologically fragile environments;<sup>11</sup> and universal access objectives, which predominate in sectors, market segments, or geographic areas where the market cannot be relied upon to provide services deemed essential to the exercise of citizen rights (such as education, health, transport services in remote regions, or access to a telephone or to the internet in rural areas).

In the latter three cases, regulation enacted in response to market failure may not always restrict trade directly, but may represent an unduly burdensome means of attaining an otherwise legitimate public policy objective. It is in regard to such domestic regulatory measures that the GATS Article VI:4 mandate calling for the development of stronger disciplines on nondiscriminatory regulatory conduct have been envisaged.

Trade agreements such as GATS or the services provisions of PTAs should not be seen as undermining the sovereign right of countries to regulate their services markets in pursuit of public policy objectives—a right that is reaffirmed in the preambles to most agreements. Rather, trade agreements afford ways of questioning the *means* used to secure compliance with legitimate public policy objectives, of encouraging countries to pursue regulatory objectives in a manner that minimizes adverse effects on trade and investment whenever possible, and of ensuring that such objectives, and the means to achieve them, remain proportional, are not unduly burdensome, and are not disguised trade restrictions. Developing disciplines on nondiscriminatory regulatory conduct has proven highly contentious at both the WTO and PTA levels, raising delicate policy sensitivities across regulatory communities and civil society.

### Diversity

Services, like goods, display considerable diversity, yet such diversity holds different implications in services trade; it contributes to an architecture that juxtaposes horizontal disciplines, applicable to all sectors subject to GATS rules, with a set of vertical rules, embedded in a series of sector annexes that deal with

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<sup>11</sup> State intervention in the form of regulation may also be motivated by the desire to generate positive externalities, such as in the case of film or television and radio broadcast quotas aimed at securing “shelf space” for domestically produced cultural content that may contribute to strengthening national cohesion and promote diversity in content offerings.



the regulatory specificities of individual sectors (telecommunications, financial services, maritime transport, civil aviation) or specific negotiating issues (MFN, movement of service suppliers). No analogous sector-specific treatment can be found in GATT with the exception of separate agreements dealing with trade in dairy products, bovine meat, and subsidies for civil aircraft.

The dual nature of services rules affirms several realities. First, one size most likely does not fit all, given the diversity of sectors involved, the differing nature of market failures to which regulation responds, the political strength of various regulatory agencies involved, the particular policy sensitivities at play, and so on. Second, responsibility for the conduct of negotiations must be shared between trade, foreign, and sector ministries and affiliated regulatory agencies, given the complexity of the subject matter and the challenge for services negotiators. They must master—indeed “speak”—highly diverse regulatory languages and must properly represent the complexity of offensive and defensive interests typically found in individual countries. Third, the sheer novelty of the subject matter—services trade was negotiated for the first time in a multilateral setting a mere two decades ago—entails a certain amount of tension between the trade and sector regulatory communities, requiring mutual learning by doing for its release. Addressing the specific policy concerns of the regulators (such as a prudential carve-out in financial services, pro-competitive disciplines in basic telecommunications, and clarification that the granting of temporary entry privileges does not confer a right of access to labor markets and is not a route to permanent residence or citizenship) through dedicated annexes has been a useful means of maintaining broad sector coverage while also ensuring that such concerns are properly addressed.

Finally, services negotiations require mastery of the art of dealing with, and at times orchestrating interaction with, various interest groups. In particular, building bridges with user groups and consumer coalitions may prove an essential means of overcoming internal resistance to change. In sectors where predominantly defensive concerns are expressed (such as antiliberalization), key industry players or industry associations will typically be “closer” to the sector ministry and affiliated regulatory agencies than to the trade or foreign ministry in charge of conducting overall negotiations. Enlisting user communities to lobby for domestic regulatory change may be an important means of overcoming domestic or international blockage on specific issues. The opening of telecommunications markets achieved in the Uruguay Round, for instance, was greatly facilitated by the clamor from the financial industry—a highly influential lobby in most countries—for lower input costs in running their global operations over public telecommunication networks and proprietary networks that required access to the public networks.



### The Need for Complementary Policies and the Key Role of Regulation

Experience suggests that the pursuit of competition-enhancing reforms in services is hardly ever an easy task, particularly in resource-constrained countries. There is often a need to balance the promotion of greater competition with the legitimate role of government intervention to offset market failures and to achieve noneconomic objectives such as the universal provision of education or health care services. Regulatory reforms must be designed carefully, so that such objectives are attained in an efficient manner.

Disciplines on domestic regulation arising from trade agreements can play a significant role in promoting and consolidating domestic regulatory reform efforts. Such disciplines can also equip developing-country exporters with the means to address regulatory barriers to their own exports in foreign markets. As repeated bouts of financial market instability in a number of emerging markets have shown in recent years, inadequate domestic regulation may give rise to serious internal distortions, which in turn can entail equally severe social dislocation. At the same time, inadequacies in domestic regulation, for example in the field of professional licensing, can legitimize external barriers to trade, to the detriment of developing-country exporters.

For service sector policies—and national commitments on trade and investment in services in the WTO or in PTAs—to contribute to development, liberalization will need to be accompanied by strengthened regulation in many instances. In many settings, regulation and competition policy may need to be in place to complement liberalization. Regulatory intervention will also typically be required to ensure that liberalization improves access to essential services by the poor or the geographically disadvantaged.

Liberalization of the service sector is not a panacea, and many of the benefits flowing from greater market openness may take time to materialize. In contrast, the costs associated with the rationalization of service industries will appear early on under the guise of changes in the structure of industry ownership and possibly labor displacement. Affected workers, incumbent firms (domestic or foreign), and bureaucracies, who will often perceive liberalization as a threat to employment, profitability, or rent-seeking behavior respectively; opposition from these groups adds to the complexity of liberalization efforts with respect to services.



For a number of reasons, the adjustment associated with greater market openness in services trade and investment is generally smoother in many sectors than in some more traditional areas of goods production. First, adjustment in service industries such as telecommunications and finance often occurs within a dynamic sector environment, where expanding market segments and firms can more readily absorb workers from shrinking sectors. Workers who are negatively affected by structural changes may find it easier to reposition themselves in a dynamic economy generating favorable income and employment opportunities than in a stagnant system that defies or resists change.<sup>12</sup> Second, some three-quarters of international trade continues to take place in manufactured products. This generally means that service sector workers are less directly exposed to trade-led job displacement; though, as noted earlier, ICT-induced labor market arbitrage and the steady rise in skill levels in developing countries have both intensified labor market pressures noticeably in recent years. Third, and perhaps most importantly, because they exhibit less sector-specific professional specialization and above-average educational levels, service sector employees tend to have greater overall labor market mobility. This mobility may explain the observed tendency for displaced workers in nonmanufacturing activities to experience shorter periods of unemployment, higher overall reemployment rates, and smaller earnings losses on average upon reemployment than workers in manufacturing.<sup>13</sup>

Experience has shown that services trade liberalization carries risks and potential costs as well as benefits. For example, foreign providers might cherry-pick the most profitable market niches and show limited interest in more marginalized market segments or user communities, displace domestic providers, and contribute to

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<sup>12</sup> Adlung, R. 2000. Services Trade Liberalization from Developed and Developing Country Perspectives. In Sauvé, P. and R.M. Stern, eds. *GATS 2000: New Directions in Services Trade Liberalization*. Washington, DC and Cambridge, MA: Brookings Institution Press and Center for Business and Government, Harvard University. pp. 112–131.

<sup>13</sup> Research carried out by Lori Kletzer at the Peterson Institute for International Economics shows that import competition is associated with low reemployment rates because of the individual characteristics of workers vulnerable to rising import job loss. She concludes that it is not import competition per se that is at fault; it is who gets displaced from (and employed by) industries with rising import competition. “What limits the reemployment of import-competing displaced workers? The same characteristics that limit the reemployment of all displaced workers: low educational attainment, advancing age, high tenure, minority status, and marital status. Compared to high school dropouts, workers with a college degree (or higher), [the great majority of whom are employed in service industries] are 25 percentage points more likely to be re-employed, high school graduates 9.4 percentage points more likely and workers with some college experience 11 percentage points more likely to be re-employed.” See Kletzer, L. 2001. *Measuring the Costs of Trade-Related Job Losses*. Testimony prepared for the United States Senate Committee on Finance. Washington, DC. 20 July. <http://finance.senate.gov/072001ktest.pdf> use the following link: <http://bookstore.petersoninstitute.org/book-store/110.html>



brain drain in certain professions.<sup>14</sup> Government intervention to correct for market failures through regulation and to ensure sufficient competition is therefore crucial if the benefits of services liberalization are to be realized. Indeed, regulation is crucial in most service sectors whether or not they are open to trade and investment. For example, regulation is required to

- create a level playing field and facilitate competition between market players (for example, by ensuring access to networks for new entrants in the electricity or telecommunications sector);
- guarantee the quality of the services provided (for example, by specifying licensing requirements for service providers such as doctors, engineers, and architects);
- protect consumers (for example, from fraudulent practices);
- ensure the provision of sufficient information (for example, about the availability and features of services provided);
- prevent environmental degradation (such as that arising from high levels of tourism or use of transport infrastructure);
- ensure adequate access to critical services (such as electricity, water, sanitation services, health, and education);
- maintain financial stability (in the banking sector); and
- minimize disruptions in supply (for instance, in electricity markets).

However, domestic regulation can be unnecessarily burdensome, and can sometimes interpose a disguised barrier to services trade and investment.

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<sup>14</sup> A recent World Bank study on service sector reforms in Zambia documents some of these concerns: despite significant financial market liberalization—foreign banks and insurance companies today manage two thirds of Zambian bank assets and insurance premiums—credit available to the private sector remains, at 8% of GDP, lower than in the preliberalization period. As of 2005, 90% of bank loans were made to some 5,000 Zambian individuals; firms outside the country's three main cities had to give collateral 65% greater on average for securing bank loans; and nearly 80% of fixed telephone lines are found in the capital Lusaka and the country's copper belt, which together account for 30% of total population. See Mattoo, A. and L. Payton, eds. 2007. *Services Trade and Development: The Experience of Zambia*. New York and Washington, DC: Palgrave-Macmillan and the World Bank.



Barriers can sometimes be an unintended consequence of a regulation (as when required professional qualifications are available only from national educational establishments), but are sometimes imposed deliberately to prevent or limit foreign entry (as with limits on foreign equity participation, or requirements for foreign entrants to form joint ventures with domestic companies).<sup>15</sup>

Liberalizing trade in services usually involves some degree of regulatory reform to make it easier for foreign firms to enter the market. But new or more sophisticated regulatory frameworks are also often required to ensure that liberalization delivers the expected benefits. And the establishment of an appropriate regulatory framework can also be important in enabling a country to take advantage of potential export opportunities by developing well-functioning domestic service sectors that meet world standards of provision. For example, by facilitating the development of a safe and reliable health-care system, a good regulatory framework can enable a country to take advantage of new opportunities to sell health-related tourism services. Similarly, an appropriate legal and regulatory framework in the financial sector can help to build consumer confidence in a new offshore financial center.

Other complementary policies can help to maximize the benefits and minimize the risks of service sector liberalization. These vary from sector to sector, and may include the provision of education and training (for example, in information technology (IT), medicine, or languages) that will enable domestic firms as well as individuals to take advantage of service sector export opportunities, mechanisms to enhance spillovers and technological diffusion from foreign export providers, and strategies to manage the temporary movement of service suppliers, to facilitate greater remittances and maximize their likelihood of return with enhanced skills, networks, and capital.

Summing up, there is much evidence showing that the potential gains from service sector liberalization are substantial. But there are also risks that need to be considered against the risks of not liberalizing. A range of complementary policies,

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<sup>15</sup> For a comprehensive discussion of the relationship between domestic regulation and international trade in services, see Delimatsis, P. 2007. *International Trade in Services and Domestic Regulations: Necessity, Transparency and Regulatory Diversity*. London: Oxford University Press. See also Krajewski, M. 2003. *National Regulation and Trade Liberalization in Services: The Legal Impact of the General Agreement on Trade in Services (GATS) on National Regulatory Autonomy*. The Hague: Kluwer Law International. Mattoo, A. and P. Sauvé, eds. 2003. *Domestic Regulation and Service Trade Liberalization*. Washington, DC: Oxford University Press; and Sauvé, P. Completing the GATS Framework: Addressing Uruguay Round Leftovers. *Aussenwirtschaft*. 57(3). pp. 310–341.



including appropriate regulation, the creation of competitive market conditions, the provision of specialized training of adequate quality and scale, and policies to protect health, environment, and consumers and ensure adequate access to services, are crucial if liberalization is to deliver the expected benefits.

### Policy Questions for Discussion

- Why does the importance of policy in the service sector go beyond the sector itself?
- How can an inefficient service sector act like a prohibitive tax on a national economy?
- What policy implications, including in the trade field, can be said to flow from the fact that services are used intensively in the production of all goods and services?
- From the perspective of GMS countries as a whole or your own country, which of the various determinants of recent service sector growth has had the strongest influence on overall performance?
- How problematic is the lack of adequate data on services and services trade in formulating policy in the sector? Does such a problem affect your country's negotiating strategy in services?
- How does the need for factor mobility affect the conduct of services negotiations? Does such mobility facilitate or complicate such negotiations?
- Why is national treatment not a general obligation in services agreements, when it is for goods trade?
- What is the most important source of market failure to which service sector policy responds in your country?
- How has the shifting boundary between the market and the state affected the design of trade policy in services in your country?
- What are some of the downsides of opening up service sectors to foreign competition and what means do governments have to mitigate such risks while reaping the potential gains from liberalization?



### Key Readings

Adlung, R., and A. Mattoo. (2007). The GATS. In Mattoo, A., R. M. Stern, and G. Zanini, eds. *A Handbook of International Trade in Services*. New York: Oxford University Press.

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