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The Uruguay Round

Services in the World Economy

Patrick A. Messerlin

Karl P. Sauvant

with contributions by

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Foreword

Global economic interdependence has increased dramatically since the mid-1980s. Part of this success stems from a multilateral framework in the form of the General Agreement on Trade and Tariffs (GATT), which was established in 1949 to further a more open commodity trade regime. The GATT system, although far from perfect, has served the international community well, by providing not only a system of rules and regulations for trade but, more important, a forum for multilateral trade negotiations in which countries have the opportunity to improve the system by removing trade restrictions to the maximum extent possible.

In September 1986 at Punta del Este, the international trading community began a new round of negotiations. For the first time, a multilateral round provided a mandate for negotiations on services, raising the possibility of creating a multilateral framework for international trade in services. The subsequent negotiations have aroused intense interest in both developed and developing countries. This is not surprising, since for most countries the service sector is now the largest economic sector and the most important source of new jobs.

Clearly, countries could gain significantly from a system that would offer opportunities for specialization and improved efficiency in services. For developing countries, such changes could contribute to increased rates of growth. Many developing countries have nevertheless been cautious about the prospect of liberalizing services trade. Understandably, the heterogeneity of services and the obvious gap between the levels of development and sophistication of service industries in many developing as compared with developed economies have raised doubts regarding the outcome for developing countries of liberalizing international trade in services. Furthermore, as the negotiations have made clear, the scope of international transactions in services extends well beyond what has been traditionally understood by cross-border trade. Most services can enter international transactions only through sales by affiliates established abroad by large firms or through the movement of people across borders. This raises questions regarding labor movement, foreign direct investment and transnational corporations in services, the benefits and costs for host developing countries, and the role of national foreign investment policies in the context of a multilateral framework.

The purpose of this book is to contribute to a better understanding of international trade in services so that developing countries in particular may have a stronger information base and analytical support for the policy decisions that they are being called on to make. To this end, we have asked a number of authors to contribute papers on conceptual, sectoral, and country-specific issues relating to international transactions in services. The resulting handbook is a collection of essays that is, we believe, both informative and thought-provoking. Part of the reason that these chapters are so eclectic is that the authors, not the editors or our institutions, have accepted full responsibility for their views.

The preparation of this book has provided a valuable opportunity for cooperation and pooling of experience by the World Bank and the United Nations Centre on Transnational Corporations—both of which are keenly interested in encouraging informed participation in the Uruguay Round negotiations on the part of developing countries and, more generally, in assisting developing countries in their interaction with the world economy. We hope that this book will be useful to interested persons in government and academia alike.

We should like to thank the contributors to this book for preparing their chapters under a tight time schedule and Patrick A. Messerlin and Karl P. Sauvant for editing the volume. We are also grateful to the government of Italy for the support it provided to the United Nations Centre on Transnational Corporations for this project.

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Introduction

Patrick A. Messerlin and Karl P. Sauvant

The years 1986–90 may well enter the history of international economic relations as a period of unexpected progress toward a more open world services economy with greater opportunities for trade and development. This period stands in sharp contrast to the years 1982–86, when the first initiatives toward placing services on the agenda of the Uruguay Round met with harsh criticism and—more crucially—a deep and widespread skepticism about the gains to be expected from such an effort. During the past three years, however, negotiators from both developed and developing countries have been engaged in an intense effort in the Group of Negotiations on Services (GNS) of the Uruguay Round to explore the issues regarding international trade in services and to arrive at principles that might form the basis for an agreement on trade in services—an agreement that could be put in place by the end of 1990.

The progress achieved in the Uruguay Round negotiations on services testifies that trade negotiators and national decisionmakers are coming to share a perception already common among economists: that trade in services is similar in fundamental ways to trade in goods. This is not to deny that trade in services has its own special characteristics, notably in the modes of delivering services to foreign markets. The intangibility and nonstorability of most services have raised new practical issues for negotiations on services, which must address international movements of service providers and factors of production—in particular, foreign direct investment and labor movement.

Trade negotiators have agreed on a set of concepts derived from their experiences with trade and foreign direct investment but taking into account the distinctive features of international transactions in services. These principles were endorsed by the 1988 Montreal ministerial midterm review and have since then been tested for their applicability to the main service sectors identified in the current negotiations.

The progress of the negotiations toward an agreement on principles owes much to the recognition, since the inception of the Uruguay Round, of the special concerns of developing countries. Development has in fact been one of the central themes of the GNS negotiations, and the "development of developing countries" is listed, along with the promotion of economic growth of all trading partners, as one of the aims of any future agreement designed to promote trade expansion through progressive liberalization. The challenge since Montreal, especially as far as developing countries are concerned, has been to make development an integral part of the agreement, not an appendage or the subject of a series of waivers and exceptions, as has been the case with trade in goods under the GATT. Provisions that would increase the participation of developing countries in world trade and expand their exports of services are the main (but by no means the only) avenues for incorporating the development objective into an international services framework. The Montreal agreement foresees provisions that would, among other things, promote the strengthening of the capacity, efficiency, and competitiveness of the domestic service sector in developing countries. The activities of service affiliates of large firms in developing countries can influence this process considerably, especially through transfer of technology and skills to people in host countries.

At the national level, service industries are increasingly exposed to problems of an international dimension and have, as a result, adopted the same approaches as their counterparts in the goods sectors. Managers of private and public firms have begun to constitute lobbies for freer trade or for more protection, depending on the comparative advantage of their industries or the competitiveness of their firms. At the same time, some governments are beginning to reassess the costs and benefits of new strategies based on freer trade in services.

The initial aim of this book was to elaborate these as yet relatively new ideas and developments and to disseminate them to a large audience. To our surprise, the book has done more than initially expected. It provides three crucial lessons, one factual and two that concern trade policy.

First, contrary to widespread skepticism, developing countries do have comparative advantages in particular services when services are examined at a sufficiently disaggregated level—as should be done and as is done for manufactured goods. After all, developing countries have comparative advantages in certain types of clothing, steel, shipbuilding, electronics, footwear, and food products—but not in the complete range of products in these subsectors. Similarly, some developing countries enjoy comparative advantages in certain subsectors of banking, insurance, air transport, telecommunications, tourism, shipping, construction, and professional services, including health care and software development, because of their abundant resources of labor with the needed skills. This competitive advantage stems from the position of education as one of the relatively more developed sectors in developing countries—and, not coincidentally, one of the sectors that is more open to outside influences.

It may be argued that the evidence available in services is much more fragmentary than that for manufactured goods. That is true. But confirmation of these comparative advantages that are being revealed for developing countries can be found in the more cautious approach that industrial countries are now taking in the services negotiations as they recognize that the advantages may not all be on their side. Once enthusiastic proponents of freer trade in services, these countries have realized—sometimes under pressure from their worried services industries—that both industrial and developing countries have comparative advantages, and their enthusiasm is now tempered by an awareness of the need for give and take in the provisions of an agreement.

Second, comparative advantages in services do more than create a large array of potential tradeoffs between industrial and developing countries in multilateral negotiations on services. Imports of less expensive services from industrial countries would allow developing countries to be more efficient in manufactures, for which certain services (such as telecommunications) are an essential input. Some services, like some goods, are of crucial importance for development. Being off the main air or telecommunication routes at the end of this century would be the same kind of handicap as having been off the main roads or maritime routes in the past century. Freer trade can be a way to stay in the race instead of becoming progressively more marginal. As a corollary, the fact that negotiations in goods and services are held in two different forums—the GATT for negotiations on goods and the GNS for services—should not reduce the potential gains to developing countries from the tradeoffs related to a framework for international transactions in services. Current negotiations in services should not repeat the basic mistake made decades ago, when trade in agricultural products and textiles were separated from trade in manufactured goods. That mistake—which has been particularly costly for developing countries—has made the tradeoffs of concessions involving these two sectors considerably more difficult and has isolated the sectors behind highly protectionist barriers.

Third, in services as in goods, domestic liberalization is rapidly choked if there is not an open regime, and trade liberalization without internal market-oriented reforms can be costly. Unilateral liberalizations are beneficial only if they combine domestic reforms and a unilateral opening of the borders. Few industrial countries have been able to take such actions. As in the case of goods, what counts is not so much the speed of the move as a clear commitment to freer trade, with economically sound measures reducing the range of protection and the level of rents. To extend unilateral liberalizations into multilateral ones is a cost-efficient way of achieving these goals, and some developing countries are on the verge of following this path. The Uruguay Round comes at the right time to consolidate such liberalizations and to boost new ones.

Part I of this book looks at basic economic tools and at their validity and adequacy for analyzing services trade issues within the familiar framework of trade negotiations which relies on the GATT tradition. Part II presents, for each main group of services, the economic characteristics of their production (the main "products" delivered, the size of the industry, and the key factors of production), the principal modes of delivery, the impact of the current international environment, and the existing methods and extent of regulation and protection in industrial and developing countries. Part III, through case studies of selected countries and areas, examines the basic questions that the delegations in Geneva will have in mind as they negotiate a framework agreement. In which services are their own countries expected to enjoy comparative advantages and realize gains from liberalization? Which service sectors may have to undergo an adjustment process? The answers to these questions will suggest the extent of the net gains from liberalization and of the additional benefits that consumers in industrial and developing countries will reap from freer trade in services.

Part I

The Constitutional Framework

1

Principles in Trade in Services

Richard H. Snape

Services come in a great variety of forms; perhaps more than goods they are adapted individually to the demander. Indeed, differentiation of goods frequently arises from the services that accompany their sale. With so many forms of services, how is one to approach the question of barriers to their trade? One helpful starting point is to look at the means by which trade takes place in order to find common elements in barriers that may extend across a whole range of traded services. If ways of negotiating these forms of barriers can be identified, it may be possible to develop a general agreement that covers services just as the General Agreement on Tariffs and Trade (GATT) covers trade in all types of goods.[1]

Both goods and services are produced by labor, capital, and other factors of production. International trade in services is the supply by residents of one country to demanders resident in another country of services that are not incorporated in goods (other than in the paper, film, disks, and the like used to record and transfer the service).[2] The receiver of the service may be a person (for, say, a haircut, entertainment, or transport), a legal entity such as a company or government (for insurance or banking, for example), or objects such as airplanes (for repairs or airport services) or merchandise (for transport).

For some services it is necessary that the receiver of the services be in close proximity to the supplier; for others the supplier and the receiver can be at a distance from each other. Examples of services that require proximity are tourist and transport services, surgery, and repairs. Those for which it may not be necessary include architectural and computing services, broadcast entertainment, and anything else that can be communicated through the mail or by electronic means. If service suppliers and receivers must be in physical proximity, physical movement of one or the other will generally be necessary.

The receiver of the service should be distinguished from the demander (that is, the payer). The receiver could be an object (an airplane to be repaired) or a person other than the demander (a child to be educated). An international transaction takes place when the transaction is between a supplier and a demander who are residents of different countries, irrespective of the location of the receiver of the service.

In negotiations concerning services trade, as for all international trade, considerable emphasis is given to the exchange of reductions in barriers to trade, as though the importers of services were imposing a cost on themselves by importing them. This neglects the gains from international trade that are earned by the importing countries as well as the exporters; if there were no importing, there would be little point in exporting. The gains from trade in services are similar to those from trade in goods. Trade enables a country to concentrate production on the products in which it has a comparative advantage; it provides access to new products and technology; and it facilitates the achievement of economies of scale in production. As with trade in goods, economists and others have given a great deal of attention to thinking of situations in which domestic industries should be protected against imports. But cases in which economic logic (in terms of the interests of a country as a whole) supports such protection tend to be rare, both in theory and in practice. There is a strong economic presumption that international trade in services, as in goods, is economically beneficial.

Nevertheless, a wide range of barriers does exist to international trade in services, as in goods. And these barriers do not, in general, exist by accident. Although they may often be the result of economic misperceptions, they are frequently the product of domestic political forces, and invariably they have their defenders. But despite the political costs that may have to be incurred in their reduction—and these costs may explain why trade negotiations are entered into in the form of an exchange of "concessions"—importing as well as exporting countries will generally realize economic gains from reducing barriers to trade in services as well as in goods.

Determinants of Trade in Services

What determines the patterns of international trade in services? Because all production arises from the services of factors of production, the same considerations that affect trade in goods can be expected to affect trade in services. Without barriers to trade, countries with relatively large amounts of unskilled labor will tend to export labor-intensive services as well as labor-intensive goods. Such service exports can be in many forms: the temporary movement of construction crews, the manning of ships, and the simple processing of electronically transmitted data are three examples. Countries with relatively skilled labor will have a comparative advantage in exporting services that require relatively large inputs of such labor—architectural and financial services, the writing of computer software, and the like. Countries that for reasons of geography or history have built up skills in ocean fishing are likely to export shipping services, those that have endowments of beautiful scenery will have a comparative advantage in the export of tourist services, and so on. In other words "factor endowments" are important in determining the pattern of trade in services just as with goods.

Economies of scale and scope are also likely to be important in some service industries, as for some goods. When such economies are particularly important, a large domestic market may help to provide an advantage on world markets. Thus a litigious society is likely to develop specializations in law that, at least in their international dimensions, may be marketed internationally. Financially rich countries will develop expertise in financial institutions and a whole range of interacting financial activities and will tend to export these services.

High-income countries may have an initial comparative advantage in services that are demanded by people with high incomes. But if labor costs are an important component of total costs in such industries, countries with relatively low labor costs but with the required skills may be able to compete successfully over time and take markets from those that were first in the field—international air transport is an example of this, as are data processing and typesetting. Once processes become standardized, production in many areas moves from the innovators to countries with abundant labor that possess the required skills and the necessary complementary capital equipment. Such developments are analogous to those that have occurred in some goods markets.

The availability and quality of the necessary complementary capital equipment can be particularly important. In data processing, for example, protection of a domestic computer industry, because of its effects on the costs and availability of computer hardware and software, may discourage the export of computing services by countries that would otherwise be well suited for it. Similarly the export by Ethiopian Airlines[3] of aircraft repairs and training to other African countries and elsewhere would not be possible without complementary capital equipment.

Extending the horizon to incorporate international trade in the services of financial capital leads one to consider countries that are net borrowers and lenders. Net lending is the result of an excess of domestic saving over investment; net borrowing is the opposite. Such excesses may be attributable to the choice of individuals between frugality and profligacy, to the state of development of a country, or to the budgetary policies of governments. Comparative advantage in the export of the services of financial capital thus will be linked to these considerations.

Many services that can be provided by employees of firms (that is, within a firm) can also be provided on a contractual basis from outside the firm. A manufacturer may obtain accounting services from employees or from a firm of accountants; cleaning of premises may be undertaken by employees or by contract cleaners; on-the-job training may be supplied by employees or by contractors; and so on. In each case services may be traded on the market or produced within the firm. It has been suggested that more services are being supplied on a contractual basis than in the past. Some possible reasons for this are changing technology (particularly electronic), changing laws regarding the responsibilities and liabilities of firms toward their employees, changing composition of the work force, increasing specialization owing to the growth of knowledge, and increased payroll taxes and workers' compensation insurance premiums. This turn toward contracting-out has been referred to as a splintering of services (Bhagwati 1984). To the extent that this splintering of services from goods occurs, it will lead not only to expanded domestic trade in services but also to expanded international trade. When it occurs because of increasing labor costs, provision of services is likely to move to lower-labor-cost countries—provided, as noted above, that firms in these countries have access to the required complementary equipment.

It is apparent that a whole range of services may be traded internationally purely as services or may be incorporated into traded goods. A country may import automobile design and build the automobiles itself, or it may import automobiles—which, of course, incorporate the design services. Thus among the factors that determine the pattern of trade in services must be counted not only the barriers to trade in services themselves but also the barriers to trade in goods. Barriers to imports of automobiles may lead to imports of automobile design. But we now focus on direct barriers to trade in services rather than on indirect effects through barriers to trade in goods.

Barriers to Trade in Services

Regulation is pervasive in services industries, and this in turn affects international trade. Regulation is explicitly protective of domestic producers only when it discriminates against foreigners; otherwise it will tend to protect some producers against all other producers, domestic and foreign.

Frequently, regulation is designed to protect consumers. Consumer protection in goods often takes the form of the prescription of standards for the goods produced. Such control on output is much more difficult to enforce for many services—can the quality of surgery, education, or insurance be monitored continually? Control is often exercised instead by issuing licenses for producers and by enforcing prudential or other qualifications for entry to the industry (Hindley and Smith 1984). Of course, like other regulations, restrictions on entry to industries can easily develop into protective barriers for those who are already in the industry.

Discrimination against foreign suppliers may be intentional in many cases; in others, the discrimination may be unintended and subtle. For example, if there are prudential asset requirements for entry to an industry and the assets must be held in the country imposing the restrictions, foreigners may be at a disadvantage (Hindley and Smith 1984, p. 381). Or discrimination may be a product of the difficulty of assessing foreign professional qualifications for occupations in which registration is required.

We focus now on barriers to international trade as such and not on regulations that may restrict participation by both nationals and foreigners. Depending on the manner in which services are traded, international trade in services can be discriminated against by barriers to the movement of the suppliers of the service, to the movements of the receivers of services, or to the trade itself.[4] Examples for each category follow.

1. *Barriers to the movement of service suppliers.* Restrictions on the inflow of labor for construction, artistic purposes, and the like; restrictions on the inflow of foreign investment; restrictions on foreign professionals practicing domestically; taxation of landing or port facilities for foreign carriers

2. *Barriers to the movement of service receivers.* Restrictions on residents traveling abroad for education, tourism, and so on; restrictions on equipment moving abroad for servicing or repairs

3. *Barriers to trade itself.* Restrictions on the placement of architectural, computing, accounting, and other contracts abroad; restrictions on the receipt of electronic transmissions from abroad; restrictions on the placement of banking or insurance business abroad; foreign exchange restrictions; domestic content requirements in radio and television broadcasting, in the cinema or theater, and in shipping.

The restrictions on trade in services that are most comparable to restrictions on trade in goods are those in category 3. Such services have been termed disembodied or separated services (Bhagwati 1984; Sampson and Snape 1985). As with tariff and nontariff barriers to the movement of goods, they are restrictions on the product of factors of production, not on the movement of the means to provide the service (as in category 1) or on the receivers of the services (as in category 2). It is to category 3 that the principles of the GATT are most obviously applicable, but they also apply to the barriers in categories 1 and 2.

Application of GATT Concepts

The GATT comprises a set of trading rules that apply generally across commodities and contracting parties. There are exceptions for both countries (developing countries, in particular) and commodities (agricultural products, in particular). In addition, certain products have been effectively excluded from the general provisions of the agreement for a considerable time with respect to some countries—the two main exceptions in this category are waivers for many developed countries for agricultural imports and special provisions for textile and clothing imports from a growing number of developing countries by most developed countries. But despite these exceptions, which have grown considerably since the GATT was first formulated more than forty years ago, the basic thrust of the General Agreement is toward rules of general application across countries and commodities.

The fundamental principles of GATT are to be found specifically in the main articles but are also implied by the force of the agreement as a whole. These principles include nondiscrimination among contracting parties, transparency and predictability of barriers, liberalization of trade, and equality of treatment of foreign and domestic products once the frontier has been crossed ("national treatment"). It is these principles that are most relevant in considering the extension of the GATT principles to services and, in particular, to those services that are traded without movement of the service providers or receivers. But as noted, they are also relevant to the latter categories.

Most Favored Nation (MFN)

Nondiscrimination in the GATT is expressed in the most favored nation concept in its unconditional form. Article

I of the GATT provides, "With respect to customs duties and charges of any kind imposed on . . . importation or exportation . . . any advantage, favor, privilege, or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties." In addition to stating that any "advantage" (and so on) has to be extended to all, it implies that any advantage that is withdrawn from any member has to be withdrawn from all—you cannot do to any what you are not prepared to do to your best friend. Unconditional MFN is a powerful protector of the weak and of those who might be regarded as troublemakers.[5] There are exceptions in the GATT to this rule of nondiscrimination—provisions relating to customs unions and free trade areas were part of the GATT from its inception, and preferences for developing countries were added later. Nevertheless, nondiscrimination is at the heart of GATT.

The requirement of article I that a concession given to one has to be given to all could discourage negotiation of the reduction of barriers. Each country could drag its feet in negotiations knowing that it would get the benefit from reductions in other countries' barriers whether or not it reduced any of its own: it could free-ride on the negotiations of others. Free riding has been curtailed in the successive rounds of negotiations under GATT by negotiating concessions between principal suppliers on narrowly defined products while at the same time covering a wide range of products in the negotiations as a whole (Finger 1979). In the Tokyo Round a formula reduction in barriers (with exceptions) was adopted, and this also helped to curtail free riding.

A standard argument why country A should be prepared to see concessions it has "bought" from country B extended to country C without C's "paying" for them is that country A will in turn benefit, unconditionally, from any concessions exchanged between countries B and C. It appears, however, that unconditional MFN is being eroded in goods trade as many countries focus more on the bilateral than on the multilateral and systemic aspects of trading policies (Snape 1988). In recent years there has been considerable reluctance by the main players in GATT to extend to all members the benefits under new agreements concluded under GATT auspices, even when these agreements have been interpretations of the GATT articles. Many signatories have extended the benefits only to the cosignatories of the particular agreement.[6] With such attitudes prevalent, there is little likelihood that the benefits of agreements on services will be extended to any except the signatories to the relevant agreements.

Be that as it may, the concept—if not the practice—of unconditional MFN is quite easily extended to many forms of services trade. For services in category 3—that is, where the providers and receivers do not have to come together—and for barriers to trade that resemble tariffs, the application of unconditional MFN is easy. Converting some of the barriers to services trade to tariff-like imposts would be helpful, for when trade barriers are in the form of tariffs, the application of nondiscrimination is easy and visible. This "tariffication" could apply, for example, to trade in television, radio, and movie programs, whether received directly from abroad or on tape, film, or disk; professional services that are supplied at a distance; placement of insurance and banking business abroad; and subscriptions to foreign news, educational, and similar services. Nondiscrimination, then, would simply be the application to all trading partners of the same tariff-like impost. With nondiscrimination defined and measured in this way, unconditional MFN follows easily: the same tariff-like charges would be applied to all parties to the agreement, and reductions in the charges imposed on the imports from any source would be granted to all, whether or not they gave any concessions in return.

Even if barriers to trade in these services are not converted to tariff-like levies, nondiscrimination and unconditional MFN can still be applied. For example, if there are domestic content requirements for cinemas, nondiscrimination implies (as it does already in article IV of the GATT) that the importers should have equal access to all foreign suppliers; unconditional MFN implies that access given to any foreign country would be available to all member countries without conditions. Similar provisions could apply to engaging foreign professional services if such engagement is restricted by one means or another. Thus, where entry to an industry is restricted by licensing arrangements, MFN implies equal opportunity for all foreign suppliers when licenses are issued.

When movement of the service provider or receiver is involved, similar principles can be applied, although in practice things may be more difficult in some cases. In transport services bilateral arrangements are common—bilateral reciprocity pervades international air transport, while in shipping the 40-40-20 rule[7] of the UNCTAD Shipping Code is discriminatory on a bilateral basis. In these areas nondiscriminatory tariffs or import quotas would be alternatives to the present arrangements that would allow protection of domestic suppliers while also satisfying the unconditional MFN principle.

When a domestic presence is involved as part of the international trade in a service—that is, when the provider needs labor or capital (financial or physical) in the host country—questions relating to visas, work permits, and foreign investment policy arise. Again, application of an unconditional MFN policy is easily specified in principle: the labor and capital of all parties to an agreement should be treated equally with respect to entry and, for labor, with respect to professional and related qualifications. This does not imply that all types of labor should be treated equally—only that nationality should not be a criterion for differentiation. Similarly, it does not imply that if professional architectural qualifications are a condition for practice in the host country, qualifications obtained in all countries should be treated equally if in fact they are not equal; it is the quality of the training that should be the criterion, not the country in which it is earned. With respect to both labor and capital the application of unconditional rather than conditional MFN requires that equality of treatment be applied to all parties to the agreement—and to all new parties to the agreement—without specific conditions being imposed once the general agreement has been concluded.

As noted earlier, in many services entry is limited for both domestic and foreign firms. Postal and telegraph systems are often government monopolies, and restrictions on entry to banking, insurance, and broadcasting are common even when these areas are not limited to public enterprises. Entry to many professions is also restricted. So long as entry is prohibited to foreigners, the question of MFN does not arise. If entry is allowed, then MFN would imply equal opportunity of access for nationals of all other member countries. Unconditional MFN could imply that no specific conditions regarding reciprocal rights of entry be attached.

National Treatment

National treatment is to be distinguished from MFN; it refers to the treatment of foreign products (or suppliers) not with respect to each other but with respect to national products or suppliers. Article III of the GATT requires that "internal" taxes, regulations, and the like "should not be applied to imported or domestic products so as to afford protection to domestic production."[8] It has sometimes been implied that for some services national treatment means equality of treatment of foreigners and nationals. The word "internal" in article III could suggest that once a product has cleared the port of entry, no discrimination can be applied against foreign products. But what is the port of entry for services that can be traded in a disembodied or separated form—that is, separated from the producer? Perhaps a better way to approach the GATT provision with respect to national treatment is to note that the GATT authorizes or legitimizes certain forms of discrimination against goods produced by foreigners. The generally authorized form of discrimination according to source is an import tariff, although in some circumstances quantitative restrictions on imports are permitted. National treatment then implies that once the authorized form of discrimination has been imposed on a product, there should be no further discrimination according to national source.

When one views national treatment in this manner, the way in which it could be extended to services is readily apparent. A general agreement on services could include a provision for specifying particular means of discrimination against foreign-produced services. Sector-specific agreements could then identify the particular form or forms of authorized discrimination for the services in that sector, and particular levels of these forms of discrimination could be bound among the parties to that agreement. National treatment would then imply that in all other respects domestic and foreign producers should be treated equally.

The GATT already provides one example of this in services; a local content provision is authorized for the screening of cinema films, but article IV provides for equality of treatment in all other ways—that is, for national treatment. The local content provision is not imposed at importation but at the actual screening time. As noted above, a tariff-like impost could be an appropriate form of authorized barrier for many services, including cinema films, if protection of the domestic producer is the objective of policy.

Liberalization, Transparency, and Predictability

Liberalization, transparency, and predictability are considered together because of their interconnections. Although the GATT is not an agreement to secure or even to attempt free trade, containment and reduction of trade barriers are fundamental to it. It sets a framework within which concessions can be negotiated and bound between contracting parties. There are procedures for withdrawing concessions and for raising barriers, but these are seen as temporary deviations from the norm, although in practice many such actions have been far from temporary. The GATT's procedures have provided an effective basis for reducing tariff barriers, and in its first couple of decades nontariff barriers, at least on manufactured goods, were also reduced. More recently, nontariff barriers, often in exotic forms designed to avoid the restrictive provisions of GATT, have proliferated, and attempts to curtail them have had but moderate success.

Experience with the GATT and other trade negotiations shows that reductions in tariffs are easier to negotiate across a broad front than are reductions in nontariff barriers. In general, tariffs are the most easily identified form of trade barrier and, in comparison with most forms of nontariff barriers, provide relatively little scope for bureaucratic licence and chicanery. Therefore they are relatively transparent and their effects relatively predictable. The GATT itself helps to ensure transparency by emphasizing tariffs as the generally authorized form of trade barrier and by requiring notification and publication of trade barriers.

For services, nontariff barriers, not tariffs, are the norm (Hindley 1988, p. 3). This in itself creates difficulties for liberalization: it is hard to get agreement for exchanges of concessions on a range of products when the forms of barriers are disparate and the levels often unquantifiable. Frequently it is even difficult to verify whether there *are* trade barriers, as has been noted in much of the discussion of Japanese trade policy in recent years. In such circumstances the emphasis tends to be on single products; experience teaches that such an emphasis is less conducive to significant liberalization. Thus "tariffication" of barriers to services, where feasible, could facilitate liberalization.

If this route is not attractive or is not feasible for particular services, the GATT provisions for publication and notification should be easily applicable to other forms of trade barrier. Negotiation, binding, and liberalization would thus be facilitated.

A General Agreement, or Sector by Sector, or Both?

As noted above, the GATT is a *general* agreement that applies generally, although with specific exceptions, to all parties and all goods. Furthermore, it is an open club, accessible to new members on conditions similar to those of foundation membership.

Trade negotiations that have centered on forms of barriers across a range of products have been more liberalizing than negotiations that have focused on specific products. Some examples of the latter are the Multifibre Arrangements, the codes for dairy products and bovine meat negotiated in the Tokyo Round of multilateral trade negotiations, and the UNCTAD Shipping Code. Although all of these agreements tend to organize and restrict rather than liberalize trade, it should be acknowledged that it may be the characteristics of these industries that have led to the forms of negotiations and that the agreements may be liberalizing in comparison with the situation without agreements. The comparison should be made with an alternative scenario for the product in question, not with other products. Further, extraction of, for example, textiles and clothing from coverage by the general rules of the GATT may have been the price of maintaining liberalizing coverage by the GATT on other products.

This said, and if trade liberalization is the objective, it seems wise to approach negotiations on a broad front, identifying characteristics that extend across many products, rather than product by product. Costs can then be offset by benefits within a country to a much greater extent than will normally be possible when a narrowly defined class of products is being considered. If sensitive products are involved, however, there is a tradeoff between the extent of coverage and the firmness of the liberalizing thrust of an agreement. Inclusion of sensitive products in a broad agreement can lead to ambiguous and soft wording, leaving unresolved different interpretations by different parties.

International movements of persons and capital have frequently raised sensitivities of a different nature from the international movement of goods. Just as with trade in goods, there are some services that are more sensitive than others—including some services that do not involve the international movement of service providers or receivers (category 3); clothing and textiles have their parallels in the area of services. So it may not be possible to have the same set of rules cover even all the services that fall into category 3, and, just as with goods, there will be a tradeoff between the extent of product coverage by an agreed set of rules and the liberalizing thrust and enforceability of these rules. In any case, to try to force into the same mold as category 3 the services that fall within categories 1 and 2 would appear unwise, as it would detract from what could be achieved in category 3.

These considerations have led to the proposal for a two-level set of agreements for services: a framework agreement specifying a set of principles applicable to a broad range of services and a subsidiary set of agreements (or annotations) that would apply these principles to specific service sectors. This is the manner in which the Uruguay Round negotiations on services has been proceeding. In the midterm review ministers agreed that negotiations for a multilateral agreement should continue and that a framework agreement should incorporate provisions on transparency, progressive liberalization, national treatment, most favored nation treatment and nondiscrimination, market access, increasing participation for developing countries, safeguards and exceptions, and "regulatory situation," the last item "recognizing" the right of developing countries to introduce new regulations for services, consistent with commitments under the framework. Work is now under way in the Group of Negotiations on Services to explore the application of these principles to particular service sectors.

The two-level concept still leaves open the question of the breadth of coverage of the framework and the sector agreements. The GATT covers all goods unless (as for agriculture) there are specific provisions for particular goods: it is, after all, a general agreement. The agreements for services could be structured on the same all-encompassing principle, or they could embrace only the services that are specifically identified. The contrast is between a positive list that includes only those services named and a negative list that includes all services except those specifically excluded.

Two recent bilateral free trade agreements take opposite positions on this question with respect to services. The Canada–U.S. Free Trade Agreement adopts the positive list approach; a recent extension of the Closer Economic Relationship Agreement between Australia and New Zealand provides for free trade in all services unless they are specifically exempted. For a multilateral agreement, and in particular one that does not provide for free trade, it may be more difficult to adopt the negative list approach, although experience with respect to quantitative trade barriers to goods shows that the negative list approach is more liberalizing. Thus, in the context of the Uruguay Round one of the "sector" agreements could apply to all services except those for which there are specific provisions.

Conclusion

Although it is likely that countries gain economically from trading services, as from trading goods, international negotiations in services, as for goods, tend to focus on the opportunities for exporters and not on the opportunities for gains from importing. Expressed in general form, the principles of comparative advantage apply to services trade much as they do to goods, although some services trade requires the movement of the service provider or receiver. Developed countries tend to export services that are dependent on high levels of human, physical, or financial capital; developing countries have considerable opportunities to export labor-intensive services. Many of the latter services require temporary movement of labor, and others require that complementary capital equipment be available. Barriers to trade in this equipment, often erected for the protection of domestic industries, can prevent the development of exports of these services.

Breadth of coverage appears to be an important ingredient in achieving an international agreement on services that is truly liberalizing; product-specific agreements have a history of encouraging organized and restricted trade. The main GATT principles of nondiscrimination, national treatment, liberalization, transparency, and predictability can be applied to trade in services, and the conversion of many of the regulatory barriers to services trade to forms analogous to import tariffs would facilitate the building of a GATT-like, liberalizing, agreement. But movements of labor and capital raise particular problems, and special provisions will be necessary for them in any services agreement—although GATT principles could still be applied.

Notes

Grateful acknowledgment is made of comments by Geza Feketekuty, Max Kreinin, Roger Mauldon, and Patrick Messerlin.

1. Discussion of many of the points covered may be found in Feketekuty (1988).
2. The distinction between goods and services can become rather blurred when such "services" as architectural drawings, computer programs, and musical recordings are transported in a physical form.
3. "Flying in the Face of Marxist Dogma," *Financial Times*, June 22, 1989.
4. This classification is based on that of Sampson and Snape (1985).
5. The provisions in GATT for safeguarding industries on a temporary basis from "fair" trade do not allow for discrimination, although there was considerable pressure from some developed countries for such selectivity in the Tokyo Round of multilateral negotiations (see Sampson 1987; Winham 1986), and this pressure has continued in the Uruguay Round. Such discrimination would be mainly against developing countries and has been resisted by them. Trade remedies can be applied on a selective basis against members if they cause injury to the industries of other members by means of export-promoting subsidies or by dumping—practices that are frequently described as unfair trade.
6. There is a tendency for some countries to adopt a unilateral approach toward determining whether others have satisfied the conditions of new agreements and thus toward extending to others the benefits under the agreements. This applies in particular to the Subsidies Code concluded in the Tokyo Round of multilateral trade negotiations.
7. That is, 40 percent for the carriers of country A, 40 percent for those of country B, and 20 percent for all others, for carriage of the trade between A and B.
8. Article III explicitly permits subsidies on domestic production.

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2

Principles in Factor-related Trade in Services

Brian Hindley

Services and goods differ in a number of ways. But in discussing international transactions, the difference of dominant importance is that whereas goods are tangible and, with more or less trouble or cost, can be transported from one place to another, services, which are a change in the condition of a thing or a person (Hill 1977), are not tangible and cannot be shifted from place to place.

The outcome of a service—the person or thing changed by the service—can be transported. So can the signifiers of property rights generated by a service (for example, a bank statement or an insurance policy). And, of central importance, the means of providing a service—people or goods—can be moved.

The nontransportability of services is often expressed by saying that the provision of a service requires proximity of the provider of the service and the good or the person receiving it. For this reason, international transactions in services are much more likely to require some form of international factor movement than are international transactions in goods. This does not necessarily mean that the factors of production involved in providing the service have to move to the country of the receiver of the service (Sampson and Snape 1985), but that is what it often means in practice.

This simple fact affects basic economic concepts. Consider, for example, the notion of an integrated world market. For a good, the concept is reasonably clear; it implies that the price of the good is the same in each national market when costs of transport and differences in national taxes are taken into account. If the price of a good is higher in one market than in another, shipments of the good will be diverted from the low-price to the high-price market. Hence, to produce an integrated world market in a good, obstacles to flows of the good have to be removed.

An integrated world market for a service involves different considerations. Arbitrage in goods can occur without any change in the location of the producers of the goods, but this is not true of services. Often, the means of providing the service must be to some degree located in the market of the receiver of the service. If a service is overpriced in one market in relation to another, correction of the disequilibrium requires a flow of factors.

If profits on the route from A to B are higher than those on the route from C to D, it is necessary to move ships, aircraft, or trucks—and perhaps crews—from the CD to the AB route. If the earnings of lawyers and doctors in A are higher than those in B, equalization of earnings by an arbitrage-like process will require the movement of lawyers and doctors from B to A. An integrated market for a service requires something much more akin to the process by which economists imagine that profits are equalized among different industries or wages among different occupations than to the process by which they imagine that the prices of goods are equalized among different national markets.

Even if arbitrage is unimpeded, however, it is unlikely to lead to a situation in which a service is priced the same in different national markets. One reason is that provision of a service in a locality almost inevitably entails the use of local as well as imported factors of production. Possibly more important, establishment in B is likely to require conformity with B's regulatory system, and the regulatory system in effect is likely to affect the producers' costs. Hence there is no reason to suppose that service providers from country A can exactly reproduce in country B the price-quality combinations that they can provide in A.[1]

The term "regulatory system," moreover, must be interpreted broadly in this context. A national regulatory system is usually taken to consist of rules for specific service industries, such as requirements for minimum levels of reserves or for minimum years of training at approved institutions. But an integrated world market for a service entails international factor flows, and the term "national regulatory system" must therefore be interpreted to include, for example, laws on immigration, laws regarding the establishment of foreign firms or subsidiaries or branches of foreign firms, and conditions imposed on employment generally, such as minimum wage laws and contributions to social security.

A construction company from a developing country, using labor from that country and paying its workers on that country's terms, may be capable of constructing a highway or an airport of a given quality in Europe more cheaply than could a European company using European labor. But a company from a developing country will have great legal difficulty in getting labor from the developing country into Europe. Even if it could do so, it might not be able to produce more cheaply were that labor, once in Europe, subject to European employment laws.

Not all international transactions in services call for proximity in the immediate geographic sense of labor employed to construct an airport or highway. "Tradable services"—or, in the terminology of Bhagwati (1984), long-distance services—do exist. These are services that can be provided by a supplier in country A to a user in country B without relocation by either of them, such as conducting banking business by computer terminal. Any service transaction that takes place within a country entirely by mail, fax, or phone, without direct personal contact, can also be traded internationally. This class of services is growing rapidly and may be expected to grow even faster in the future, but it is not yet large in relation to the service sector as a whole.

The scope of tradable services can be extended somewhat by adding to the category services that require only brief periods of relocation rather than permanent or semipermanent residence. An architect or consulting engineer, for example, may be able to function effectively with a few brief visits to the site of a project. By contrast, a bank is likely to need a permanent presence in a country if it is to successfully provide a full range of banking services.

Another possible exception occurs when potential users of the service can move to the location of foreign suppliers of the service (or when both are able to meet in some third location). Even if service suppliers are not free to locate in the national market, temporary relocation of users of a service might produce many of the consequences of a national market that is integrated with the world market. That this is more likely to be true the lower the cost of transport services suggests that it is more likely to apply to Luxembourg than to New Zealand.

These exceptions do not appear to constitute a major breach in the general rule that factor flows are required to produce an integrated world market in a service. The idea of permitting factor flows, however, is not popular anywhere.

Why this should be so is an interesting question. Suppose that a construction firm from the Republic of Korea, if allowed to locate Korean labor in Europe temporarily, can construct a road or an airport in Europe more cheaply than any European firm supplying a similar quality of output. If the output were a product manufactured in Korea and sent to Europe, like motor cars or television sets, most economists would reject the notion that the relative cheapness of Korean labor constituted a valid reason for resisting the import of those goods. European airports, however, cannot be built in Korea and shipped to Europe; they have to be built in Europe. But despite this difference, the logic of comparative cost that applied to cars and television sets seems to apply to airports. And that logic suggests that if the airport can be built at a lower cost by Koreans, they should build it. That in turn implies that they should be allowed to locate temporarily in Europe for that purpose.

That an idea is consistent with the logic of comparative advantage is not at all the same thing as its being politically feasible. It is as well to understand, however, that the fundamental difficulty with the idea of shifting factors of production to a location when the output of the factors cannot be shifted is political rather than economic.[2]

Developing countries, symmetrically, often reject local establishment by foreign providers of services, even when the services cannot be provided otherwise. They take this position although the terms of the rejection often concede, implicitly or explicitly, that foreign providers are more efficient than their local counterparts.

Factor Movements to Provide Services and the Uruguay Round

The United States opened the discussion of including services in the GATT with the proposal that negotiations be restricted to nonfactor services. Thus it suggested that the emphasis should be on services that can be traded in the conventional sense—a person or firm in one country sells something to a person or firm located in another country without relocation of either buyer or seller.

One motive for this suggestion was to avoid too great an affront to institutional conservatism. The GATT has in the past dealt with trade in goods, not with foreign investment. Focusing on tradable services seemed more consonant with GATT tradition.

The suggested restriction on the scope of the negotiation had the additional advantage of avoiding the difficult and contentious issues of foreign direct investment and rights of establishment. It also avoided the at least equally contentious issues that would be raised if developing countries made a counterclaim regarding a right of labor to temporarily reside in a foreign country for the purpose of supplying services.

This attempt to avoid one set of problems created others. One appeared in the form of a conflict within the United States on its negotiating position. Whatever the tactical advantages of focusing on traded nonfactor services in GATT negotiations, many U.S. service suppliers perceive their main international problem to be the lack of a right of establishment in foreign markets. They were therefore skeptical of the value of negotiations that did not include discussion of rights of establishment.

The emphasis on tradable services raised different problems for developing countries, which were not convinced that the issue of foreign direct investment could be avoided. Developing countries perceive that the logic of liberalization in the service sector requires a right of service providers to locate in the proximity of service receivers. They are typically suspicious of foreign direct investment, however, and many are hostile to the notion of introducing a GATT right of foreign service suppliers to locate in their territories—a point on which some developed countries are also likely to have doubts.

That the issue appeared as a problem of foreign investment, however, was a consequence of the way in which it had been posed. Analytically, the need of service industries that make intensive use of capital or skilled labor to locate those factors in potential markets is symmetrical with the need of providers of labor-intensive services to locate unskilled and semiskilled labor in potential markets.

Another problem that the emphasis on tradable services raised for developing countries was that whereas service suppliers based in developed countries might find it easier to use local establishments, almost all of the services for which trade without establishment is possible are those in which developed countries currently appear to possess a comparative advantage (for example, banking and financial services and informatics). Any successful liberalization in this restricted range of services would therefore probably mean an increase in developing country imports of services from developed countries without any compensating increase in their exports of services.

In GATT terms, this raises a significant problem. GATT negotiations center on exchanges of "concessions," where a concession is defined as a reduction in restrictions on imports and where concessions from other countries are won at the "cost" of relaxations in one's own import regime. Economists often scoff at the language of GATT negotiations. Ricardo's demonstration of the principle of comparative advantage, they say, destroyed once and for all the possibility of regarding increased openness to imports as a cost. That is true. It is also true, however, that economic analysis offers no solution to the political problem that the GATT process addresses through concessions.

The structure of protection in a particular country at a particular time must be taken to represent the outcome of some process of political equilibrium. To change the protective structure, therefore, the factors that support the underlying political equilibrium must be changed. An exchange of concessions offers one means of achieving this. By altering the opportunities available to actors in the domestic political process—by providing exporters with a direct connection between the barriers they face in foreign markets and the level of their own country's protection against imports—the offer of concessions alters the economic interests involved and makes possible new domestic coalitions. Hence the offer of an exchange of concessions is likely to help a government that wishes to liberalize but faces domestic opposition and may also put pressure on a government that is not persuaded of the case for liberalization.

The U.S. suggestion that the GATT negotiations be restricted to tradable nonfactor services, however, defined services in such a way that comparative advantage lay predominantly with developed countries. Hence the great bulk of potential GATT concessions in services would come from the developing countries, and this seemed to preclude the possibility of an equal exchange of concessions between developed and developing countries within the service sector.

One response to this problem has been to point to the economic gains available to developing countries as a result of liberalization in their service sectors. That such gains exist seems very likely (Hindley 1988), but their existence does not solve the dilemma for the multilateral trade negotiations. The economic gains that developing countries can obtain by liberalizing their service sectors can for the most part be obtained through unilateral action. But gains that can be obtained unilaterally are unlikely to be enough to persuade a government to join a multilateral liberalization—especially if the government has already rejected unilateral liberalization, as have the governments of most developing countries.

Bhagwati (1987) has suggested a single solution to these two problems—the desire of U.S. service suppliers to obtain some kind of establishment in foreign markets and the lack of concessions of interest to developing countries. His proposal is to introduce rights of establishment into the GATT talks but to define them to include a right to locate labor in a country temporarily for the purpose of supplying a service.

Half of this potential solution has been broached. Early in the negotiations the United States abandoned its insistence on confining the negotiations to tradable services.

For example, its first submission to the Group of Negotiations on Services (United States 1987, p. 3) states:

> The framework should apply to cross-border movement of services *as well as to the establishment of foreign branches and subsidiaries for the purposes of producing and delivering the service within the host country* (emphasis added).

The notion of a right of location for labor that is supplying services has been mentioned by a number of developing countries. So far, however, it has been less sharply crystallized.

The Statement of the Trade Negotiating Committee Meeting at Ministerial Level, issued after the midterm review held in Montreal in December 1988, deals with the question in terms of definition:

> Work on definition [of services] should proceed on the basis that the multilateral framework may include trade in services involving cross-border movement of services, cross-border movement of consumers, and cross-border movement of factors of production where such movement is essential to suppliers.

A later paragraph, under the heading of market access, states:

> When market access is made available to signatories it should be on the basis that consistent with the other provisions of the multilateral framework and in accordance with the definition of trade in services, foreign services may be supplied according to the preferred mode of delivery.

These words clearly do not commit anybody to anything much. Nevertheless, the possibility that the negotiation will attempt to liberalize international factor movements for the purpose of supplying services is open. The question of the legal and institutional forms available for the purpose is therefore relevant.

Rights of Establishment, Access, and Presence

The concept of a right of establishment is fairly clear. For example, chapter 2 (articles 52-58) of the EEC Treaty, which is the legal basis of the European Economic Community, is entitled "Rights of Establishment." Article 52 states:

> . . . restrictions on the freedom of establishment of nationals of a Member State shall be abolished by progressive stages. . . . Such progressive abolition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.
>
> Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms . . . under the conditions laid down for its own nationals by the law of the country where such establishment is effected.

The last sentence of this passage adds to the right of establishment a requirement of national treatment: a government shall not use differences in nationality as a basis for differences in legal treatment. Thus the treaty gives to a Greek national who wishes to set up a bank or an insurance company in France or Germany a legal right to do so, subject to the condition that an otherwise similar French or German national would be legally entitled to do so.

A right of establishment as such is very extensive. Application of the principle of national treatment can significantly limit the exercise of that right. For example, the two conditions taken together do not prevent a government from banning the establishment of new banks, although they do prevent acts or regulations that discriminate between the government's own nationals and those of other countries. Their combined effect is to provide that a government cannot prevent a foreigner from establishing a bank if it would have allowed a similarly qualified national to do so. A government can, however, subject the foreign-owned bank to any conditions that would apply to a bank owned by its own nationals.[3]

Many governments—some governments of developed countries among them—are likely to resist the notion of granting through a multilateral agreement a right of establishment to foreign providers of services. And even governments that might support the notion in principle would be likely to experience difficulties in practice. The United States, for example, does not permit foreign ownership of U.S. television stations or airlines.

Partly to deal with this difficulty, two new concepts have developed: the idea of a right of access and the idea of a right of commercial presence. The third principle of the Declaration on Trade in Services annexed to the Agreement on the Establishment of a Free Trade Area between the United States and Israel illustrates both:

> Each party will endeavor to provide that a supplier of a service produced within the other nation is able to market and distribute that service under the same conditions as a like service produced within the first nation, including situations where a commercial presence within the nation is necessary to facilitate the

> export of a service from the other nation or is required by that Party.

The idea of a right of access—the ability to market and distribute the service product—is intended to parallel GATT provisions on goods. Article III of the GATT requires national treatment for goods once duties have been applied at the border. In other words, it requires that tariffs (or other border measures, when authorized) should be the only means of discrimination between foreign and national suppliers. When applied to services, this idea can raise problems. For many services border measures such as tariffs are an impractical means of discrimination, and when the GATT version of national treatment is interpreted as authorizing only border measures, advocacy of national treatment tends to merge with advocacy of free trade in services.

Nevertheless, the basic perception that there is little point in attempting to negotiate a liberalization of particular barriers to international transactions if foreign products can be blocked by other barriers, such as denial of access to distribution networks, is as valid for goods as for services. Thus any sensible GATT (or other) agreement on liberalizing international transactions in services will attempt to guarantee that service products which have cleared the hurdles authorized by the GATT will receive national treatment with respect to local distribution networks—that is, right of access.

Commercial presence is a related but different concept. A footnote to the passage quoted above notes:

> . . . in the area of commercial banking, the concept of a commercial presence refers to the activities of representative offices, but not to agencies, branches or subsidiaries of commercial banks.

"Commercial presence" therefore encompasses establishments that are necessary to facilitate cross-border trade in services. It falls far short of a right of establishment. A right of establishment would allow a foreign bank to establish "agencies, branches, or subsidiaries."

Rights of establishment, access, or presence pertain to organizations (which may be small—for example, firms of lawyers or architects or the "self-employed persons" referred to in article 58 of the EEC Treaty). Establishment of a foreign-owned enterprise may mean that foreigners associated with the enterprise are admitted to the country of establishment on privileged terms to perform work there. But it does not necessarily mean that. Immigration issues—the question of which persons will be admitted to a country—are in principle separate from establishment issues—the question of which organizations will be allowed to provide services in the country.

The International Movement of Labor to Provide Services

The general question of the freedom of labor to locate in a foreign jurisdiction to provide services has numerous subdivisions. "Labor" is a broad term, and the period during which it is necessary to "locate" in order to effectively provide a service may vary from hours to years or decades.

The needs of one form of labor—that involved in the supply of professional services—has received considerable attention (see, for example, University of Chicago Legal Forum 1986). This discussion is relevant to the interests of developing countries in the multilateral trade negotiations, since these countries have considerable potential for exporting professional services.

The problems of liberalizing international transactions in professional services and those of liberalizing international transactions in labor-intensive services have elements in common, but they are not identical. Liberalization of labor-intensive services may provide a focus for developing countries' interest in supplying services for foreign markets, should the associated problems prove to be soluble and negotiable.

As noted above, the problems with making operational a temporary right of abode for the provision of services (TRAPS) are primarily political, not economic. Nevertheless it seems useful to identify some points on which decisions are essential and to sketch the consequences of the choices that might be made.

Suppose that in country H labor engaged in supplying a certain service earns \$1 an hour, whereas in country F[4] the same labor, similarly employed, is worth \$5 an hour. It seems fair to assume that even if a TRAPS is negotiated in the Uruguay Round, the number of TRAPS visas issued will not be enough to bring about equalization of the occupational wage rate in H and F. But if the wage rates are not equalized, the question arises: who obtains the difference between the wage at which H labor would be willing to work in F (say, for simplicity, \$1 an hour) and the value of H labor when employed in F? The answer is that the difference will accrue to those who receive the TRAPS visa rights.

The right to employ persons under the TRAPS scheme could be issued to, say, providers in country F of the service that employs this particular kind of labor. Those F employers would have a right to hire in country H at \$1 an hour labor that in F is valued at \$5 an hour. This allocation of TRAPS rights implies that providers of the service in F receive the difference.

At the other extreme, the rights could be issued to workers in country H (on a first-come-first-served basis, say, since there are likely to be more H workers willing to work in F for $1 an hour than there are TRAPS visas). The outcome for the post-TRAPS distribution of income would then be quite different. Assuming competition among F employers willing to pay $5 an hour, allocation of TRAPS rights to H workers would mean that those H workers fortunate enough to receive the rights would be paid $5 an hour by employers in F. In this case the fortunate H workers would receive the difference between the $1 an hour at which they are willing to work in F and the $5 an hour that their labor is worth to F employers.

An alternative and perhaps more plausible way of distributing TRAPS visa rights to H residents would be to allocate the rights to H firms that wish to supply the associated service in F. The consequence of that distribution would be that H firms willing to make the attempt would receive the $4 an hour difference—in effect, a substantial subsidy to their export of the service.

An issue that is likely to be central to political discussion of a TRAPS is the application of F employment laws to H workers entering F under a TRAPS visa. But the answer arrived at is not crucial from the standpoint of the economics of the scheme. In the first place, the displacement from employment of competing F workers will be controlled by the assumed limit on the number of H workers admitted to F, not by the wages they receive in F. In the second place, H workers willing to work in F for $1 an hour but not allowed to work for less than, say, $4 an hour by F law or union rules will be prepared to pay $3 an hour for the right to work at the official rate in F. Such a payment can be made in many ways. To determine whether it actually has been made is therefore likely to be difficult or impossible.

Another issue that is likely to be central in political discussions has more economic relevance: whether the limit on the number of TRAPS visas should be for the service sector as a whole or should be subdivided among service industries. The latter course seems more politically feasible, as it would avoid the possibility that workers in any one industry would bear the full brunt of the employment consequences of a TRAPS scheme. It might also have the advantage, especially when combined with the allocation of TRAPS visas to foreign service-providing firms, of increasing the variety of services that such firms have an incentive to export.

Concluding Comment

There is no doubt that improving the ability of service-providing factors of production to move internationally could lead to significant economic gains for both developed and developing countries. The difficulties in achieving that result are primarily political. Service industries in which international transactions require international factor mobility are often unused to foreign competition, and they do not all welcome the prospect. In developing countries resistance acquires additional political force because industries that feel threatened often have a central economic position and substantial financial resources (examples are banks and insurance companies). In developed countries the industries in which employment might be threatened are those that employ low-wage domestic labor, which, as experience with international trading arrangements in the textiles and garment and footwear industries has made clear, can also command a great deal of political support. Nevertheless, the potential economic gains are there, and many of them would accrue to developing countries—which, by and large, have shown the greatest resistance to the attempt in the multilateral trade negotiations to introduce services into the GATT.

Of course, even if something like a temporary right of abode to provide services were offered in the Uruguay Round, developing countries might not regard it as a satisfactory quid pro quo for the rights of presence or establishment called for by developed countries. But unless the negotiation is to proceed on the basis of threats, either a quid pro quo must be found or the possibility must be faced that the bulk of developing countries will not join any eventual agreement—or will join it only on terms that make the agreement vacuous, at least as far as they are concerned.

Notes

1. This is also true of goods at the retail level. The equality of price to be expected in an integrated world market for a good is the net-of-transport-cost price at the dock, before any local services have been applied to it. An essential difference between goods and services is that for many services there is no equivalent of the dock—no point, short of delivery to the ultimate user of the service, at which it makes any sense to talk about the price of the service.

2. The *Financial Times* of July 12, 1988, however, reports John Reed, chairman of Citicorp and of the Services Policy Advisory Committee (which advises the U.S. administration), as saying that "U.S. business wanted a global agreement on services with as broad a participation as possible by developing countries. The Reagan administration should be prepared to trade off freer movement of Third World labor to U.S. projects in return for greater access for U.S. service companies to developing markets." Reed's remarks were made as he arrived in Geneva with U.S. Special Trade Representative Clayton Yeutter and fourteen members of the committee "to push for swifter progress on services in GATT's trade-liberalizing Uruguay Round."

3. The United States (1987, p. 6) noted this difficulty:

> In some cases in the past, regulators have effectively cartelized a given services sector by denying the issuance of new licenses for decades. National treatment obviously has no value in these instances from the standpoint of trade liberalization. While in a few instances regulators have established a legitimate need to limit the number of participants, a framework agreement should provide for a degree of foreign participation if such restricted circumstances recur.

4. This is not equivalent to the proposition that F residents who are members of the occupation receive $5 an hour. It is not necessary to the argument that H and F labor be of the same quality.

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3

The Uruguay Round Negotiations on Services: An Overview

Mario Marconini

At a meeting in Punta del Este, Uruguay, in September 1986, representatives of countries from around the world launched the eighth round of multilateral trade negotiations in the forty years of existence of the General Agreement on Tariffs and Trade (GATT). The ambitious character of the Uruguay Round was especially evident in that for the first time liberalization of trade in services was formally placed on the multilateral negotiating agenda. Its inclusion reflected the view of some countries that the potential for a larger role of services in world trade was restricted by the lack of multilaterally agreed rules governing their trade. Negotiations aimed at establishing a multilateral framework of rules for this dynamic category of international transactions could furthermore be seen as a way of maintaining the forward momentum of the liberalization process achieved for goods in the postwar era.

The negotiating process has been complex, reflecting considerable differences in the range and level of sophistication of service sectors in participating countries. Perhaps even more important, the negotiations have been in large measure guided by countries' differing assessments of the potential contribution that an open and liberal trading system in services could make to economic development. Countries in which the tradable services sector is large and services contribute significantly to gross domestic product (GDP) have seen negotiations on trade in services as a crucial element in strengthening the world's trading system and developing national economies. For countries in which the service sectors are less developed, the negotiations have been more difficult to assess, particularly in the absence of statistical information and of a conceptual foundation on which to base national priorities. Despite these differences, participating countries have undertaken to negotiate on a framework. The challenge facing all countries alike is to ensure that the framework contains the elements necessary for promoting greater global welfare alongside the economic development of individual states.

The main objective of this chapter is to shed some light on the principal developments that have been largely responsible for bringing the Uruguay Round negotiations on trade in services to where they are currently. The analysis will be undertaken chronologically to bring out the evolutionary character of the negotiations. Where possible, the implications of the various features of the negotiating process for participating countries are discussed.

The Initial Steps and the Punta del Este Declaration

In 1982 the United States submitted to the GATT a document that placed great emphasis on the importance of services to the world economy and on the GATT as a "solid basis" for a framework for trade in services.[1] Whereas most countries of the Organisation for Economic Co-operation and Development (OECD) could lend some support to the U.S. initiative, almost all developing countries opposed, although to varying degrees, the U.S. push to establish a working party that would set in motion the liberalization of trade in services through GATT negotiations. The opposition was initially based on the GATT's lack of legal competence in the matter.

The work program agreed on in November 1982 recommended that national studies on services be undertaken and invited contracting parties to exchange information,[2] but agreement on how the exchange should take place was reached only in November 1984. Between 1984 and 1986 seventeen national studies were circulated, and comprehensive documentation was received from thirteen international organizations. None of the national studies submitted was from a developing country.

By mid-1986 the persisting disagreement on the question of services continued to threaten the successful launching of a new round of multilateral trade negotiations. As a result of two years of intense discussions, however, the negotiations had gained in complexity as positions had become more elaborate, going beyond concerns about the legal competence of GATT to more fundamental issues such as the suitability of the conceptual structure and the scope of application of GATT to services trade, the definition of trade in services, the international competitiveness of services firms, and the role of regulation in the services sector.[3] In a parallel development, clusters of participating countries crystallized around common positions on specific issues and on the general approach to the negotiations. Four main clusters became apparent in the period just preceding the Punta del Este meeting: (1) the United States and some OECD countries, which favored the original proposal; (2) the European Community (EC), some OECD members, and some developing countries, which were working toward an overall compromise; (3) a group of ten developing countries (the G–10), led by Brazil and India, which strongly opposed the U.S. initiative; and (4) a group of twenty developing countries (the G–20) that were prepared to accept the U.S. proposal depending on the terms. (Richardson 1986). The inclusion of trade in services in the ministerial declaration owed much to the compromises struck among these four clusters of governments.

Negotiations on trade in services were launched through part II of the Punta del Este declaration of September 1986. Whereas part I, which launched negotiations on trade in goods, constituted a decision by the GATT contracting parties, part II was drafted as a separate decision by ministers in their capacity as representatives of their governments. The two-part decision, by setting up two distinct tracks for negotiations on goods and services, did much to allay the fears of some countries that trade in services would fully become a part of the GATT. The decision thus reflected an important compromise between countries (the United States, the OECD countries, and some developing countries) that favored the GATT as a forum for negotiations on services and those (the G–10) that preferred such negotiations to be outside the GATT conceptual and institutional structure. Despite this strict distinction between goods and services, however, the Uruguay Round as a whole was considered a single undertaking to be conducted within the same time frame and under the same "umbrella," the Trade Negotiations Committee (TNC).

In addition to this procedural agreement, a substantive element in part II that reflected the making of a compromise was the differentiation between expansion of trade on the one hand and liberalization as such on the other. Expansion of trade was assigned the status of an objective to be achieved "under the conditions of transparency and progressive liberalization." Liberalization was thus not the ultimate aim but merely a means toward that aim, along with transparency. This language sufficed to satisfy those countries that could see the merits of expanded trade, whether or not that implied a more liberal domestic economy. As confirmed by the Brazilian position at the time, for some heavily indebted developing countries the prospect of increased trade flows in general was a good goal to strive for, especially if combined with the recognition that general liberalization was to perform a secondary role in the evolving trade in services regime.[4] The qualification to the liberalization process introduced by adding the word "progressive" was also instrumental in drawing country positions closer. Admittedly, such a qualification carried with it the recognition that services structures and capacities varied widely across countries and that countries would differ in their capacity to liberalize their markets for services.[5]

Another related element was the linkage made between progressive liberalization and growth and development. Liberalization was identified as a means of promoting not only the "economic growth of all trading partners" but also the "development of developing countries." Even though expansion of trade had been assigned greater priority than liberalization as such, for some developing countries there was no necessary link between expansion of world trade and development. It was not disputed that trade expansion could contribute to development, but some countries were reluctant to accept that such a contribution followed automatically, without any qualification. By singling out the development of developing countries as one of the intended end results of a future agreement, scope was established for exploring how to substantiate the link between expanded trade and development, and it was ensured that the development objective would permeate all aspects of the negotiations. The language of the declaration thus did much to meet the desire of some developing countries that special consideration be given to their situation.

Finally, the text stated that the framework agreement should "respect the policy objectives of national laws and regulations applying to services." This sentence represented to many participants an acknowledgment that some national regulations affecting services could be maintained alongside a multilateral agreement on services trade. This acknowledgment implied a qualified approach to barriers or obstacles to trade whereby not all related laws and regulations were to be scrutinized but only those that impinged directly on trade in services.[6] The call for respect for national policy objectives created the possibility that liberalization might be interpreted as a limited undertaking that did not necessarily imply deregulation in all cases. It thus helped to narrow the gaps between national positions—gaps that in any case were not as wide on this issue as on some others, since developing countries were not the only ones interested in maintaining certain regulations in place. Many developed countries were also reluctant to reform their often sophisticated regulatory frameworks for services—especially through multilateral discipline. The position of the EC at the time was a case in point.[7]

The Negotiating Agenda

Following the adoption of the Punta del Este declaration, the Group of Negotiations on Services (GNS) was established, with a program for the initial phase of the negotiations that, in broad terms, aimed at addressing underlying issues not resolved in the ministerial declaration while shedding some light on how to fulfill the guidelines and objectives agreed on in Punta del Este. The work program for the GNS agreed on in February 1987 consisted of five agenda items.

- *Definitions and statistics.* Some countries maintained that no progress could be expected from the negotiations unless agreement were reached on a specific definition of trade in services. This argument was based on a perceived need to limit the scope of a future agreement so as to exclude "nontraditional" forms of trade that involved more than the movement of the services being provided across borders. Since delivery of certain services required proximity between the producer and the consumer, the claim had been made during the negotiations that the mobility of factors of production (capital, labor, technology, and information) and of consumers was essential for trade in services. International capital mobility, it was contended, should be sanctioned in a framework agreement on trade in services to give firms the choice of establishing in foreign markets to provide their services. "Establishment trade" constituted the "nontraditional" form of trade most strongly opposed by some developing countries such as Brazil and India. These countries placed great emphasis on the symmetry that would be required if some aspects of establishment-related investment were included in the agreement: if certain forms of permanent capital movements were to be sanctioned by future rules and principles applying to trade in services, consistency would require that certain forms of permanent labor movements be sanctioned as well. The full spectrum of definitional possibilities was thus on the table. At one extreme, trade involving only services that themselves crossed borders was being contemplated; on the other, services trade that necessitated the movement of production factors across frontiers was being considered.

On the question of statistics, some countries maintained that a considerable amount of work was still required, in particular with relation to the collection and disaggregation of available statistical data on services, to afford participants a better assessment of their negotiating interests. During the two years following the Punta del Este meeting, the secretariat produced a paper on the subject, and other international organizations—including the International Monetary Fund (IMF), the United Nations Centre on Transnational Corporations (UNCTC), and the United Nations Conference on Trade and Development (UNCTAD)—were invited to brief GNS participants on relevant work they had undertaken.

- *Concepts.* Even though efforts were made to introduce new concepts to fit the mandate's objectives, the discussions still relied to a considerable extent on traditional GATT terminology. Thus, concepts such as national treatment, most favored nation treatment and nondiscrimination, and transparency were put forth as principles for a future agreement.[8] Although some countries still had reservations as to the applicability of GATT concepts in their "pure" form, a consensus became increasingly apparent that traditional GATT "labels" might be acceptable if they were accompanied by nontraditional conceptual formulations. The discussion on national treatment illustrated this consensus. If national treatment were applied as set out in article III of the GATT, it would have different implications for services that crossed borders than for those that were delivered through locally established firms in a foreign country. Cross-border services might be treated analogously to trade in goods, where national treatment was used to ensure that concessions made at the border were not nullified internally by the actions of the government of the importing country. For services involving the cross-border movement of factors of production, national treatment would no longer apply to the movement of products (or activities) across borders but to the activities of producers within borders. Such a formulation should reflect some agreement on whether national treatment would apply only after some form of market access (for example, establishment) had been granted or whether it would in effect imply both market access and equal treatment for foreign providers in terms of their operations after access had been granted.[9]

- *Sectoral coverage.* During the Group's deliberations, there had been few indications of the sectors that participants were interested in considering for negotiation. Some developing countries contended that the coverage of an agreement on trade in services should achieve a balance of interests for all participants and not reproduce the situation persisting in goods trade, where whole sectors of interest to developing countries, such as textiles and agriculture, in effect remained outside GATT discipline. It had become evident, however, that such a balance depended on complex linkages between coverage and other elements of the agenda. For example, some developing country participants maintained that sectoral coverage could only be resolved once a definition was adopted as to what did and did not constitute trade in services. This contention stood in direct opposition to that of several other participants, who considered the identification of sectors or transactions within sectors of interest to be the main means for achieving a workable definition of trade in services. A similar linkage obtained between coverage and concepts. Whereas some participants (mostly developing countries) preferred to know what sectors were being considered for inclusion before committing themselves on the concepts to be included in the framework, others clearly favored the adoption of a general framework of widely applicable rules and principles irrespective of whether agreement had been reached on including or excluding certain sectors.[10]

• *Existing sectoral arrangements and disciplines.* Whereas the original questioning of the GATT's legal competence became less of an issue after the Punta del Este meeting, the competence of other organizations in relation to trade in services was increasingly considered worthy of careful examination.[11] Several developing countries pointed out that even though existing sectoral arrangements on services had not focused primarily on the services sector as a whole or on the multilateral liberalization of trade in services, the services negotiations could hardly be construed as occurring in a complete legal vacuum. In recognition of that fact, the Group extended invitations to participate in the relevant GNS discussions to the International Telecommunications Union (ITU), the International Civil Aviation Organization (ICAO), and UNCTAD (for a presentation of the U.N. Convention on a Code of Conduct for Liner Conferences). The participation of these organizations, in addition to confirming that there was no "legal vacuum," also attested to the fact that such arrangements did not have as their primary objective the establishment of a multilateral framework to expand trade in services and to promote economic growth and development.

• *Measures and practices contributing to or limiting the expansion of trade in services.* The discussion of this item centered on how a future agreement could fulfill the Punta del Este directive on respecting the policy objectives of national laws and regulations. While the deliberations reflected in large measure the acknowledgment implicit in the Punta del Este declaration that laws and regulations were often intended to achieve legitimate national policy objectives, much thought was devoted to ways of differentiating between "acceptable" or "appropriate" measures and measures that were candidates for negotiated liberalization.[12] Some developing countries maintained that all laws and regulations that were in place to fulfill policy objectives should be immune to multilateral disciplines. Other participants tended to view objectives as unassailable but not the individual laws and regulations embodying them. Also, for some participants, trade-restricting measures and practices were not confined to the public sector but were also very prominently employed by private market operators. Underlying the discussions on this item was the recognition by most participants that, owing to the peculiarities of service transactions (for example, their being unaffected by tariffs), barriers to trade in services were difficult to identify, regardless of the policy objectives they might embody.

The Montreal Text: Content and Implications

Following an intense period of informal consultations that led to the report to the TNC meeting at ministerial level, agreement was reached in Montreal on the text setting the guidelines for the future work of the GNS. The text contained some substantive provisions that addressed many of the concerns expressed during the negotiations by both developing and developed countries.

Perhaps the greatest progress achieved in Montreal related to one of the most difficult aspects of the negotiations: providing for the development of developing countries under a framework agreement. The "development objective" had permeated all aspects of the negotiations during the two years preceding the midterm review, and many participants concurred that development should be included as an integral part of the agreement and not as an "appendage" or a series of waivers and exceptions. Many participants' idea of what should be sought was very different from the development approach embodied in part IV of the GATT, which set out the guidelines for special and differential treatment for developing countries in the goods area.

The Montreal text would largely succeed in creating the context for exploring different possibilities for integrating development-related concerns into the agreement. Of special relevance was a comprehensive passage headed "increasing participation of developing countries," which directly linked greater participation in world trade in services and expanded services exports by developing countries to the strengthening of the capacity, efficiency, and competitiveness of the domestic services sectors in those countries (GATT 1989a, p. 40). The establishment of this linkage in effect created the scope for the exploration of policy options reflecting the strategic role of services in the national development process, including joint ventures, infant industries, and technology transfer.[13] A second element that contributed to making development an integral part of the agreement was the language contained under the concept of progressive liberalization, which tied the progressivity of the liberalization process to the level of development of individual countries. Appropriate flexibility was also deemed necessary for countries in opening "fewer sectors or liberalizing fewer types of transactions or in progressively extending market access in line with their development situation" (GATT 1989a, p. 39). The injection of progressivity into the liberalization process went a long way toward accommodating the wishes of developing countries which perceived the liberalization of trade in services to be feasible only in the long term. Progressivity could allow these countries the necessary additional time and stimulus to engage in domestic liberalization efforts before submitting their service sectors to broader commitments to external liberalization.

The third element in the text relevant to development and developing countries related to regulatory matters. The concept of "regulatory situation" recognized the differences between regulatory structures in developed and developing countries (GATT 1989a, p. 40). Even though this recognition did not include the claim by developing countries that development itself was a policy objective of national laws and regulations, it gave these countries the possibility of introducing new regulations to correct the regulatory asymmetries between themselves and their developed counterparts. This prescription, along with the recognition that "governments regulate service sectors, e.g., by (among other things) attaching conditions to the operation of enterprises within their markets," would create the possibility of regulating matters relating to technology transfer, investment, and even the movement of labor and personnel.

In addition to these strides toward a consistent treatment of development under the framework, the conceptual basis underpinning the discussion of the GNS was expanded to include other innovative formulations. For those traditional GATT concepts that appeared in the text, nontraditional formulations prevailed, reflecting the specificity of service transactions as compared with trade in goods. National treatment, for example, was to apply not only to exports of services but also to service providers, in effect creating the possibility of treatment no less favorable being granted to foreign established companies as well as to foreign labor and professionals. There was no most favored nation treatment formulation in Montreal, but market access received a broad formulation stating that "foreign services may be supplied according to the preferred mode of delivery." Some governments had advanced the concept of "preferred mode of delivery" during the negotiations to indicate that service firms, in gaining access to foreign markets, should be able to choose the manner in which they would deliver their services—through a local commercial presence, through telecommunication links across borders, through local agents, and so on. This formulation of market access was closely related to the passage on definitions, which stated that "the framework may apply" to services that themselves move across borders or that involve the cross-border movement of consumers, factors of production, or both. It was recognized that mobility across borders may differ, depending on the mode of delivery preferred. It was also implicit that giving service firms the possibility of choosing the mode of delivery might create a favorable climate for transfer by these firms of technological expertise and operational know-how. For many industrial countries, that freedom of choice was considered indispensable in the framework agreement, but for some developing countries, such freedom implied a significant relinquishment of sovereignty. This was why the Montreal text stated that market access should be made available in accordance with the definition of trade in services.[14]

The Montreal text did not resolve the definition issue, but it did give it more precision. Similarly, the sectoral coverage of the agreement was left open even though the text stated that certain sectors could eventually be excluded in whole or in part because of certain overriding considerations (GATT 1989a, p. 38). Finally, the Montreal text included a provision stating that close attention should be paid to the extent to which any of the negotiating objectives in part II of the Punta del Este Declaration could be achieved through existing arrangements and disciplines (GATT 1989a, p. 38).

The Post–Montreal Period

In addition to providing a substantive conceptual basis, the Montreal text contained an elaborate timetable as to how the negotiations were to proceed. The GNS was able to meet this timetable despite the four-month interlude after the Montreal meeting caused by the lack of agreement in other groups of negotiations.[15]

In accordance with timetable, the first issue to be tackled by the GNS was sectoral coverage. To ensure that progress would be made on the issue, ministers had instructed the GATT Secretariat to draw up a reference list by April 1989. To complement such a list—which was not to represent a negotiable document or necessarily reflect all negotiable sectors—participating countries were also invited to submit "indicative lists" of sectors of interest to them, and it was agreed that no service sector would be excluded a priori. This arrangement, which was to be concluded by May 1989, represented an attempt to address the concern expressed by many participants that without at least an indication of the sectors countries might be interested in negotiating, it might be difficult to expect meaningful commitments with respect to other areas of the negotiations. Even though only the European Community, Hong Kong, and Poland submitted indicative lists, the reference list drawn up by the secretariat served to add some precision to an otherwise very broad discussion.

To address the linkages between the coverage issue and the concepts issue, ministers agreed on the need to examine the implications and applicability of concepts, principles, and rules for particular sectors and specific transactions. By mid-September 1989 the examination process had been completed for six sectors: telecommunications, construction, transport, tourism, financial services (including insurance), and professional services. Undoubtedly, the sectoral testing exercise, although it did not involve any real negotiations, was useful in bringing out some of the more relevant features of the sectors examined in relation to the concepts agreed in Montreal. As the agreement on the formulation of these concepts was only "considered relevant" for the elaboration of a multilateral framework of principles and rules on trade in services, definite conclusions cannot be drawn from the exercise. Some of the implications are, however, revealing.

Certain concepts do indeed have broad applications across many sectors. Transparency, for example, can feasibly be applied to relevant laws, regulations, administrative guidelines, and international arrangements in many sectors.[16] The same is true of progressive liberalization, which is by nature a flexible concept that could relate to subsectors, transactions, activities, or even modes of delivery relevant to each sector (for example, on-line data bases in telecommunications, the phasing out of cargo-sharing arrangements in maritime transport, and licenses to establish in the domestic market in insurance). The concept of "regulatory situation" is also widely applicable; the general aim of readdressing regulatory asymmetries among countries would not be compromised by the introduction of different types of laws and regulations tailored to the sector in question. For example, in tourism environmental protection and health standards might redress asymmetries among regulatory systems, whereas safety regulations might have a more corrective effect in the air transport sector.

For some concepts, however, a generally applicable formulation does not suffice to address significant specificities in certain sectors. For example, it was believed in some quarters that defining national treatment so as to require that foreign providers be treated no less favorably than national providers was not enough to afford increased levels of market access to foreign providers. Restrictive regulatory systems applicable to national providers would simply be extended to foreign providers if the principle were applied without any qualification or reformulation. The financial services sector was a case in point. Providing a comparable level of competitive opportunities for foreign and domestic financial institutions through the application of national treatment is especially difficult, given that some countries enforce an institutional separation of banking and securities activities whereas others do not. The unqualified application of the most favored nation principle—traditionally a central element in the multilateralization of concessions exchanged among trading partners—could also run into problems, since many of the regulatory frameworks obtaining internationally reflect reciprocal arrangements reached among countries. Examples are enhanced telecommunications services and some financial services, as well as civil aviation, which has been governed by bilateral reciprocity arrangements aimed at achieving an equitable distribution of market access opportunities for carriers of trading partners.

The sectoral testing exercise benefited from the active participation of most countries. Although countries' assessments of the exercise varied—some more readily finding evidence that sectoral specificities would override the supposed utility of a multilateral framework of generally applicable rules and principles—the exercise constituted a valuable input into the assembling of the main elements for a draft framework, which ministers had earmarked for December 1989.

What Lies Ahead

In an effort to push forward the negotiations toward the fulfillment of the ministerial schedule, the United States submitted in October 1989 a very elaborate and comprehensive text—drafted in legal language—on the structure of the framework agreement. In addition, thirteen other parties—Austria, Brazil, Canada, the EC, India, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Peru, Singapore, and Switzerland—submitted papers on the subject during the second half of the year, but none had the same degree of legal clarity. On the basis of such documents and related discussions, agreement was reached on a text that will guide the negotiations during the last year of the Uruguay Round. Even though it is early to discern the physiognomy of the final framework, the process of assembling the main elements has made evident that five areas will be central in determining the nature of the agreement: definition, scope, concepts, structure (including coverage and modalities of the liberalization process) and institutional aspects (for example, the relationship of the GNS agreement to the GATT).

Although long-standing issues such as definitions and concepts have been further refined, the structure of the agreement has loomed as the crucial issue on which hinges the very utility and attractiveness of the agreement. Only once a structure is in place can governments meaningfully initiate the process of exchanging commitments, as only then will they have a clear idea as to the rights and obligations emanating from the framework agreement. A related element of great importance is the treatment of sectoral specificities. Even though there seems to be wide agreement on the need for annotations which while being an integral part of the agreement would "interpret or clarify" framework provisions as they apply to each individual sector, agreement will need to be reached on the format and content of such annotations. Annotations may, for example, differ considerably among sectors according to whether the realm of activities of the sector in question is affected by the provisions of an international agreement—such as those enforced by the ICAO or the ITU.

While the importance of this issue is widely recognized by all participants, it should also be noted that different participants attach different degrees of priority to this and other issues. For example, several developing countries are laying great emphasis on the issue of definition and on the final formulation that might be given to certain concepts. In particular, a very truculent discussion might take place in the months leading up to the conclusion of the Uruguay Round if some countries perceive that the GNS is giving less priority to "increasing participation of developing countries" than to some other issues. A well-balanced consideration of the essential elements of the framework will do much to highlight the complexity of the subject while constituting a last meaningful attempt at crafting a truly multilateral framework of rules and principles governing trade in services.

Notes

1. The Consultative Group of Eighteen, a group of high-level government officials established as a permanent GATT body in 1979, held the first real substantive discussion of trade in services in the GATT in March 1981. That discussion focused on the links between trade in goods and trade in services and on the relevance for trade in services of existing commitments under the General Agreement and the most favored nation codes (GATT 1981).

2. The recommendation for individual national studies was in itself a compromise between countries that wanted the GATT Secretariat to undertake a general study and those that opposed the involvement of the secretariat in matters relating to services.

3. The views on such issues did not follow a clear North–South line in all instances. The issue of regulation, for example, was an important concern for both developed and developing countries. There was, however, a certain difference of emphasis; developing countries placed more emphasis on infant industry protection and the balance of payments situation than did developed countries, which gave greater priority to prudential and fiduciary concerns.

4. This point was further elaborated in a communication from Brazil to the GNS, published by the Brazilian negotiator in Batista (1987, p. 62, para. 16).

5. This concern is well exemplified in Argentina's statement that "account had to be taken of the fact that for historical reasons or due to different perspectives, some sectors were more highly regulated than others, both among different services sectors and within the same sector in different countries" (GATT 1985a, para. 63).

6. This point was elaborated upon by the Indian negotiator at the time in Randhawa (1987, p. 165).

7. Just before the Punta del Este meeting the EC stated that "the appropriateness of national regulation of services sectors would need to be respected as a legitimate constraint on any multilateral action on trade in services; any agreement would therefore need to strike a balance between the benefits accruing from liberalization of trade on a nondiscriminatory basis and those pursued by regulation of services sectors for the promotion of domestic economic and political goals such as development" (GATT 1986, para. 2).

8. In a paper submitted by Mexico to the GNS, the concept of relative reciprocity, based on article 36(8) of the GATT, figured as a central element addressing the concerns of developing countries. According to the original formulation, developed countries should not expect strict reciprocity for commitments made to developing country signatories (GATT 1988a, p. 12).

9. A concept that was a modified version of a GATT principle was that of optional most favored nation treatment, introduced by Switzerland. This was an attempt to limit most favored nation treatment by providing that countries could choose to grant it to third parties only on request (GATT 1988a, p. 13).

10. The U.S. approach, outlined in a document of May 1988, prescribed the negotiation of a multilateral framework of rules and principles as the first phase of a three-phase procedure for the completion of the Uruguay Round negotiations on services. The sectoral issue would be handled only in the second phase, starting with the anonymous notification of the sectors on which individual countries would be willing to negotiate (GATT 1988b, p. 8).

11. An examination of the activities of thirteen international organizations dealing with services was undertaken before the Punta del Este meeting, and a summary of the information made available by the relevant organizations was prepared by the secretariat (GATT 1985b).

12. In a paper submitted to the GNS in December 1987, the EC envisaged a system based on the identification of "accepted appropriate" and "unacceptable inappropriate" forms of regulation as a means toward movement on this issue. A "regulations committee" would be set up to examine relevant measures once the agreement entered into force (GATT 1987, p. 8).

13. In addition, the concept of increasing participation of developing countries set out improved access to distribution channels and information networks as relevant for the facilitation of effective market access for those countries' exports. It thus implicitly recognized the importance for development of data and information infrastructures and services.

14. See for details GATT (1989a, p. 42). "The choice of mode of delivery could therefore be circumscribed by the definition of trade in services, which should be examined further in the light of, inter alia, the following criteria: cross-border movement of service and payment, specificity of purpose, discreteness of transactions and limited duration" (GATT 1989a, p. 38). This qualification of market access by linking it to the definition of trade in services to be adopted was the Montreal expression of the investment-related concerns of some developing countries, which dated from before the Punta del Este declaration.

15. Even though the GNS negotiations were on a separate track from the goods-related negotiations, they also fell prey to the wish of some governments to put a halt to all Uruguay Round negotiations until agreement was reached on the four areas on which agreement was not reached in Montreal: textiles and clothing, safeguards, agriculture, and trade-related aspects of intellectual property rights (GATT 1989b, p. 1).

16. The problems arising from the application of transparency, however, were also common to many sectors. The establishment of

national enquiry points to facilitate the dissemination of relevant market information, for example, could involve considerable administrative burden no matter what the sector in question.

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4

Services-Related Production, Employment, Trade, and Factor Movements

Bernard M. Hoekman

In many countries services account for the largest share of employment and gross domestic product (GDP), and in industrial countries most employment growth in recent years has been generated by services. Furthermore, technological and managerial innovations have created and increased both the demand for and the supply of new services, and many types of services are becoming increasingly tradable across frontiers. This chapter discusses some services-related facts and figures to provide a perspective for the sector and country studies in parts II and III.

Standard conventions will be followed in defining services, trade, and investment in services. In terms of domestic production and employment, services are considered to include wholesale and retail trade, all transport of freight and people, storage, communications, and information-related activities, business and professional services, banking and financial services (including insurance), and personal, community, and social services. Most of these services will be discussed in part II.

Trade in services is defined on a balance of payments basis to comprise certain nonmerchandise transactions between residents and nonresidents of a country.[1] The discussion of foreign direct investment will be limited to data on the sectoral distribution of stocks in host countries.[2]

Before turning to the data, a word of warning is required regarding their reliability and their comparability across countries. Statistics on the service sector are notoriously poor. In contrast to goods, services are usually intangible and are thus difficult to measure. For example, customs agents typically cannot observe flows of services across the frontier, as the services are usually embodied in an information flow, a person, or a good.[3] Moreover, since services are often not storable, their production and consumption usually must take place simultaneously, and this too makes them more difficult to register than goods. Finally, existing procedures for the classification and collection of statistics were designed chiefly for goods, reflecting the fact that until recently there was not a great demand for tracking developments in the service sector (see appendix 4–A).

Cross-country comparisons in the area of services need to be treated with particular caution. Often nations classify identical services under different headings or utilize different measurement and estimation techniques. For example, wholesale trade activities might be measured in terms of the gross value of goods bought and sold or in terms of the (estimated) average gross or net margin of the traders. Banking services may be reported in total loans and deposits or in gross income instead of as the sum of net interest income and payments received for intermediation services.

Care must also be taken in making comparisons across time, since the technological changes and increasing specialization associated with economic growth may lead to the creation of new services that are not captured in existing classification systems. Furthermore, firms may shift from in-house provision of intermediate service inputs to arm's-length sourcing, or services that were provided at arm's length might come to be provided within firms or households. The do-it-yourself phenomenon is a good example of a shift of services back into the household, with the implication that they will no longer be registered in the national accounts.

The Evolution of Services in Economic Structure

Services in GDP

As can be seen from table 4–1, in 1965 the share of services in GDP ranged from a low of 16 percent for Oman to a high of 73 percent for Singapore. On average, the share of services in GDP varied between 40 and 55 percent in 1965. Since 1965 the share of services in GDP has increased for most countries, but this trend is far from

Table 4–1. ***Distribution of GDP by Sector, Selected Economies, 1965 and 1986***
(percent)

Group and economy	*Agriculture* 1965	*Agriculture* 1986	*Industry* 1965	*Industry* 1986	*Manufacturing* 1965	*Manufacturing* 1986	*Services* 1965	*Services* 1986
Low income	42	32	28	35	21	24	30	32
Burma	35	48	13	13	9	10	52	39
China	39	31	39	46	30	34	23	23
India	47	32	22	29	15	19	31	39
Rwanda	75	40	7	23	2	16	18	37
Sudan	54	35	9	15	4	7	37	50
Tanzania	46	59	14	10	8	6	40	31
Togo	45	32	21	20	10	7	34	48
Zaire	21	29	26	36	16	n.a.	53	35
Middle income	20	15	30	36	20	22	50	48
Argentina	17	13	42	44	33	31	42	44
Brazil	19	11	33	39	26	28	48	50
Cameroon	32	22	17	35	10	12*	50	43
Congo	19	8*	19	54*	n.a.	6*	62	38*
Hong Kong	2	0	40	29	24	21	58	71
Indonesia	56	26	13	32	8	14	31	42
Mexico	14	9	31	39	21	26	54	52
Oman	61	3	23	59*	9	3*	16	38*
Panama	18	9	19	18	12	8	63	73
Philippines	26	26	28	32	20	25	46	42
Singapore	3	1	24	38	15	27	73	62
Thailand	35	17	23	30	14	21	42	53
Industrial	5	3	40	35	30	23*	55	61
Australia	9	5	39	34	26	17	51	62
Canada	6	3	40	36	27	n.a.	53	61
France	8	4	39	34	28	n.a	53	63
Germany, Fed. Rep. of	4	2	53	40	40	32	43	58
Italy	11	5	41	39	23	22	48	56
Japan	9	3	43	41	32	30	48	56
Spain	15	6	36	37	n.a.	27	49	56
United Kingdom	3	2	46	43	34	26	51	55
United States	3	2	38	31	28	20	59	67
Developing	29	19	29	36	n.a.	n.a.	42	46
Oil exporters	22	18	29	33	15	15	39	49
Manufactures exporters	34	18	31	35*	n.a.	n.a.	36	44*
Highly indebted countries	18	15	32	36	23	23	49	47
Sub-Saharan Africa	39	36	19	25	10	10	42	36

Notes: For some economies indicated by an asterisk (*) the most recent available data are for 1985. Definitions of regions are those used in World Bank (1988).
Source: World Bank (1988).

uniform. Many nations report a decrease in the relative importance of services in domestic activity; they include Algeria, Burma, Cameroon, Chad, China, Congo, Costa Rica, Madagascar, Mauritius, Mexico, Nicaragua, Nigeria, the Philippines, Singapore, Sri Lanka, Tanzania, Tunisia, Zaire, and Zimbabwe. The only industrial nation for which this occurs is Norway, owing in large measure to exploitation of North Sea oil. Despite such exceptions, services have become, on average, relatively more important in nominal terms.

An inspection of table 4–1 reveals that the share of services in GDP tends to vary with per capita income. Middle-income developing countries have a higher share of services in GDP than do low-income countries, and the difference between the two groups is larger than that between middle- and high-income countries.

Reasons for this are not hard to find.[4] First, agriculture and extractive industries tend to dominate in many developing countries. Second, many types of producer (intermediate) services require a diversified manufactur-

Table 4–2. *Average Annual Growth Rates of GDP by Sector, Selected Economies, 1965–80 and 1980–86*
(percent)

	GDP		*Agriculture*		*Industry*		*Manufacturing*		*Services*	
Group and economy	1965–80	*1980–86*	*1965–80*	*1980–86*	*1965–80*	*1980–86*	*1965–80*	*1980–86*	*1965–80*	*1980–86*
Low income	4.8	7.5	2.7	4.9	7.6	10.6	7.8	11.2	5.0	6.6
Burma	3.9	4.9	3.7	4.7	4.4	6.3	3.9	5.8	4.0	4.8
China	6.4	10.5	3.0	7.9	10.0	12.5	9.5	12.6	7.0	9.4
India	3.8	4.9	2.8	1.9	4.1	7.1	4.4	8.2	4.8	6.0
Rwanda	4.9	1.8	n.a.	0.9	n.a.	4.8	n.a.	4.1	n.a.	1.1
Sudan	3.8	0.3	2.9	0.4	3.1	2.1	n.a.	0.0	4.9	-0.3
Tanzania	3.9	0.9	1.7	0.8	4.2	-4.5	5.6	-4.6	6.7	2.9
Togo	4.4	-1.1	1.9	1.7	6.8	-2.2	n.a.	-2.6	5.4	-2.3
Zaire	1.4	1.0	n.a.	1.7	n.a.	2.7	n.a	-0.7	n.a.	-0.7
Middle income	6.5	2.3	3.5	2.3	7.6	2.1	7.0	2.5	6.7	2.6
Argentina	3.3	-0.8	1.4	2.3	4.4	-1.7	2.7	0.4	3.9	-0.8
Brazil	9.0	2.7	4.7	2.0	10.0	1.6	9.8	1.2	9.4	3.8
Cameroon	4.9	8.2	4.2	2.0	8.1	15.9	7.0		4.4	7.0
Congo	5.9	5.1	3.1	0.6	10.3	8.4	n.a.	2.9	4.7	3.7
Hong Kong	8.5	6.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Indonesia	7.9	3.4	4.3	3.0	11.9	1.8	12.0	7.7	7.3	5.6
Mexico	6.5	0.4	3.2	7.6	0.3	7.4	n.a.	6.6	3.6	0.4
Oman	12.5	5.7	n.a.	n.a.	n.a	n.a.	n.a.	n.a.	n.a.	n.a.
Panama	5.5	2.6	2.4	2.2	5.9	-1.4	4.7	0.2	6.0	3.7
Philippines	5.9	-1.0	4.6	2.0	8.0	-3.5	7.5	-1.7	5.2	-0.6
Singapore	10.2	5.3	3.1	-3.5	12.2	4.4	13.3	2.2	9.7	6.1
Thailand	7.4	4.8	4.9	2.9	9.5	5.0	10.9	5.2	8.0	5.6
Industrial	3.7	2.5	1.2	2.5	3.6	2.5	4.0	n.a.	3.9	2.6
Australia	4.0	3.1	2.6	6.1	2.9	2.0	1.2	n.a.	5.4	3.5
Canada	4.4	2.9	0.7	2.8	3.4	2.9	3.8	3.6	5.5	2.9
France	4.4	1.3	0.8	2.8	4.6	0.6	5.3	n.a.	4.6	1.6
Germany, Fed. Rep. of	3.3	1.5	1.4	3.1	2.9	0.7	3.3	0.8	3.7	2.1
Italy	3.9	1.3	0.8	0.5	4.2	0.2	5.1	-0.2	4.1	2.1
Japan	6.3	3.7	0.8	1.0	8.5	5.0	9.4	7.8	5.2	2.9
Spain	5.2	1.8	3.0	2.8	5.8	0.8	6.7	0.3	4.6	2.3
United Kingdom	2.2	2.3	1.7	4.1	1.2	2.0	1.1	2.1	2.9	2.6
United States	2.8	3.1	1.1	3.1	1.9	3.2	2.7	4.0	3.4	3.0
Developing	6.0	3.8	3.1	3.6	7.6	4.6	8.0	5.9	6.4	3.4
Oil exporters	6.8	1.7	3.2	2.4	8.3	1.6	8.5	2.4	6.9	1.9
Manufactures exporters	6.7	6.2	3.2	5.0	8.8	7.8	n.a.	8.6	7.4	5.3
Highly indebted countries	6.4	0.7	3.2	1.8	7.3	-0.2	7.3	0.4	6.8	1.0
Sub-Saharan Africa	5.3	0.0	1.9	1.2	9.7	-1.6	9.8	0.3	5.4	0.1

Note: Definitions of regions are those used in World Bank (1988).
Source: World Bank (1988).

ing base that is often lacking in many of these countries. Finally, to some degree the differences between countries may come about because prices of many services tend to be lower in developing than in industrial countries.[5] Research indicates, however, that the share of per capita spending on services that satisfy final demand is roughly equal in developing and industrial countries if a common set of average international prices is used to value the components of GDP (see Kravis, Heston, and Summers 1983; Summers and Heston 1988). This is because use of such prices reduces the dispersion of per capita income among nations.

Table 4–2 reports average annual growth rates of the components of GDP valued in constant prices. Growth rates for most countries dropped dramatically in 1980–86, the main exceptions being low-income countries such as Bangladesh, Burma, China, India, and Senegal. For most developing countries services grew slightly faster than GDP in both 1965–80 and 1980–86. For developing countries as a whole, industry outperformed services in 1965–80, while in 1980–86 both industry and agriculture grew faster than services. In lower-middle-income countries, however, services outperformed both agriculture and industry in 1980–86. A result implicit in table 4–2 is that the share of services in GDP does not appear to increase significantly when measured in constant prices. That is, growth rates of services output do not significantly exceed those of GDP for the principal country groups reported. For developing countries as a whole, the share of industry in total output grows, that of agriculture declines, and that of services remains relatively constant.

It is beyond the scope of this paper to analyze in greater detail and for a longer time period the evolution of sectoral shares. Stern and Hoekman (1988) report figures on the percentage breakdown by sector of U.S. national income in current prices from 1869 to 1984 and of GDP for Japan from 1890 to 1980. Finance, insurance, and other private services became increasingly important in the United States after the 1940s, whereas government services expanded significantly after the 1930s. The increasing share of other private services reflects a decline in the share of personal (domestic) services that was more than compensated by a substantial increase in business (intermediate) and medical services. For Japan there does not seem to be any discernible trend in the relative importance of services over the ninety-year period as a whole. But when the share of services in output is measured in constant prices, a negative overall trend appears: the services share, which in 1900 was about 50 percent, declined to about 34 percent before World War II, rose to a peak of almost 50 percent in 1953, and then declined to 39 percent in 1969.

One conclusion that emerges is that in many countries large increases in the observed share of services in GDP have not taken place recently. This, of course, does not mean that the composition of the service contribution to GDP has remained constant. The dynamics have been occurring within the service sector, as reflected especially by the increasing importance of business (intermediate) services. Green (1985) has demonstrated that expenditures on producer services as a proportion of the value of manufacturing output increased on average by approximately 20 percent in the Federal Republic of Germany, Italy, and the United Kingdom between 1975 and 1981. In the United States most service subsectors have been growing faster than manufacturing output, especially for producer services such as telecommunications, wholesale trade, brokerage, and business and miscellaneous professional services (Adams and Siwaraksa 1987). The driving force behind the growth of producer services has been the increasing scope for arm's-length sourcing owing to innovations in information technology, to increasing specialization, and to product differentiation.

Services in Employment

As can be seen from table 4–3, the relative importance of services in terms of employment has increased dramatically for many countries since 1950.[6] The increasing share of employment in services took place especially in industrial and more advanced developing nations. In many industrial countries the share of services in total employment is currently more than 60 percent, and for some it is about 70 percent. For most low-income developing countries the share of services in total employment has risen relatively slowly even though the rising trend has been observed in virtually all countries.

The figures reported in table 4–3 include government activities. Not surprisingly, if public sector employment is excluded, the average share of services in total employment falls substantially. Blades (1987) has estimated that the average share in OECD nations drops to 40 percent, which implies that about one-third of employment in services is in the public sector. Figures reported by UNCTAD (1988) reveal that the share in developing countries is substantially higher, at 50 percent.

The main point is that service employment shares tend to vary directly with real per capita income. Explanations for this usually revolve around differentials in labor productivity between sectors and fundamental changes in the structure of economies over time. Lagging labor productivity in services has been shown to be an important determinant of the growth of service sector employment.[7] Structural changes are in large part a reflection of the process of economic development and include

(a) increased female participation rates in the labor market;
(b) increasing rates of urbanization;
(c) increasing specialization and technological changes that lead to the creation of new (market-oriented) service activities;
(d) expansion of part-time employment opportunities (largely in the service sectors);
(e) growth of government services such as education and health; and
(f) growth of international trade and investment.[8]

International Trade in Services

Information on international trade in services is less comprehensive than data on domestic production and

Table 4–3. ***Shares of Employment by Sector, Selected Economies, 1950, 1965, and 1980***
(percent)

	Agriculture			*Industry*			*Services*		
Group and economy	*1950*	*1965*	*1980*	*1950*	*1965*	*1980*	*1950*	*1965*	*1980*
Low income	n.a.	86	80	n.a.	5	8	n.a.	14	15
Burma	70	64	53	9	14	19	20	23	28
China	88	81	74	5	8	14	7	11	12
India	78	73	70	8	12	13	13	15	17
Rwanda	96	94	93	2	2	3	2	3	4
Sudan	92	82	71	2	5	8	6	14	21
Tanzania	94	92	86	2	3	5	4	6	10
Togo	82	78	73	7	9	10	11	13	17
Zaire	87	82	72	7	9	13	6	9	16
Middle income	n.a.	56	43	n.a.	17	23	n.a.	27	34
Argentina	25	18	13	32	34	34	43	48	53
Brazil	60	49	31	17	20	27	24	31	42
Cameroon	92	86	70	3	4	8	5	9	22
Congo	67	66	62	10	11	12	21	23	26
Hong Kong	12	6	2	56	53	51	32	41	47
Indonesia	79	71	57	6	9	13	14	21	30
Mexico	60	50	37	17	22	29	23	29	35
Oman	76	62	50	9	15	22	15	23	28
Panama	56	46	32	14	16	18	30	38	50
Philippines	67	58	52	12	16	16	21	26	33
Singapore	8	6	2	20	27	38	71	68	61
Thailand	86	82	71	3	5	10	11	13	19
Industrial	22	14	7	36	38	35	42	48	58
Australia	15	10	7	40	38	32	45	52	61
Canada	20	10	5	36	33	29	44	57	65
France	31	18	9	35	39	35	34	43	56
Germany, Fed. Rep. of	23	11	6	43	48	44	34	41	50
Italy	44	25	12	31	42	41	25	34	48
Japan	49	26	11	24	32	34	27	42	55
Spain	50	34	17	25	35	37	25	32	46
United Kingdom	6	3	3	49	47	38	45	50	59
United States	12	5	4	37	35	31	51	60	66
Developing	81	70	62	7	12	16	12	18	22
Oil exporters	n.a.	61	49	n.a.	15	19	n.a.	24	31
Manufactures exporters	n.a.	71	66	n.a.	11	16	n.a.	16	17
Highly indebted countries	n.a.	51	40	n.a.	18	23	n.a.	31	37
Sub-Saharan Africa	87	79	75	5	8	9	8	13	16

Note: See note to table 4–2.

Table 4–4. ***World Exports of Merchandise and Invisibles, 1970–87***

Item	*Value (billions of dollars)*		*Share of total (percent)*		*Average annual change (percent)*		
	1970	*1987*	*1970*	*1987*	*1970–79*	*1980–87*	*1970–87*
Merchandise	264	2,080	71	66	20.5	2.5	13.0
Invisibles	110	1,078	29	34	21.0	5.0	14.0
Private services	64	504	17	16	19.0	5.0	13.0
Investment income	26	415	7	13	25.0	6.5	17.5
Other official goods, services and income	8	45	2	1	17.0	2.0	10.5
Unrequited transfers	12	114	3	4	22.0	4.0	14.0
Total	374	3,135	100	100	20.5	3.0	13.0

Note: See text for definitions.
Source: IMF balance of payments statistics.

Table 4–5. *Ratio of Exports of Private Services to the Sum of Exports of Merchandise and Private Services, 1970 and 1980*
(percentage share, based on value)

Economies with constant or declining share of private services	*1970*	*1987*	*Economies with increasing share of private services*	*1970*	*1987*
Selected developed countries			Selected developed countries		
Australia	16	16	Austria	32	36
Belgium and Luxembourg	20	20	France	23	28
Canada	12	10	Greece	42	44
Germany, Fed. Rep. of	13	13	New Zealand	12	23
Denmark	25	23			
Finland	16	16			
Ireland	12	11			
Italy	23	22			
Japan	12	11			
Netherlands	22	21			
South Africa	24	11	Selected developing economies		
Spain	48	39	Chile	10	17
Sweden	17	17	Côte d'Ivoire	8	10
Switzerland	25	21	Egypt[d]	13	53
United Kingdom	28	25	India[a]	13	23
United States	18	18	Indonesia	1	5
			Kenya	33	40
Selected developing economies			Malaysia	4	12
Algeria	8	6	Morocco	26	32
Brazil[a]	10	7	Peru	15	26
Cameroon	18	17	Philippines	14	32
Colombia	21	17	Saudi Arabia	9	11
Iran[b]	6	2	Senegal	25	27
Israel	38	29	Singapore	20	21
Korea, Rep. of	17	15	Sudan	9	35
Mexico[c]	53	24	Thailand	20	24
Nigeria	5	4	Tanzania[a]	20	23
Taiwan	12	7	Zaire	2	9
Venezuela	6	6	Zambia	1	5
World	20	20			

a. 1986.
b. 1984.
c. With exports of maquiladoras included, the share of private services in merchandise exports declined from 111 to 24 percent between 1970 and 1987.
d. The reported value of exports of private services in 1970 was significantly understated because it did not include travel services. In 1977, the first year for which travel was reported, exports of private services amounted to 77 percent of merchandise exports.
Source: GATT Secretariat, based on IMF balance of payments statistics and national sources.

employment. It is, moreover, difficult to relate trade data to domestic data because the classification systems are not compatible. As discussed in appendix 4–A, care must be taken in interpreting statistics on trade in services. Since the primary source of information on such trade is the balance of payments, this section focuses on the nonmerchandise components of the current account.

Table 4–4 reports data on the nominal value of world exports of merchandise and invisibles for the period 1970–87.[9] Although invisibles and merchandise exports grew at similar rates during 1970–80, invisibles outperformed merchandise after 1980. In 1987 the share of invisibles in world trade was about 34 percent (compared with 29 percent in 1970), while that of private services was 16 percent (17 percent in 1970).[10] Thus while the share of invisibles in world trade in merchandise and invisibles has been increasing, the share of private services has apparently been declining.

Individual country experiences do, of course, vary. In particular, many developing countries experienced a reduction in the relative importance of merchandise exports after 1970, whereas the converse holds for most industrial countries. As can be seen from table 4–5, for many developing countries the relative importance of

Table 4–6. ***World Exports of Private Services, by Category, 1970–87***
(percentage, based on value)

Service Category	*Share in exports of private services* 1970	1980	1987	*Average annual change in exports* 1970–79	1980–87
Passenger transport	5	5	6	19.0	7.5
Shipping	21	16	13	15.0	1.5
Other transport	12	16	11	21.5	0.0
Travel	29	27	29	18.0	6.5
Other market services[a]	23	30	34	22.0	6.5
Property and labor income	10	6	7	12.0	6.0
Private services	100	100	100	19.0	5.0

a. Includes nonmerchandise insurance, communication services, advertising, brokerage and management services, leasing, merchanting, and other professional and technical services.

Source: IMF balance of payments statistics.

exports of private services has increased dramatically in the past two decades. In only four of the twenty industrial countries listed in table 4–5 did the relative importance of private services increase, compared with eighteen out of twenty-nine developing countries.

In general, the relative importance of private services increased for developing countries as a group. Declines occurred only for fuel exporters and high-income countries—that is, for those countries that are net exporters of capital. Low- and middle-income countries experienced an increase in the relative importance of private services.

Table 4–7. ***Exports of Merchandise and Private Services, 1967–87***
(percentage annual average growth rates)

Region	*1967–72* Goods	Services	*1972–77* Goods	Services	*1977–82* Goods	Services	*1982–87* Goods	Services	*1967–87* Goods	Services
World	14.3	14.1	22.1	18.4	9.9	11.2	5.6	6.5	13.0	12.3
Western Europe	15.4	14.6	19.6	18.2	9.5	9.9	9.5	8.2	13.4	12.2
North America	11.1	8.5	18.4	13.8	11.4	12.0	4.3	7.0	11.2	10.6
Middle East	16.6	16.7	49.0	30.1	5.5	9.4	-16.9	-1.6	12.4	13.2
Asia	17.3	20.6	24.2	24.4	12.4	17.9	8.4	3.7	15.4	16.0
Africa	12.1	10.4	28.5	21.0	6.4	10.2	-9.6	-0.1	8.4	11.1
Latin America	9.8	14.4	23.5	17.1	13.8	10.1	-1.0	2.6	11.7	10.8
Selected Eastern Europe[a]	n.a.	n.a.	20.5	13.7	6.7	10.4	-7.5	1.3	n.a.	n.a.
Developing economy oil exporter	15.4	14.9	42.3	22.5	8.3	7.5	-13.4	-1.5	12.5	10.5
Developing economy manufactures exporters[b]	15.5	24.2	27.9	26.5	14.1	19.4	8.4	-0.1	16.3	17.0
Least developed economies[c]	5.6	7.3	16.0	7.6	3.2	19.0	-4.1	-7.1	1.4	4.0
Low-income high-growth[d]	5.5	6.1	20.3	25.3	7.4	17.2	2.8	-4.0	3.9	6.7
Middle-income high-growth[e]	13.3	21.0	32.5	28.6	16.6	21.7	6.1	3.6	16.9	18.7
High-income high-growth[f]	13.6	12.8	20.6	16.0	11.7	12.3	6.1	6.1	12.9	11.9
All developed economies	14.7	13.9	19.6	17.7	10.1	10.3	8.3	7.8	13.1	12.1
All developing economies	11.5	15.3	32.4	23.1	9.7	15.0	-3.8	0.6	12.4	13.3

a. Hungary, Poland, and Romania.

b. Argentina, Brazil, Hong Kong, Republic of Korea, Singapore, Taiwan, and Yugoslavia.

c. UNCTAD definition.

d. Bangladesh, Benin, Burma, China, India, Kenya, Nepal, Pakistan, Senegal, Somalia, and Sri Lanka. High-growth countries are those with annual average growth rates of GDP of more than 3 percent in 1980–86.

e. Algeria, Botswana, Cameroon, Congo, Egypt, Indonesia, Jordan, Republic of Korea, Malaysia, Mauritius, Morocco, Oman, Singapore, Thailand, Tunisia, Turkey, and Yemen.

f. Australia, Japan, Norway, and United States.

Source: IMF balance of payments statistics.

Table 4–8. ***Share in World Exports of Merchandise and Invisibles, 1970–87***
(percent)

Region	Merchandise and invisibles		Invisibles		Private services		Passenger transport	
	1970	1987	1970	1987	1970	1987	1970	1987
Western Europe	52.3	54.9	55.7	58.3	63.5	63.5	65.0	54.9
North America	23.3	17.4	25.3	18.7	18.6	13.9	17.3	19.0
Middle East	2.5	2.7	2.4	3.5	1.9	2.2	2.1	3.1
Asia	11.9	18.1	8.5	13.5	7.9	13.7	9.5	13.3
Africa	4.0	2.0	3.3	2.1	2.0	2.0	1.1	3.9
Latin America	5.4	4.0	4.5	3.2	5.7	4.3	4.9	5.5
Selected Eastern Europe	0.6	0.9	0.7	0.7	0.5	0.9	n.a.	0.3
Developing economy oil exporters	5.4	4.6	3.4	3.6	4.1	2.9	2.0	3.2
Developing economy manufactures exporters	3.2	4.9	3.1	3.3	2.8	4.9	3.5	4.9
Least developed economies	0.7	0.4	0.9	0.7	0.5	0.3	0.6	0.3
Low-income high-growth	1.3	1.8	1.3	1.3	0.9	1.2	0.3	1.6
Middle-income high-growth	3.7	6.8	4.0	5.5	2.4	7.1	0.9	7.6
High-income high-growth	26.8	25.5	28.7	26.4	23.8	20.0	26.3	27.4
All developed economies	83.9	83.4	86.2	85.8	87.7	84.0	91.3	81.2
All developing economies	16.2	15.0	14.0	13.6	12.4	15.1	9.6	18.1

Notes: See notes to table 4–7.
Source: IMF balance of payments statistics.

Components of Trade in Services

Table 4–6 focuses on the relative importance of the components of private services in world trade. In 1987 exports of transport services and expenditures by travelers in host countries each made up somewhat less than one-third of global private service credits. The remainder was a mix of business and professional services, construction, and exports of labor and intangible property, such as know-how and trademarks. Only two categories grew faster than merchandise exports in 1970–80: passenger transport and "other market services" (construction, telecommunications, nonmerchandise insurance, brokerage, operational leasing, processing and repair, and other business and professional services). The slowest-growing component was property and labor income.

Since 1980 shipment and other transport services have lagged behind merchandise.[11] The same qualitative results are obtained with world imports. But because world exports of shipment are underreported (owing to nonreporting of revenues by certain large exporters and vessels flying flags of convenience), world imports give a more accurate view of the relative importance of shipment in world trade. In 1987 the share of shipment in world imports was 18 percent, as opposed to the 13 percent reported on an export basis.[12]

The relative importance of invisibles and private services in trade varies among countries and regions. Invisibles are of above average importance for North America and the Middle East, while they are least important for Eastern Europe and Asia. Not surprisingly, since 1970 the fastest growth in the relative importance of invisibles in total trade occurred in the Middle East, reflecting tremendous increases in investment income. In general, invisibles became more important for fuel exporters and least developed countries; between 1970 and 1987 they increased from 16 to 27 percent for fuel exporters and from 21 to 30 percent for the least developed countries. They declined in importance for the group of low-income, high-growth countries, from 31 percent in 1975 to 15 percent in 1987.

Growth Rates of Service Exports

Table 4–7 reports growth rates for exports of merchandise and private services for five-year intervals starting in 1967. 1972–77 was a boom period as far as (nominal) trade values were concerned; many regions registered average annual growth rates of more than 20 percent. To a large extent this may have been the result of inflationary forces, but unfortunately data on the volume of trade in invisibles do not exist.

World merchandise exports grew faster than private services between 1967 and 1977. The reverse was true in 1977–87. Note, however, that Asia demonstrates an opposite pattern in that private services grew faster than merchandise exports in 1967–82, whereas merchandise exports outperformed private services after 1982. Until

Shipping		*Other Transport*		*Travel*		*Other market services*		*Property income*		*Labor income*	
1970	*1987*	*1970*	*1987*	*1970*	*1987*	*1970*	*1987*	*1970*	1987	1970	1987
75.2	63.1	44.7	51.0	61.4	64.0	68.2	70.0	27.2	39.3	82.4	71.7
10.1	8.1	27.6	22.9	19.2	13.6	13.1	8.9	72.6	51.9	n.a.	1.8
1.6	1.7	2.5	1.4	1.9	2.0	2.3	3.0	n.a.	0.2	2.2	1.8
9.8	21.2	16.7	16.1	4.5	10.7	7.8	12.8	n.a.	8.2	3.1	17.3
1.2	1.3	3.0	3.7	2.3	2.4	2.4	1.2	n.a.	n.a.	1.2	3.7
2.1	3.2	5.5	4.5	10.1	6.5	4.5	3.1	n.a.	0.2	10.7	3.7
n.a.	1.5	n.a.	0.4	0.3	0.7	1.6	1.1	n.a.	0.1	n.a.	n.a.
1.2	1.4	4.1	1.6	8.4	3.7	2.9	3.6	n.a.	n.a.	7.3	2.4
3.0	6.6	5.4	6.6	2.7	4.7	2.1	4.4	n.a.	n.a.	2.8	3.2
0.2	0.2	0.9	0.2	0.4	0.3	0.8	0.3	n.a.	n.a.	0.7	2.3
0.8	2.0	2.5	1.3	0.6	1.7	1.0	0.9	n.a.	n.a.	0.2	0.3
1.0	7.6	4.3	8.2	3.0	8.8	2.8	5.6	n.a.	n.a.	2.9	8.7
28.3	26.8	38.1	33.1	15.7	13.9	15.3	14.1	n.a.	60.5	1.1	5.1
93.7	84.4	83.4	84.0	82.7	80.8	86.9	86.1	99.6	99.7	84.5	78.2
7.2	12.9	16.6	16.1	18.2	18.6	11.6	13.1	0.4	0.3	15.2	21.8

1982–87, exports of private services usually grew faster in low- and middle-income high-growth developing countries than exports of merchandise. The same pertains to developing countries that are substantial exporters of manufactures.

It is noteworthy that the decreases in the growth rates of exports experienced by many countries and regions after 1982 were concentrated in merchandise exports more than in private services. This may in part reflect the dependence of the export prices of many services on domestic rather than international developments. (This is especially so for those services—tourism, for example where the recipient moves to the location of the provider.) One hypothesis is that the terms of trade for services may well be less sensitive to international shocks. For example, in 1979–85 the terms of trade for services showed little net change for Australia, despite fluctuations, whereas the terms of trade for merchandise fell continuously. (See Bureau of Industry and Economics 1988 for a more comprehensive discussion.)

A policy implication is that diversification of productive activities into services might reduce the sensitivity of an economy to external shocks. This, however, does not necessarily have to be the case; the growth rates of private service exports of high-growth developing countries fell faster than their merchandise exports.[13] The general inference to be drawn from table 4–7 is that exports of private services have grown in importance and have tended to be more dynamic than exports of merchandise in the recent past.

Shares in Global Exports

During 1980–87 Asia, the Middle East, and Western Europe increased their shares in global flows associated with both invisibles as a whole and with private services, whereas the shares of Africa, Latin America, and North America declined.[14] High-growth developing countries increased their share in total trade, while developing countries as a whole experienced a slight reduction. As table 4–8 shows, developing countries increased their share in private services as a whole, reflecting growth in exports of passenger transport, shipment, and other market services.

On a regional basis, much of the increased share in passenger transport was attributable to an increase in exports from Asia. In terms of selected country groups, virtually all of the increase was attributable to the substantial rise in exports from middle-income high-growth countries, which increased their world market share from 0.9 percent in 1970 to 7.6 percent in 1987. The same phenomenon occurred for shipment, for which the numbers were virtually identical. Asian countries, in particular, increased their share of world shipment exports significantly, from 9.8 percent in 1970 to 21.2 percent in 1987. (For a detailed discussion, see Miklius 1988; Sien and Trace 1988.)

The category "other market services" demonstrates the same pattern. This category is probably of the greatest current policy interest, as it has been the fastest growing category of invisible exports for many countries. Fur-

Table 4-9. *Comparison of Countries That Specialize in Toursim, 1987 or Latest Available Year*

Country	*Tourism receipts as percentage of exports of private services*	*Average expenditure per arrival (dollars)*
Seychelles	50	1,000
Vanuatu	50	930
Kenya	51	520
Mexico	52	650
Nepal	53	225
Thailand	54	560
Netherlands Antilles	56	520
Belize	57	240
Guyana	57	320
Uruguay	57	460
Maldives	57	300
Cyprus	60	700
Malta	60	490
Paraguay	60	1,190
Portugal	64	350
Tunisia	64	360
Tonga	64	530
Fiji	65	530
Jamaica	67	800
Samoa	67	200
Spain	69	450
Barbados	71	800
Morocco	72	450
Dominican Republic	74	510
Indonesia	82	750
St. Kitts and Nevis	86	570
Bahamas	87	790
Gambia	88	490
Haiti	88	760
St. Vincent and Grenadines	90	630
Grenada	94	530
Dominica	97	390
Antigua and Barbuda	98	660

Note: Figures may be biased for countries with incomplete coverage of the components of private services. This is the case for Indonesia, in particular, as it does not report shipment statistics.

Sources: Receipts share: IMF balance of payments statistics; expenditures: World Tourism Organization (various years).

thermore, these services have become an increasingly important determinant of external competitiveness. Countries in Africa, Latin America, and North America experienced a reduction in their share of world exports of these services, while those in Asia and Western Europe increased their share. On a more aggregate level, however, little has changed since 1970; industrial countries have generally maintained their relative share.

Industrial nations dominate credit flows associated with sales of intangible property. These sales consist in large part of fees for licensing and franchising arrangements, trademarks, and technology, all of which can be seen as intermediate inputs. These countries also have a much larger share in world credit flows associated with the temporary movement of labor. The same pattern holds here as for most other categories of services: the increase in the share of developing countries is attributable primarily to an increase in exports from Asian countries.

Tourism

For many countries expenditures by travelers (tourists) are an important source of revenue.[15] This is especially true for many developing countries, which often have a surplus on the travel account. Tourist expenditures are usually varied; they may include outlays on transport, tours, lodging, entertainment, and souvenirs. Trade in the

Table 4-10. ***Leading Exporters and Importers of Private Services, 1970 and 1987***

Economy	Exports: Rank 1970	Exports: Rank 1987	Exports: Value, 1987 (billions of dollars)	Exports: Share, 1987 (percent)	Economy	Imports: Rank 1970	Imports: Rank 1987	Imports: Value, 1987 (billions of dollars)	Imports: Share, 1987 (percent)
United States	1	1	56	11.2	Germany, Fed. Rep. of	2	1	65	12.4
France	3	2	53	10.6	United States	1	2	56	10.8
United Kingdom	2	3	43	8.6	Japan	5	3	52	10.1
Germany, Fed. Rep. of	4	4	41	8.2	France	4	4	43	8.3
Italy	5	5	33	6.5	United Kingdom	3	5	33	6.4
Japan	6	6	28	5.5	Italy	6	6	26	5.0
Netherlands	6	7	23	4.5	Netherlands	8	7	23	4.5
Spain	8	8	22	4.3	Belgium and Luxembourg	9	8	17	3.3
Belgium and Luxembourg	10	9	19	3.8	Canada	7	9	16	3.1
Austria	15	10	15	2.9	Switzerland	15	10	12	2.3
Switzerland	12	11	14	2.8	Sweden	10	11	10	2.0
Canada	9	12	11	2.1	Norway	13	12	10	1.8
Sweden	14	13	9	1.7	Saudi Arabia	44	13	9	1.8
Norway	11	14	8	1.7	Austria	18	14	9	1.8
Korea, Rep. of	27	15	8	1.7	Spain	16	15	8	1.6
Denmark	16	16	8	1.5	Australia	11	16	8	1.5
Singapore	22	17	7	1.5	Denmark	17	17	7	1.4
Hong Kong	—	18	7	1.4	Taiwan	—	18	6	1.0
Mexico	13	19	7	1.3	Korea, Rep. of	32	19	5	1.0
Australia	17	20	5	1.0	Hong Kong	—	20	5	1.0
Taiwan	26	21	4	0.9	Mexico	12	21	5	0.9
Greece	20	22	4	0.9	Singapore	40	22	5	0.9
Yugoslavia	18	23	4	0.9	Yugoslavia[a]	20	23	5	0.9
China	—	24	4	0.8	Finland	26	24	5	0.9
Thailand	33	25	4	0.7	South Africa	14	25	5	0.9
Total			437	86.7	Total			444	86.0
World			504	100.0	World			516	100.0

— Not applicable.

a. 1986.

Source: GATT Secretariat, based on IMF balance of payments statistics and national sources.

products of service sectors such as hotels and restaurants, recreation and culture, and domestically provided transport will in large part be measured as expenditures by tourists and business travelers, if it is registered at all.[16]

By region, the shares of Latin America and North America in world exports decreased substantially after 1970, while Asian countries more than doubled their share, from 4.5 to 10.7 percent. (For an analysis of this development, see Mak and White 1988; Findlay and Forsyth 1988.) Again, middle-income high-growth countries did extremely well, tripling their share from 3 to 9 percent. Individual country data reveal great differences in the relative importance of tourism as well as in "performance" (average receipts per arrival). Statistics on the value of travel-related receipts (excluding passenger fares) for countries that obtained at least 50 percent of their private services receipts from tourism are reported in table 4-9. Not surprisingly, many of the countries included in the table are small (usually island) economies. Reported average expenditures by travelers in the countries included in table 4-9 vary widely, from $200 to $1,200.

Service Trade Balances

It is widely assumed that industrial countries generally register surpluses in trade in invisibles and that developing countries tend to run deficits. One should beware of such generalizations. Although most industrial nations have had positive invisible trade balances at some time, in 1987 countries with negative invisible trade balances outnumbered those with positive balances. This applies to both invisibles as a whole and to private services.[17] Furthermore, many developing countries tend to have positive trade balances in private services. In 1987 roughly four out of ten developing economies registered a surplus or were in approximate balance—a figure not much different from that for developed countries. Differ-

Table 4–11. ***Inward Stock of Foreign Direct Investment in Services, Selected Host Economies***

Economy and year	*Value (billions of currency units)* Total FDI	*Value (billions of currency units)* FDI in services	*Share of services in total FDI (percent)*
Industrial economies (national currency, except Japan)			
Australia			
1975	7.0	3.1	43.0
1983	18.1	8.5	47.0
Belgium			
1970	113.8	11.1	10.0
1981	238.8	41.3	17.0
Canada			
1975	37.4	9.2	25.0
1984	81.8	23.6	29.0
France [a]			
1980	89.7	33.1	37.0
1985	129.0	81.7	63.0
Germany, Fed. Rep. of			
1976	78.9	26.3	33.0
1985	119.1	54.9	46.0
Italy			
1974	5,449.0	1,723.0	32.0
1985	31,769.0	11,752.0	40.0
Japan			
1975	1.5	0.3	18.0
1986	7.0	2.0	29.0
Netherlands			
1973	20.7	5.8	28.0
1984	58.3	24.9	43.0
Spain			
1975	142.8	31.2	22.0
1984	1,097.8	339.2	31.0
United Kingdom			
1971	5.6 [c]	0.6 [c]	11.0
1984	38.5	13.3	35.0
United States			
1974	26.5	11.5 [b]	43.0
1986	209.3	111.2	53.0
Latin America (U.S. dollars)			
Argentina [d]			
1981	2.4	0.6	25.0
1985	3.1	0.9	26.0
Brazil			
1971	2.9	0.5	16.0
1985	25.7	5.6	22.0
Chile			
1973	0.4	0.1	27.0
1983	2.0	0.7	33.0
Mexico			
1971	3.0	0.6	19.0
1981	13.5	3.2	23.0
Peru			
1978	0.8	0.2	25.0
1986	1.4	0.4	30.0

Economy and year	*Value (billions of currency units)*		*Share of services in total FDI (percent)*
	Total FDI	*FDI in services*	
Asia (U.S. dollars)			
Hong Kong			
1981	3.8	2.4	55.0
Indonesia [e]			
1977	2.9	0.3	11.0
1985	6.4	0.7	10.0
Korea, Rep. of			
1980	1.1	0.3	23.0
1986	2.2	0.7	27.0
Malaysia [f]			
1972	0.7	0.2	37.0
1984	2.9	1.2	40.0
Philippines			
1976	0.5	0.2	34.0
1983	2.0	0.5	26.0
Singapore			
1970	0.6	0.3	55.0
1981	8.2	4.2	51.0
Taiwan			
1986	5.9	1.4	23.0
Thailand [g]			
1975	0.5	0.3	56.0
1985	2.0	0.9	47.0
Africa (U.S. dollars)			
Egypt [h]			
1979	7.0	4.0	57.0
1984	14.9	6.7	45.0
Nigeria			
1975	3.0	0.6	20.0
1982	4.3	1.6	37.0

Note: The shares of services were calculated before stock figures were rounded and may therefore differ from the shares that would result from use of rounded figures.

a. Cumulative flows, 1975–80 and 1975–85.

b. Data for 1974 are not fully comparable with data for later years because services do not include banking and petroleum–related services.They do include other industries (agriculture and mining but not petroleum).

c. Excludes banking and insurance. Services include agriculture and mining.

d. Cumulated approved FDI since March 1, 1977.

e. Data exclude FDI in oil, insurance and banking.

f. Equity shares held by foreign residents in limited liability companies incorporated in Malaysia as of December 31, 1984 (paid–up value).

g. Cumulated flows since 1971.

h. Projects established under the Investment and Free Zones Law, cumulative1974–79 and 1974–84.

Source: UNCTC (1988), pp. 378, 380–81.

ences between developed and developing nations in net balances are therefore not as great as is commonly assumed.[18]

Leading exporters and importers of private services are reported in table 4–10.[19] Although relative rankings varied slightly, the top six exporters of merchandise in 1987 were also the top six exporters of private services. But the ranking for private services is not identical to that for merchandise. In particular, the ranking of countries such as Austria, Mexico, Norway, and Spain is substantially higher for services.[20]

International Factor Movements

As noted in earlier chapters, the provision or sale of a service frequently requires proximity between provider and receiver. This implies that a commercial presence of the foreign provider in the country of the consumer may be a precondition for provision and that temporary or long-term movement of factors of production (capital and labor) may be necessary. This section focuses on transactions that are or may be associated with a change

Table 4–12. *Composition of the Service Sector in Inward Foreign Direct Investment in Selected Host Economies by Principal Categories, Latest Available Year*

		Industry Share (percent)					
Economy and year	*Value of stock in services (billions of currency unit)*	*Trade*	*Banking, finance and insurance*	*Transport*	*Communications*	*Construction*	*Other services*
Industrial countries (national currency, except Japan)							
Belgium, 1981	41.3	35.1	n.s.a.	n.s.a.	n.s.a.	n.s.a.	64.9
Canada, 1984	23.6	27.1	55.9	n.s.a.	n.s.a.	n.s.a.	16.8 [a]
France, 1983	55.1	30.3	55.5 [b]	1.2		n.s.a.	8.7
Germany, Fed. Rep. of, 1985	54.9	36.2	53.3 [c]	2.5		0.7	5.1 [d]
Italy, 1985	11,752	12.3	64.5	4.1		n.s.a	19.1
Japan (U.S. dollars), 1986	2	43.7	35.2 [e]	2.9		2.9 [f]	15.4
Netherlands, 1984	24.9	42.2	24.5	2.8		2.8	27.7
United Kingdom, 1984	13.3	24.1	43.3 [g]	1.5		1.5	1.5
United States, 1986	111.2	41.3	46.9 [h]	2.1		6.4 [i]	3.3
Latin America (U.S. dollars)							
Brazil, 1985	5.6	17.7	65.9 [j]	0.9	n.s.a.	n.s.a.	15.3
Mexico, 1981	3.2	33.3	58.4	1.7	n.s.a.	6.1	0.6
Peru, 1985	0.4	40.1	36.6 [k]	1.9	2.3	0.9	18.0 [l]
Asia and Pacific (U.S. dollars)							
Indonesia, 1985	0.7	44.9	n.a.	2.5	5.7	9.3	37.5 [m]
Korea, Rep. of, 1986	0.7	n.s.a.	12.7	4.0	n.s.a.	18.9	64.4 [n]
Malaysia, 1984	1.2	17.2	64.3	n.s.a.	n.s.a.	2	16.5
Philippines, 1983	0.5	19.9 [o]	55.0	6.1		4	14.9
Singapore, 1981	4.2	32.1	57.8	6.6		2.6	0.7
Thailand, 1984	0.9	39.1	16.1	8.9		28.2	7.8
Taiwan, 1985	1.2	2.1 [p]	20.3	5.2	n.s.a.	9.2	63.3
Africa (U.S. dollars)							
Egypt, 1984	6.7	n.s.a.	39.0	n.s.a.	n.s.a.	21.3	39.7
Nigeria, 1982	1.6	43.3 [q]	7.5			46.4	n.s.a.

n.s.a. Not separately available.
a. Other enterprises.
b. Of which 39.4 percent real estate.
c. Of which 31.8 percent holding companies.
d. Of which 1.1 percent public utilities.
e. Includes unclassified services.
f. Includes real estate.
g. Of which 10.5 percent real estate.
h. Of which 19.1 percent real estate.
i. Includes 1 percent petroleum-related services.
j. 44.4 percent holding companies.
k. Of which 13.3 percent is real estate.
l. Includes 2.1 percent tourism and 7.7 percent electric power.
m. Includes 17.4 percent hotels.
n. Mainly hotels and tourism.
o. Includes property.
p. Foreign trade.
q. Includes business services.
Source: UNCTC (1988), p. 593.

in residency, in particular foreign direct investment and movement of labor.[21]

Foreign Direct Investment (FDI)

Global data on FDI are scanty, and country data, if reported at all, are usually at a high level of aggregation. The basis for FDI stock and flow figures varies widely, and statistics are usually not readily comparable across countries. It is important to recognize, moreover, that breakdowns of FDI in goods and services industries are possible for only a limited number of countries and that stock data are often biased owing to the widespread use of historical cost valuation methods (as opposed to current market value) and the distorting effects of fluctuations in the exchange rate.

Table 4–11 reveals that FDI in services varies between 25 and 50 percent of the total stock of FDI in most host countries. As of the mid-1980s about 40 percent of the world stock of FDI and approximately 50 percent of the annual (new) flow of FDI was in services (Sauvant and Zimny 1987). In countries that report data, FDI in services

Table 4–13. ***Approximate Stock of Migrant Workers Abroad by Selected Source Country, Early 1980s***

Country	*Approximate number of workers (thousands)*	*Approximate percentage of labor force remaining*	*Value of remittances (millions of SDR)*	*Remittances as percentage of total exports*
Africa				
Algeria	330	13	380	3
Benin	200	12	56	40
Burkina Faso	2,000	55	106	62
Egypt	700	8	2,040	35
Guinea	3,000	>100	n.a.	n.a.
Lesotho	160	30	330	78
Mali	3,000	75	40	22
Niger	200	12	9	2
Sudan	630	10	214	24
Togo	300	30	7	2
Asia				
India	2,000	8	2,100 [a]	20 [a]
Pakistan	1,900	7	1,880	68
Philippines	1,200	6	700	10
Yemen, Arab Rep. of	500	30	920	312
Yemen, P.D.R.	100	20	325	207
Turkey	2,000	30	1,900	37
Europe				
Greece	170	5	965	14
Italy	2,300	11	2,600	3
Portugal	1,100	28	2,400	45
Yugoslavia	1,000	15	4,050	21
Latin America [b]				
Bolivia	700	40	10	1
Chile	300	10	72	2
Colombia	700	25	100	3
Paraguay	550	60	45	7
Uruguay	80	10	n.a.	n.a.
Mexico	2,000	30	250	1

a. Includes private transfers.

b. Data are for the 1970s. In general, the reported figures should be interpreted as giving an indication of order of magnitude only. Remittances equal the sum of labor income, worker's remittances, and migrants' transfers and are averages for the years 1980–82.

Sources: For labor: Africa, Swamy (1985), Dommen (1985); Asia, United Nations (1987); Europe, OECD (1987); Latin America, ILO (1984). Labor force data from ILO (1988): remittances and total exports from IMF balance of payments.

has almost invariably become more important over time. The distinguishing characteristics of service provision are probably one of the driving forces underlying this increase. Because physical proximity is often a necessary condition for provision, FDI of some sort may be required. The increase in the relative importance of FDI in services occurs in both industrial and developing economies, although the increase is more marked for the former. Much of services FDI in developing countries is related either to investment in offshore financial centers and tax havens or to investment in flags of convenience. Even when these are excluded, however, the share of services in total FDI rises in these countries (UNCTC 1988).

In the case of services the motivation for foreign investment is typically not so much exports (or re-exports) as the ability to provide a service with a view to satisfying local demand, both intermediate and final. Kravis and Lipsey (1988) have shown that the export propensity of U.S. service affiliates is quite low. Because local demand is often the primary force behind FDI in services, this type of FDI, other things being equal, should be less subject to the vagaries of the trade policies of trading partners. The main conclusion to be drawn at this point is that the increasing relative importance of services in terms of domestic production and employment appears to have gone hand in hand with an increase in the relative importance of services in global flows of FDI. In large part the increase is attributable to both the process of economic development and the characteristics, described earlier, that distinguish the provision of many services.

Despite its obvious interest, data on the sectoral composition of FDI in service activities is limited. Table 4–12

Table 4–14. *Estimated Contribution of Services to World Value Added and Gross Output, 1986*

Item	*Value added (billions of dollars)*	*Gross output (billions of dollars)*	*Average share in value added (percent)*	*Average gross output/value added ratio*
World [a]	13,000	23,000	100	—
Goods related	4,680	9,500	36	2.0
Services				
Construction	900	2,000	7	2.3
Distribution	1,700	2,250	13	1.5
Hotels and restaurants	260	400	2	1.5
Transport	650	1,200	5	1.9
Communication	260	500	2	1.9
Finance	520	700	4	1.4
Insurance	130	200	1	1.4
Business services	1,300	1,900	10	1.4
Education and health	390	600	3	1.5
Recreation and culture	130	200	1	1.5
Personal	260	400	2	1.5
Government	1,950	3,000	15	1.5

— Not applicable.

a. Excludes Eastern Europe and the U.S.S.R. owing to incompatible national accounts methodologies.

Sources: Blades (1987); estimates by GATT Secretariat based on UN national accounts data and World Bank data.

shows that FDI in wholesale and retail trade and financial services dominates in those countries for which information is available. Almost half of the stock of existing FDI in services reflects the establishment of service affiliates by firms whose primary activity is industrial (that is, goods-related) in nature. In large part these investments are directed toward financial and distribution-related activities and are intended to support production and sales by parent firms.

Thus, much of the investment in finance and distribution is not independent. For Germany, for example, multinational service enterprises controlled 29 percent of the total outward stock of FDI in 1984, and service affiliates represented 60 percent of the total number of affiliates and 45 percent of the total assets of all affiliates of German-based multinational enterprises. The same phenomenon holds for the United States, where the figures were 55 and 68 percent respectively; the share of services in the total outward stock of FDI, however, was only 37 percent (*CTC Reporter* 1987, p. 19).

Presumably this indicates that services required by the multinational enterprises involved are not available abroad, are of insufficient quality, or are too costly. Furthermore, they are either not tradable separately or are too costly to trade. It would be interesting to know the relative roles of barriers to trade, market structure (characteristics), and technological constraints in this regard. For industries such as retail banking, distribution, and hotels and restaurants FDI will clearly be required if services are to be provided. For other services national regulations may require establishment; insurance is a typical example. As discussed elsewhere in this book, the pattern of international trade and production will be in part a function of the incentives and disincentives created by national governments; tax regimes and performance requirements are prime examples.

Movement of Labor

Cross-border movement of people has been a recurring phenomenon throughout history. Migration may be temporary or long-term, legal or illegal. In the past two or three decades various regions have been demanders of foreign labor; examples include Europe in the 1960s and early 1970s (approximately 6.5 million foreign workers in 1974), the Middle East in the latter half of the 1970s (more than 3 million in 1980), Ghana and Côte d'Ivoire during the 1970s (more than 1 million as of the early 1980s), Argentina and Venezuela (about 3 million during the 1970s), and the United States (approximately 5 million) (ILO 1984).

In contrast to the case of FDI, it is not possible to provide information on the sectoral breakdown of employment of foreign workers. For a number of developing countries employment abroad is an important source of foreign exchange. As can be seen from table 4–13, this is true of Benin, Burkina Faso, Egypt, Lesotho, Pakistan, Portugal, Turkey, the People's Democratic Republic of Yemen, the Yemen Arab Republic, and Yugoslavia. Many Latin American countries are or have been significant exporters of labor but do not report large revenues. To some extent this presumably reflects nonregistration of remittances.

The Relative Importance of the Principal Service Industries

Interest is often expressed in the absolute and relative sizes of specific service sectors in the world economy. Comparable sector-specific data, however, are not currently available. To provide some perspective for the sectoral chapters in part II of this book, some estimates of the relative importance of different service sectors in the world economy are developed in this section. The sectors include business services, construction and engineering, communications, distribution, education and health, finance, hotels and restaurants, insurance, personal services, recreation and culture, and transport.[22]

Table 4–14 reports estimates of the contributions of service sectors to world value added (GDP), which was about $13,000 billion in 1986. To estimate the sectoral contributions, the average breakdown of total value added for the OECD economies for 1980–84 was used. Among services, distribution contributed the most to total value added, followed by business services, construction, transport, and finance. Value added data can be converted into estimates of gross output by using an average of the ratio of gross output to value added as reported by thirty-seven countries. (This procedure is followed because most countries do not report gross output data for services.) Gross output is the sum of value added (payments to factor inputs) and intermediate consumption (payments for intermediate inputs) and can thus be regarded as one estimator of relative market size. Multiplying the value added estimates by the appropriate ratio yields the gross output estimates. These can be considered ballpark estimates of the global size of these service activities. Excluding government, but including construction, they total approximately $10,000 billion.

Concluding Remarks

For most countries the relative importance of services has grown in terms of both domestic production and employment. Generalizations are difficult to make, however, as in a number of developing economies industrial output has been expanding more rapidly than services. FDI in services has been increasing in relative importance, especially in industrial countries, and tends to be concentrated in distribution and finance-related activities.

As far as trade is concerned, it is noteworthy that private services have grown much faster than merchandise trade in the post-1980 period but that the relative importance of private services in world trade has not changed much since 1970. The share of developing countries in shipment and passenger transport increased significantly, while their share in other market services and travel increased slightly. The share of developing economies in world receipts of labor income also increased, although the relative importance of labor income in world trade declined.

The importance of exports of private service in relation to those of merchandise has grown significantly for many developing countries, but their share of world trade in private services has increased only somewhat since 1970. More significant changes have occurred with respect to the composition of trade in private services. In particular, intermediate (producer or business) services have come to play a key role in the competitive process, and trade in these "other market services" has been one of the most dynamic components of trade in invisibles.

Appendix 4–A. Measurement Issues and Trade in Services

Because of the intangibility of most services, trade data can be derived only from central bank information on flows of foreign exchange or from periodic surveys or censuses of service industries. Banking data pertains to payments, not transactions, and thus this source can give only an incomplete picture of trade in invisibles. Registered flows of foreign exchange often cover only part of a transaction or may apply to a number of transactions. Only payments that are made through resident banks will be registered. Furthermore, many payments do not go through a financial intermediary—as, for example, when bills of exchange are used. Finally, information on central bank cash flows is often reported on a net basis, making it impossible to determine exports and imports.

Since surveys of enterprises focus explicitly on transactions, not payments, in principle these problems will not arise. But surveys give rise to other problems. In particular, they do not capture imports by households and by the government or transactions by firms that are not in the registry maintained by the surveying agency. Thus it is crucial that an up-to-date and comprehensive registry of the universe of service providers be maintained. Often this will be difficult to attain. Although it is technically feasible to achieve detailed coverage of service transactions with the use of these sources, this can be both burdensome and costly. In practice, most countries tend to rely primarily on central bank data.

Service transactions are likely to be substantially underreported in the balance of payments. Services such as transport, insurance, legal advice and financial intermediation may be in part subsumed under the value of the goods to which they are related, or they may be misclassified, overreported, underreported, or not reported at all. Overreporting may occur for categories such as merchanting (transactions of goods between residents and nonresidents where the goods do not cross a frontier). Some countries define trade in this category to include the value of the goods traded; others measure only the service component—that is, the trade margin. Misclassification may occur when the payment for a service is reported as the payment for a factor service or the reverse. Data for services that require movement of the consumer, such as medical and educational services, are often not reported, even though they may at times be substantial. Thus it has been estimated that expenditures by nonresidents on U.S.-based health and education services were at least $100 million and $1,600 million, respectively, in 1983 (OTA 1986). One result of different practices and nonreporting is that export and import data rarely match. Of course, this problem also arises for merchandise trade, but it is much more prevalent for services.

Trade may consist of transactions between affiliated firms or between nonaffiliated entities. There are well-known difficulties with the registration of transactions between affiliates. The existence of differential tax rates, exchange restrictions, and investment performance requirements, as well as variations in the degree to which firms are forced to reinvest earnings, lead to transfer pricing strategies that bias reported trade figures. Separate statistics on transactions between affiliates do not exist on a global basis. This is regrettable because it is likely that much trade between affiliates consists of intangibles.

The conclusion is that data on trade in services are not very reliable and are likely to be biased downward. Research indicates that aggregate balance of payments figures for the United States in the early 1980s, for example, may have been anywhere from 40 to 100 percent too low, depending on how trade in services is defined.[23] Because of nonreporting of specific categories or the inclusion of various categories in what is reported for an item, cross-country and cross-regional comparisons for specific categories are likely to be biased. For this reason, most attention in this chapter focuses on aggregates, as these are less subject to variations as regards what is covered in the various components of trade in services.

Notes

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1. The IMF criterion for residency is used: a change in residency occurs when factors of production stay abroad for more than one year. The relevant nonmerchandise components of the current account are discussed in greater detail below.

2. Frequently the sales of foreign affiliates are an object of policy interest, and they are sometimes considered part of trade in services. This chapter takes the standard view that trade occurs only if the transactions are between residents and nonresidents.

3. See, for example, Feketekuty (1988). This is one of the reasons that balance of payments statistics distinguish merchandise from nonmerchandise trade and not goods from services. Nonmerchandise trade encompasses everything that is not observed by customs agents as passing a frontier.

4. It should be noted that to some extent the reported share of services in GDP in developing countries may be too low if activity in the informal sector is widespread.

5. Bhagwati (1984) discusses various explanations for the observed difference in relative prices.

6. Employment statistics are generally not comparable across countries, owing to widely differing methodologies. The figures in table 4–3 are drawn from a study undertaken by the International Labour Organization (ILO 1986) that is the only source of comparable statistics on employment; its drawback is that the data reported are highly aggregated (only three sectors) and are available only on a ten-year basis.

7. See Baumol (1967) and Fuchs (1968) for the original arguments. Productivity increases, however, vary widely among service sectors, and it is difficult to measure productivity in services. Many of these issues are discussed in Inman (1985).

8. Among others, Stanback and others (1981), Gershuny and Miles (1983), and Stern and Hoekman (1988) contain more detailed discussions of these matters.

9. Invisibles encompass all nonmerchandise components of the current account with the exception of unrequited transfers. They include flows related to portfolio and direct foreign investment, transport of freight and people, expenditures by travelers, flows related to temporary movement of labor, and sales of business services and intangible assets.

10. The term "private services" denotes the sum of nonmerchandise transfers of real resources that are neither official nor financial. Thus private services are equal to invisibles minus investment income and official flows. More specifically, private services include shipment, passenger services, travel, and the nonofficial components of the IMF category "other goods, services, and income." The last category includes such items as agents' fees, commissions, communications, financial services, nonmerchandise insurance, and consulting. Private services also includes property and labor income. The reason is that some countries do not report these items separately, and including them in private services ensures that at the aggregate level the data reported will at least be on a comparable basis.

11. Shipment comprises both freight and insurance on freight, the latter being on average about 5 percent of total world shipment debits. By far the largest proportion of shipment pertains to maritime transport, which in 1983 accounted for more than 90 percent of world shipment debits (IMF 1987). Other transport consists in large part of port services and charters and is thus closely related to shipment.

12. The difference between world exports and imports is a measure of the total revenues accruing to countries that do not report shipment exports (especially Greece) or do not register exports under flags of convenience. In 1970 the discrepancy was small, but in 1980 and 1985 world credits were only 65 percent of world debits. For a detailed investigation of balance of payments shipment statistics see Johansen and Panagakos (1988).

13. Some of the countries involved are relatively specialized in service exports that are sensitive to foreign economic developments. Examples include construction (Korea), personal services (Philippines), and transport (Korea, Singapore). In general, much depends on the pattern of specialization in different types of services.

14. Because many countries do not report data for specific components of private services, reported country and regional shares will be biased. As noted in appendix 4–A and in note 10, data are more comparable at the aggregate level of private services.

15. According to the World Tourism Organization, international tourist arrivals totaled about 360 million in 1987, accounting for approximately $160 billion in gross receipts. For the world as a whole, roughly two-thirds of all arriving travelers are on vacation.

16. Of course, since tourists buy goods (souvenirs, clothing, books, and so forth) as well as services, total travel expenditures cannot be attributed solely to the service sector.

17. Countries that have had negative balances in recent years include Australia, Canada, Germany, Ireland, Japan, Norway, South Africa, and the United States. North America (the United States and Canada) is a net importer of passenger transport, shipment, and travel and a net exporter of other transport. The converse holds for Western Europe, which is also a net exporter of other market services.

18. The deficits run by developing countries are primarily attributable to net imports of freight and other market services and are often compensated by positive net exports of other types of transport services and receipts from travel. Many countries in Africa and Latin America tend to run deficits on most components of private services, the exceptions often being travel and labor receipts. Asian developing economies are a mix of net importers and exporters.

19. The lists of twenty-five leading exporters of invisibles and of private services are quite similar.

20. All these countries move up at least ten places: Spain from seventeenth in manufactures to eighth in services, Austria from twentieth to tenth, Norway from twenty-sixth to fourteenth, and Mexico from twenty-eighth to eighteenth. The list of top merchandise exporters used for purposes of comparison can be found in GATT (1988).

21. Residency is used here in its statistical sense, that is, movement abroad of factors of production for one year or longer.

22. Global trade data exist for some sectors, including insurance, civil aviation, maritime transport, and construction. These will be discussed in part II.

23. OTA (1986). For more on these issues, see Ascher and Whichard (1987); Stern and Hoekman (1987); IMF (1987); Drechsler and Hoffman (1988); and White and Walker (1982).

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Part II

Service Industries

5

Banking

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When the General Agreement of Tariffs and Trade (GATT) was instituted in 1948, its mandate excluded industries such as banking, insurance, and telecommunications. These service sectors were highly regulated and protected in most countries for various reasons including, in some cases, their sensitivity with respect to national security or cultural identity. Financial services, to take one example, involve complex issues of prudential regulation, monetary policy, and stability of financial markets.

Under prompting from the United States, the Uruguay Round talks have turned to financial services—banking in particular. This has occurred in part because of the growing importance of formal finance as gross national product (GNP) per capita rises and because a number of developing countries are now seen as sizable prospective markets. Another reason is the dramatic growth of trade in financial services among industrial countries over the past two decades, which has been partly spurred by rapid technological innovation.

Trade in financial services is defined here as:

- The provision of financial services by an institution in one country to a consumer of those services in another country (that is, provision of services across borders). This is a relatively pure form of trade.
- The provision of services through the establishment of subsidiaries, branches, or agencies by a financial institution in a country other than its home country; here, trade is associated with investment.[1]

In general, the latter issue has received more attention in discussions of barriers to trade in financial services, whereas cross-border trade has generally been viewed within the context of the removal of exchange controls or the liberalization of capital movements. The distinction may be important because each of these two forms of trade may call for different approaches and solutions in the multilateral trade negotiations.

Financial services are defined as comprising (a) deposit taking and lending, whether in domestic or foreign currency, to governments, corporations, private individuals, and others; (b) specialized forms of lending, including trade financing, loan syndications, and participation; (c) trading and dealing in domestic and foreign currencies; and (d) various advisory and brokerage services. Insurance is dealt with separately in chapter 6 and is explicitly excluded from this analysis.

Products, Agents and Markets

Banking and financial services interact with a broad range of economic activities and agents and play an important role in the credit, monetary, and payments systems. They have close relationships with public policy, and their operation is strongly influenced by the regulatory environment and by other aspects of the economy. The issue of opening them up to international trade is consequently complex.

The first mode of trade in financial services, which involves international exchange of financial flows and, essentially, the liberalization of the capital account, allows agents in one country to enjoy financial services provided by institutions in other countries.[2] The range of activities in which this is possible is limited because of the need for a certain degree of proximity between intermediaries and their clients. Proximity between the supplier and the purchaser is usually more important for services than for goods. At first sight it is not clear why proximity should be important for financial services in the same way as for, say, haircuts. But the characteristics of financial transactions—mainly the need for frequent information and trust—can make this a pressing need.

The second mode of trade involves direct foreign investment in financial institutions located in the country of residence of the user of the service. Most commonly, this investment is in the form of locally owned subsidiaries or branches. The issue here is not liberalization of the capital account but the treatment accorded by host country regulatory authorities to foreign banking affiliates.[3]

Ownership of Banks

Attitudes toward licensing foreign banks and other financial institutions vary widely among developing countries. Some countries totally exclude foreign financial institutions; others permit representative offices but not branches. The Bahamas, Bahrain, Hong Kong, Panama, and Singapore view exports of financial services as a source of employment and foreign exchange, and in a few, usually small, developing economies foreign institutions account for nearly all financial assets. Table 5–1 shows the range of experience. The three foreign banks that operate in Botswana hold all commercial banking assets, although there are several smaller indigenous nonbank intermediaries that take deposits, make loans, or do both. In Malaysia, which has traditionally had an open policy toward the financial system, sixteen foreign banks account for one-quarter of banking assets; in Chile, Kenya, and the Philippines the share of foreign banks is also appreciable. In Nigeria foreign shareholdings in banks have been tightly limited to create a class of co-owned enterprises; in Tanzania a foreign-owned banking system was nationalized after independence. The representative country of table 5–1 had eight foreign banks, which held 6 percent of system assets.

Historically, the establishment of branches and subsidiaries by international banks followed closely the location of major international clients and the finance of trade. Today the main activities of foreign banking affiliates in developing countries are still largely in these areas, even though the doubling of international bank lending that has taken place since 1980 has occurred against a background of virtually no increase in world trade.

The case of Uruguay illustrates another common characteristic of developing countries—the overwhelming presence of government in many domestic banking systems. In Uruguay the indigenous banking system is, in fact, totally government owned as a result of the rescue operation mounted by the authorities in the mid-1980s. In India, Tanzania, and many other countries the indigenous banking system is state owned because of nationalization. Even in free-market Chile the government's effective participation in the financial system through the Banco del Estado is about 25 percent. This implies that in many cases trade liberalization in banking services—as in certain other service sectors—might amount, in effect, to breaking a government monopoly. In most African countries banks are either government owned or foreign owned. Nigeria was the only country in Africa to develop indigenous commercial banks before the late 1940s.

Although there are some exceptions, foreign banks are much less likely than domestic banks to have an extensive branch network. This implies that they are usually more dependent on wholesale funds or on funds from abroad and that they are more likely to provide services to large clients in the main urban centers than to small farmers. The cost structure of foreign banking affiliates may therefore differ significantly from that of indigenous banks. In particular, they may have a higher cost of funds (because of fewer demand deposits) but far fewer staff per unit of assets. They may also rely more on fee-based income.

This bias toward larger clients—and, in most cases, toward subsidiaries of multinational corporations—segments the financial markets and clearly limits the benefits that might be derived from the presence of a sophisticated and perhaps relatively more efficient financial intermediary.[4] Many residents of the host country who are clients of foreign bank affiliates might in any case have had access to the corresponding bank headquarters abroad. Conversely, smaller savers and borrowers may be left captives of the indigenous financial intermediaries and their range of products and services. But it is also true that the threat of foreign competition, even if only for a limited sphere of business, may cause domestic intermediaries to improve their services and products.

The impact of the entry of foreign financial institutions on the balance of payments is not clear.[5] On the positive side, these institutions may stimulate inflows of capital, including funds to establish their own capital base if they are subsidiaries; they may act as a conduit for foreign funds, especially if the international standing of indigenous banks is not adequate to sustain correspondent relationships; and they may be able to supply services that would otherwise have to be imported. On the negative side, it is sometimes alleged that foreign banking affiliates facilitate the export of capital in circumstances in which foreign returns exceed domestic returns or domestic savers face major uncertainties.[6]

Banking Systems in Developing Countries

The above discussion takes for granted that the main function of the financial services industry is to provide financial services to clients efficiently and on a more or less competitive basis. But this is not true in all countries. There are important differences between industrial and developing countries and very large differences among developing countries that bear on the question of liberalizing entry.

Table 5–1. ***Foreign Commercial Banks in Developing Country Markets***

Country and date	*Number of foreign banks*	*Percentage share in total bank assets*
Argentina, 1987	32	20
Bangladesh, 1986	7	6
Bolivia, 1987	3	3
Botswana, 1986–87	3	100
Brazil, 1987	17	6
Chile, 1987	21	17
Colombia	8	6
Indonesia, 1986–87	10	6
Kenya, 1986–87	11	37
Malaysia, 1988	16	25
Nepal, 1988*	3	6
Nigeria, 1987–88*	15	74
Pakistan, 1987–88	20	12
Peru, 1987	5	2
Philippines, 1986–87	4	19
Senegal, 1986–87	2	4
Thailand, 1988	14	4
Tunisia, 1985	7	1
Turkey, 1986–87	18	4
Uruguay, 1987	8	10
Venezuela, 1987	3	1
Median	8	6

*Joint venture foreign banks
Source: World Bank reports.

Role

Despite some trend toward reform, in a large number of developing countries financial intermediaries are still expected to distribute subsidies by means of below-market credit, to cross-subsidize among clients, and to finance the government through forced investments and high reserve requirements. This role may be part of broad development policy, or it may be imposed to satisfy special interests. To give some idea of the size of such impositions, subsidies to government and others through financial systems frequently amount to 3 to 4 percent of GNP and may reach 7 to 8 percent of GNP—this for a sector in which normal value added amounts to only 5 to 6 percent of GNP. For a set of ten developing countries the inflation tax averaged 2.6 percent of GNP in 1987 (World Bank 1989, box 4.5); the inflation tax in developed countries is typically less than 1 percent of GNP. There is inevitably some conflict between these objectives and the entry of foreign banks that expect to operate according to the principles of their home countries. Foreign banks will expect to hold and price assets on the basis of risk and return rather than according to government directions. Indeed, governments are sometimes reluctant to permit entry because they recognize that it will be more difficult to persuade foreign institutions to fall in line with their objectives.

Condition

Technical insolvency is widespread among financial systems in developing countries. Although it is not possible to obtain a complete picture of the situation of banks in either industrial or developing countries, there is little doubt that insolvency problems loom far larger in the latter. These problems are often not apparent, owing to inadequate systems of prudential regulation and supervision, but when they surface (sometimes as a liquidity crisis), it is not uncommon for losses to amount to a multiple of the capital of intermediaries and to a sizable fraction of gross domestic product (GDP)—from a few percentage points to, occasionally, 25 percent.

In general, financial liberalization increases the stress on ailing intermediaries. The entry of new and more efficient financial institutions that are not burdened with portfolio problems tends to further undercut existing, distressed, financial institutions. To compensate for loan losses, the latter must try to recover income from good clients by raising spreads and charges (as occurred in the savings and loan industry in the United States), but they are likely to face severe competition from new entrants not burdened with bad loans. Of course, the objective of liberalizing markets and opening them up to foreign entry is precisely to cause stress to established firms through increased competition. But this needs to be handled carefully in the case of banks; large losses by depositors are invariably unacceptable, and it will finally be the government that will have to bear the loss.

Protectionism

Protectionism in banking services may be defined as the absence of equality of competitive opportunities for foreign as compared with domestic banks. This can occur through exchange controls or through restrictions on foreign investment.

Exchange restrictions typically constrain domestic savers from acquiring financial assets abroad (although external debt problems have led to constraints on domestic borrowers as well). Pension and insurance funds in developing countries typically cannot save abroad and therefore cannot be serviced by foreign investment firms. Capital restrictions may also prevent institutions located in foreign countries from offering other types of services. For example, it may be difficult for a foreign institution to underwrite a domestic security issue in the presence of exchange controls. (It should be noted that for much of the post-World War II period most industrial countries have also maintained exchange controls.)

Restrictions on the establishment of foreign banking affiliates take the form of discriminatory *barriers to entry* and discriminatory *operating constraints.* The issue concerning entry is not the existence of barriers as such; with rare exceptions entry into domestic banking sectors has historically not been free in any country. In liberalized market-based systems, entry restrictions typically specify minimum capital requirements, management integrity, and competence. In other systems, entry restrictions are varied, ranging from absolute prohibition of any foreign presence to limitations on capital participation in domestic institutions.

There are many ways in which operating constraints affect the ability of foreign banking affiliates to compete with domestic banks. For example, they may influence the affiliates' funding possibilities by mandating differential access to the central bank discount window, prohibiting the receipt of deposits from the public, or limiting the number and location of branches. National banks may handle all government and parastatal business, which assures them of large volumes of low-cost deposits. Governments may not require dividend payments from nationalized banks,[7] and they may impose special requirements regarding the nationality of top management and directors, constrain the type of services that can be offered, and so on.

Operational constraints can be further classified as *intentional* and *accidental* (see appendix 5–A for examples). Intentional operational constraints explicitly discriminate against foreign banking affiliates. They are frequently designed to limit foreign bank operations to certain segments of the financial market while preserving other segments entirely for indigenous banks. Accidental operational constraints are those regulations or national economic policy measures which, even though applied equally to foreign and indigenous banks, have a differential and negative impact on the ability of foreign banks to compete in the host country banking market because of the different nature of their operations.[8] One of the most common constraints of this kind emerges from maximum permissible asset-capital ratios and limits on the size of loans to individual borrowers in relation to capital. Both of these constraints are imposed by most countries for prudential reasons, to ensure minimum levels of capitalization and portfolio diversification and so enhance the safety of the institutions. Also for prudential reasons, many nations treat foreign banking affiliates in the host country as independent entities. This means that asset-capital ratios and lending limits are based exclusively on the foreign banking affiliate's capital, which is typically only a small fraction of the total capital of the parent organization. As a result, the affiliates' volume of operations and individual loan sizes can be seriously constrained.

In other cases, competitive inequities result from measures related to general economic and balance of payments policies. Given the international orientation of foreign banking affiliates' operations, limitations on foreign exchange transactions have a greater negative effect on them than on their domestic counterparts. Many developing countries control the expansion of credit through bank-by-bank credit ceilings rather than through broad monetary policy tools, such as open-market operations. Such measures discriminate against new entrants and against banks with limited branch networks if allocations are made on the basis of deposits collected. This constraint is not always easy to abolish. Concerns about losing control over monetary and credit policy if direct controls are given up are related to the level of sophistication of the domestic financial system and in some cases are well founded.

Some governments have deliberately reduced competitive inequities that affect foreign banking affiliates by applying regulatory requirements flexibly or by granting the affiliates privileges not extended to domestic banks. For example, foreign banks, because of their limited branch networks, might be exempt from onerous obligations to lend to small farmers.[9] In some cases, measures that apply equally to both groups of competitors can have a favorable impact on foreign banking affiliates because of the nature of their operations. All of these measures may be classified as *preferential treatment measures* (see appendix 5–A).

As in the cases of minimum capital-asset ratios and maximum lending limits, discussed above, many constraints on banking operations are prudential, especially in developing countries. Prudential regulations establish the outside limits and constraints placed on banks to ensure safety and soundness.[10] The issue then is not the constraints themselves but equality of treatment between foreign and domestic banks. This is the *national treatment principle* discussed at the Montreal midterm meeting. In most developing countries national treatment does not prevail, and in many of these countries the regulatory framework is not transparent, which worsens the problem. For example, certain countries have no explicit policy of not licensing foreign banks, yet no foreign banks have been licensed for twenty years. This important dimension of liberalization—*transparency* of regulation—has been emphasized by representatives of industrial countries. In this context transparency is defined as the ability of all participants in a market to have equal knowledge of and access to regulatory and legal changes.[11]

In some cases difficulties in achieving exact equality of treatment are the outcome of significantly different foreign and domestic banking structures. (Any constraints resulting from such differential structures would be classified as "accidental.") For example, in the United States banking and commercial activities are largely separated, as are banking and securities activities by the Glass–Steagall Act of 1932, but in many other countries commercial activities may be conducted by companies affiliated with banks, and banks can operate in securities markets. This has made it difficult to implement the U.S. policy of national treatment with respect to direct investment by foreign banking organizations and their nonbanking affiliates.

As noted above, foreign ownership of banking institutions is frequently a politically sensitive topic in developing countries. This is especially so when the banking industry is seen as a policy arm of the government, which can exert far greater control and moral suasion over national institutions, but it is also a result of the role of banks in implementing monetary policy and financing government out of seigniorage. Banks are typically not popular institutions (many ethical systems have an aversion to interest), and in some cases a fear of foreign banking affiliates is said to add to their unpopularity, regardless of nationality. The poor financial condition of many indigenous financial institutions is also an invitation to protection by governments unprepared to face the fiscal cost of financial reform.

Political Economy and Welfare

Sagari (1989) has shown that skilled labor is a source of comparative advantage in financial services. This explains why the developing countries, which are well endowed with skilled labor, wish to extend GATT-like rules to financial services, and why developing countries have given a less than enthusiastic welcome to such proposals. Within the principal industrial economies inclusion of finance in a GATT-like framework is probably less relevant for smaller banks than for the major multinational banks.

Gains for Developing Countries

The issue of the potential gains for developing countries from free trade in financial services is clearly complex. Major developing country banks often have branches in the main money centers—to effect payments speedily, to fund positions in foreign currencies through the interbank markets, and in some cases (such as the Banco do Brasil) to attract short-term credit to help support the balance of payments. Developing country nationals also manage a number of international banks, such as the Bank of Credit and Commerce, Librabank, Bladex, and Arlabank. Banks from certain countries, such as the Republic of Korea and Thailand, are starting to show signs of moving into industrial country markets, and it was not so long ago that Japanese banks, now major international players, confined their operations to their home country. These examples suggest that there is a real possibility that developing countries can export banking services. Further, the dynamic efficiency gains forced by opening domestic markets to competition will probably be needed to spur developing country banks to try to export their services. For most developing countries, however, the potential gains from the opening of banking are still seen to be those deriving from the presence of foreign banking affiliates in their markets.

A General Equilibrium Approach

An in-depth cost-benefit analysis of this topic should, of course, take into account the fact that financial services are largely intermediates. This increases the already large problem of measuring their quantity and quality. In principle, the effects of protecting intermediate services are similar to those of increasing the cost of intermediate goods such as steel. Some authors (for example, Bhagwati 1987) have argued that in the case of financial services the negative effects may even be more severe than for goods. In denying access to efficient banking services, the protective policies may deny domestic exporters of goods access not only to cheaper credit but also to the entire vector of services—such as hedging facilities and swaps—that modern international banks can provide to facilitate international commerce. General equilibrium welfare analysis of protection suggests that barriers to trade in financial services lead to inefficiencies in the allocation of productive resources, distorted consumption patterns, and significant static and dynamic welfare losses. Over time, the effect of liberalization of trade in financial services can be substantial in breaking down established oligopolistic and corporatist structures and stimulating change in other sectors. It will be especially interesting to observe the experience of Europe in the 1990s. (A proposal for the rules that will govern banking in the European Community—the EC—is summarized in appendix 5–B.) But, as discussed above, to the extent that the clients that benefit from the local presence of foreign banking affiliates are largely enterprises that could have accessed similar services in international markets, overall welfare gains may be smaller.

The critical question is, therefore, the extent to which foreign banking affiliates can constitute an actual or potential source of competition and reduce the power and wastefulness of national banking oligopolies. The answer, as well as the willingness of host country authorities to welcome foreign banking affiliates, may well depend on the relative degree of sophistication of the indigenous banks and their desire to become more active internationally. In less sophisticated markets it is likely that foreign multinational banks will not upset the prevailing level of competition in most retail markets and will merely insert themselves into typical market niches.

This points to a general characteristic of direct foreign investment: gains are less likely when markets remain oligopolistic and segmented and are most likely when foreign entry contributes to a effective increase in the number of competitive firms or, perhaps, the breaking of a government monopoly. The extent to which opening the banking industry will have such a favorable and widely felt impact varies considerably among developing countries.

Foreign banking affiliates, however, can also make a significant dynamic contribution to the *development* of domestic financial markets. They can introduce modern, sophisticated banking techniques and systems more quickly than many indigenous institutions can develop them. Foreign banks frequently innovate—they have introduced a bankers' acceptances market in Spain, credit cards and ATMs in some countries, and so on. In some countries, such as Kenya, foreign banks have established venture capital affiliates. Another important contribution of foreign banks is on-the-job management training. Managers of indigenous banks in developing countries are increasingly drawn from the ranks of host country nationals who have risen to the executive level in foreign banks. The experience of these nationals combines exposure to modern banking techniques with understanding of the local market. In the longer run this infusion of skills may be the most important spinoff from the entry of foreign banks, especially given the difficulty that most developing country banks would now face in trying to establish themselves in developed markets.

An Analysis of Liberalization Options

The full liberalization of banking and financial services requires both free capital movement and nondiscriminatory entry and operating conditions for foreign banking affiliates as compared with indigenous banks. Allowing foreign financial institutions to offer their services to residents of a country is of little use if such operations are subject to conditions that preclude all competition with indigenous institutions and limit profitability.

Total liberalization would also require—and, indeed, exert strong pressure for—the harmonization of national legislation and policies that determine the operating environment of financial intermediaries. Differences in regulatory standards are likely to translate into a competitive advantage for banks subject to a particular regulatory regime. Harmonization, however, is difficult; it can be expected that each country will prefer its own system. The politically sensitive nature of the financial sector slows the process of modifying banking laws and regulations, which is subject to lengthy and complicated political debates. The process followed by the EC in its integration efforts offers an example of some of these difficulties.[12] Santomero (1989) notes that the United States itself had a tradition of regulation centering on product restrictions and geographic limitations, the result being a fragmented industry with an excessive number of participants. He describes the "long and tortuous road" followed by the industry in its efforts to move closer to full interstate banking.

The case of the developing countries is even more complex: few have a tradition of free capital movements, and the foreign debt crisis has rendered their foreign exchange problems even more serious. Their indigenous banking systems have frequently grown within a framework of distorted signals owing to a combination of protection and governments' use of the banks as instruments for achieving noneconomic targets. In most developing countries prudential regulation and supervision are woefully inadequate. In such circumstances, adjustment to a fully competitive setting cannot be made abruptly. The speed of adjustment will reflect the costs of reorganizing, of learning, and in general, of developing new instruments and practices within institutions.[13] Liberalization of domestic financial markets may need to take precedence over liberalization of capital movements (that is, external liberalization). Blejer and Sagari (1987) elaborate on the issues of sequencing in financial liberalization. The need is for evolutionary mechanisms within which steady and phased adjustment of national policies and institutions can take place.[14]

Another issue related to the opening of the capital account is a propensity of international lenders to urge developing country governments to assume ultimate responsibility for the debts of the private sector. The case of Chile in the 1980s is an interesting example.

Given the unique characteristics of financial services, is the Uruguay Round the right forum for discussing their liberalization?[15] When the GATT was established in 1948, banking was explicitly excluded from its mandate. But the principles and concepts of the GATT—for example, the national treatment principle discussed above—might form part of a general framework for agreements pertinent to trade in financial services. Moreover, the GATT principles are gradual in process and flexible enough to allow a great degree of bilateral adjustment, which will be crucial in the work undertaken in the Group of Negotiations on Services (GNS).

The problem with the Uruguay Round forum is the importance of regulation in shaping financial systems and the highly specialized knowledge needed to modify and harmonize different countries' frameworks. An alternative, and perhaps a natural, complement to the GNS is to negotiate issues of trade and investment in the financial sector in an international forum supported by agreements among the pertinent central banks. For example, the Basel risk-based capital framework constitutes an accord among the banking authorities of the principal industrial countries rather than a formal international agreement or treaty. Bringing the developing world on board will probably require the progressive replacement of national laws and regulations with those promoted by this international agency. These measures could then be enforced by the national authorities.

But such regulatory harmonization cannot be expected to be successfully implemented within a short time. A promising approach may be that adopted by the EC: *mutual recognition*, whereby each country recognizes the laws, regulations, and administrative practices of other member states as equivalent to its own. This approach precludes the use of differences in national rules as a means of restricting access. Clearly, however, a prerequisite to mutual recognition is the harmonization of the most essential aspects of legal systems, statutory provisions, and regulatory and supervisory practices.

Moreover, as discussed above, the distinction between the provision of financial services by subsidiaries of foreign banks, on the one hand, and their provision through branches or across borders, on the other, may be pertinent to the design of the preferred approach. In the case of the EC, operations of subsidiaries of financial firms headquartered in other member states will continue to be covered by the principle of national treatment; that is, subsidiaries of foreign financial institutions are treated in the same manner as other incorporated entities in the host state. This "dual" solution is, to a certain extent, counterintuitive since, at least in the short run, it is bound to bring about some competitive inequalities and fragmentation of markets, in contrast to the objectives supposed to be achieved though "liberalization." Over the longer run, however, it is expected that market forces will create pressure on governments that will lead to the convergence of those national rules and practices that have not been explicitly harmonized at the EC level.

Nonetheless, one should be careful not to overestimate the applicability of the experience of the EC to a global approach to multilateral trade negotiations on services. The economic, institutional, and political characteristics of the EC differ greatly from those that might be observed in a grouping that includes both developed and developing countries. EC decisions are made in the context of a fairly powerful supranational legislature and judiciary to which the member states have already transferred a significant degree of sovereignty and of acceptance of the prevalence of Community law over national law.

Conclusions

The U.S. proposal for the liberalization of trade in services has initially met with a response on the part of developing countries that varies from cautious to hostile. As with other sectors, this to some extent reflects concern over the perceived comparative advantage of industrial countries and the power of strong vested interests, including the interests of governments, which may seek to make the financial system an instrument of public policy rather than a market-based intermediary. But it also reflects recognition of the peculiar situation of the banking industry in many developing countries. In some countries there is essentially no banking industry in the sense understood in industrial countries. In many, much of the banking sector is technically insolvent, and massive and costly efforts are needed to restructure intermediaries' balance sheets, reform the management of banks, and improve—or, indeed, build—systems of prudential supervision and regulation. These measures are frequently necessary before financial systems can operate on a market basis. But they cannot be effected immediately. The opening of borders to foreign competition, although an important and necessary part of liberalization, may proceed in line with wide-ranging domestic reforms.

Appendix 5–A. Discriminatory Operating Constraints

Constraints that discriminatorily affect the operations of foreign banks once they are established in the host country's markets may impede the ability of foreign banking affiliates (FBAs) to compete with domestic banks in several ways. For instance, they may increase their cost of funds or their general operating costs in relation to those of domestic competitors or may constrain expansion of their operations within the country. The U.S. Treasury Department *Report to Congress on Foreign Government Treatment of US Commercial Banking Organizations* (1979) suggests that these regulations can be grouped into three types: intentional operational constraints, accidental operational constraints, and preferential treatment measures. We have further divided each of these sets of regulations according to the facets of banking activity they affect.

Intentional Operational Constraints

Constraints that are explicitly established to discriminate against foreign banks are common in developing countries. In many cases such constraints are designed to limit foreign bank operations to certain segments of the financial market while preserving other segments entirely for local banks.

• *Regulations related to private sources of funds* are among the most prevalent intentional operational constraints. They restrict FBAs' solicitation of some kinds of deposits—for example, retail deposits or deposits of specific business sectors—or limit borrowing from nonbanks. Deposits are one of a bank's lowest-cost sources of funds, and to the extent that deposit-taking restrictions force foreign banks to use more expensive sources, the result is a significant competitive disadvantage for these banks.

Frequently, the government's policy is to hold its financial accounts exclusively with indigenous institutions, in many cases government-owned ones. Among other consequences, this provides a comparative advantage to those banks, typically by making available to them large volumes of low-cost deposits.

• *Regulations that affect the number or location of FBAs* limit the sources that FBAs can tap for local deposits. The combination of constraints on acceptance of certain types of deposits and on the expansion of branch networks severely restricts FBAs' access to inexpensive local sources of funds.[16]

• *Regulations that affect FBAs' access to central bank discount facilities* are also rather common. They put FBAs at a disadvantage in dealing with their liquidity needs, forcing them generally to hold a larger proportion of their assets in lower-yield reserves.

• *Restrictions on the services that FBAs can offer, other than those related to deposit-taking and lending* make it difficult for FBAs to expand their market share because they cannot offer the full line of services permitted to domestic banks. Frequently seen examples of these restrictions have to do with security management and underwriting business, limits for guarantees, and the types of currencies that FBAs can deal in.

• *Restrictions related to the loan and security portfolio* may limit the type of borrowers FBAs can service or may force them to hold a larger proportion of their loan portfolio in low-yielding, longer-term loans than is required of domestic banks.

• *Tax-related regulations* normally lead to higher costs of doing business. Examples are a tax rate on foreign branch profits remitted to the parent bank that is larger than the tax rate on dividends (the analogous payment for domestic banks), exemptions for domestic banks of withholding taxes on interest paid to nonresidents, and so on.

• *Sundry operational constraints* explicitly discriminate against FBAs. Examples are ceilings on the annual repatriation of FBAs' profits, differential initial capital requirements, differential foreign currency reserve requirements, restrictions on the sources of funds for capital increases, restrictions on the ability to hold liens on real property, and regulations concerning the nationality of FBA executives.

Accidental Operational Constraints

In many cases operating regulations or national economic policy measures, although applied equally to foreign and domestic banks, have a differential negative effect on the ability of foreign banks to compete in the host country banking market.

• *Limits on the volume of assets, liabilities, or sizes of loans to individual borrowers* are among the most prevalent of the measures that effectively discriminate against FBAs. The constraints emerge from maximum permissible asset-capital ratios and limits on the size of loans to individual borrowers. They are imposed in most countries for prudential reasons, with the objective of ensuring minimum levels of capitalization and portfolio diversification and so enhancing the safety of depository institutions. Also for prudential reasons, many nations treat FBAs in the host country as independent entities. Consequently, asset-capital ratios and lending limits are based exclusively on the FBAs' capital, which is typically just a small fraction of the total capital of the parent organization. As a result, FBAs' total volume of operations and individual loan sizes are seriously constrained. Competitive inequities are exacerbated if such measures are imposed simultaneously with the enforcement of limits on imports of capital.

- *Credit ceilings imposed for purposes of domestic monetary policy* may apply to both foreign and domestic banks, but if foreign banks are relatively later entrants in the market, they have had less time to build up their domestic business and are consequently more constrained in expanding their portfolios. In some cases lending limits are based on domestic deposit liabilities. Where this type of constraint is enforced simultaneously with regulations affecting FBAs' access to local deposits, the resulting competitive inequities are even more significant.
- *Other restrictions resulting from general economic and balance of payments policies* may lead to competitive inequities. Because of the international orientation of FBAs' operations, limitations on foreign exchange transactions affect them more negatively than they do their domestic counterparts. Constraints on business with nonresidents, which typically represents a larger share of operations for FBAs than for local banks, also has a differential effect. Capital controls tend to be more restrictive on foreign banks that are funding their operations by borrowing from their parent institution.
- *Other accidental operational constraints* result from measures completely divorced from the banking sector, such as requirements for alien work permits and nationality requirements. FBAs may be affected more severely than domestic banks because they may desire staff of their own nationality and because difficulties in obtaining work permits may limit their ability to develop their staff.

Preferential Treatment Measures

Some governments have deliberately reduced competitive inequities that affect FBAs by applying regulatory requirements flexibly or by granting FBAs privileges not extended to domestic banks. In some cases measures applied equally to both groups of competitors have a favorable impact on FBAs because of the nature of their operations.

- *Regulations concerning reserve requirements on deposits or funding in the interbank market*, such as lower reserve requirements on foreign currency or nonresident deposits than on domestic deposits, decrease FBAs' cost of deposit funds, since they normally hold a greater proportion of foreign currency liabilities than do domestic banks. Another example is the waiver of reserve requirements on funds raised in the interbank market, which FBAs use more extensively than do domestic banks.
- *Preferential measures related to directed lending* include flexibility in the application of credit controls and exemptions from the obligation to support government bond issues, to participate in rescue operations of failing firms, or to extend loans to priority sectors identified in government development plans.
- *Sundry preferential measures* include a variety of regulatory features that explicitly or accidentally favor FBAs. Examples are access to special swap facilities not available to domestic banks (to compensate for the impact on foreign bank operations of the denial of access to the discount window, for example), flexibility in the application of foreign exchange controls, and the like. In some cases governments have offered inducements for the establishment of foreign banking affiliates in the form of special tax concessions or preferential tax treatment.

Appendix 5–B. EC Bank Legislation

The EC's Second Banking Directive is viewed as the centerpiece of EC banking legislation for the post-1992 era. Key (1989) discusses a comprehensive proposal for the directive, dealing with the powers and geographic expansion of banks within the Community. The following points are among the most important aspects of this complex proposal.

- Branches of EC banks established throughout the Community under this directive would be authorized and supervised by the home country (single license and home country control).
- The directive, however, specifies certain conditions that an EC bank must meet in order to establish branches without host country licensing (minimum initial capital requirements and provisions relating to the identity, extent of holdings, and suitability of major shareholders).
- The directive introduces a list of "universal" banking powers for EC banks which includes underwriting and trading, for customers or on the banks' own account, of practically any type of security, participation in share issues, money brokering, leasing, and issuing credit cards, but no insurance activities. Branches of banks chartered by individual EC member states would be permitted to engage in any of the listed activities, provided that the EC home country permits such activities.

- The directive acknowledges the public interest exception to the principle of home country control. In addition, it establishes three specific exceptions: (a) the host country retains exclusive responsibility for measures resulting from the implementation of monetary policy; (b) until further coordination, the host country retains primary responsibility for the supervision of liquidity; and (c) until further coordination, the host country is permitted to require credit institutions authorized in another member state to make sufficient provision against market risk with respect to operations in host country securities markets.

The approach to the question of access for non-EC institutions tends to follow the principle of reciprocity; under discussion are details on the type of reciprocity (reciprocal national treatment or mirror-image reciprocity)[17] and other concepts (such as the better-than-national-treatment approach under which the Community would seek to have a non-EC country offer EC banks treatment comparable to that accorded banks within the Community).

Notes

1. A branch is a legal entity of the home country and is treated as an integral part of the parent bank. A subsidiary is a legal entity of the host country and is a separate corporation wholly or majority owned by the transnational bank parent. The difference matters because of regulatory treatment and, in particular, capital requirements.

2. For example, much financial intermediation in Venezuela has historically been carried out offshore, through banks in Miami and the Caribbean. Another example is situations in which surplus countries have exported capital and at the same time as they are borrowing abroad; in Botswana, for example, major projects are, for the most part, not funded through the domestic financial system, although there is a surplus of loanable funds.

3. An important issue for licensing policy is whether to allow foreign branches, subsidiaries, or both. Countries differ in this regard. For example, Botswana allows foreign subsidiaries but not branches, whereas Uruguay permits branches. In Canada financial reforms have, in effect, brought about the conversion of foreign banking operations from branch to subsidiary operations, with both positive and negative effects for the banks concerned.

4. A common argument for multinationalization of banking cites the benefits to be derived from integrating capital and financial markets. Terms and availability of credit will not necessarily be equalized within different countries.

5. This is true even without considering the complex problems arising from the protection of an input—such as financial services—that is intensively used by the productive sectors of the economy. See the section "A General Equilibrium Approach."

6. According to IMF data, during 1981–87 gross flows of foreign investment to developing countries were $118 billion, but net flows, taking into account dividend remittances, were negative $10 billion. For nonoil developing countries, gross and net flows were $85 billion and $21 billion, respectively.

7. In Uruguay, for example, the National Bank, which accounts for about 70 percent of the system's assets, handles all government accounts and is not required to pay dividends. Reforms in these areas are a prerequisite for the evolution of a competitive financial system.

8. This notion is linked to the concept of effective market access, which emerged in the context of the Uruguay Round midterm review. The concept seems to be related to two issues: (a) the potential differential impact on foreign and domestic institutions of a highly regulated host country environment and (b) the potential market distortions created by differences in the laxity of the regulatory framework for banking services in the host country compared with the home country. The first issue implies that in a highly regulated environment it may be more difficult to achieve national treatment for foreign banking affiliates than in a more open system. The second calls for the harmonization of regulatory structures, as discussed in the section "An Analysis of Liberalization Options."

9. In such cases, foreign banks might need to deposit an equivalent amount of funds in a low-interest account at the central bank. If loan losses on farm loans are high (as is frequently the case), the penalty of low interest may be preferable to lending.

10. The key components of a banking prudential regulatory framework focus on licensing and other corporate activities, exposure limits, loans to insiders, capital adequacy, asset classification and provisioning, submission of false financial information by borrowers, enforcement powers, treatment of problem and failed banks, permissible or prohibited activities, and scope, frequency and content of audit programs. For a comprehensive description of these aspects see Polizatto (1989).

11. Bankers frequently complain about changes in regulations that take place without their knowledge or advice.

12. For instance, as of April 1989 only four European countries—Denmark, the Federal Republic of Germany, the Netherlands, and the United Kingdom—had fully liberalized capital movements with respect to both other EC members and third countries. France still prohibited nonbank residents not involved in international commercial activities from holding deposits at banks in foreign countries or holding foreign currency deposits, other than those denominated in ECUs, at banks in France.

13. For an example of the magnitude of institutional reforms needed by large Indonesian banks, see World Bank (1989, box 7.5).

14. Even in the case of the EC, the accession treaties of the new member states (Greece, Portugal, and Spain) provide for derogations or time lags in which to implement the directives in the area of freeing capital movements.

15. The U.S. position has clearly been to prefer augmenting the GATT to include services. By contrast, the group of ten developing countries led by Brazil and India (the G-10) wished to separate any potential services agreement from the GATT. Within this approach, the negotiations would be undertaken by the governments themselves, not by the GATT contracting parties.

16. In some cases official pressures go in the other direction, forcing foreign bankers to branch into specific regions more widely and more quickly than they consider economically reasonable.

17. Reciprocal national treatment means that the Community would offer national treatment to a non-EC bank provided that its non-EC home country offered national treatment to banks from all EC countries. Mirror-image reciprocity involves an attempt to achieve a precise balancing of the treatment accorded EC and non-EC banks in each other's markets.

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6

Insurance

Robert L. Carter

Access to insurance contributes to the welfare of risk-averse individuals and organizations in all countries and generates other macroeconomic benefits. Most insurance services can be and are supplied domestically. Without international trade, however, insurance markets would not be able to supply all of the insurance demanded for very large individual and catastrophic risks. Trade also promotes the spread of innovation in products and processes and generally stimulates market efficiency. Nevertheless, since the 1950s trade in insurance has increasingly been subject to trade barriers. This chapter examines the case for liberalizing international trade in insurance and suggests how it might be done.

The Nature and Benefits of Insurance Services

This section reviews how insurance permits the transfer and sharing of risk, contributes to the accumulation of funds for investment, and provides a mechanism for private saving. Among other benefits, insurance gives firms the cushion of security they need to undertake innovative activities.

Risk Transfer

Insurance is a mechanism for spreading uncertain losses over time or over larger numbers of persons. It enables individuals and organizations to pay an agreed premium to transfer the risk of financial loss arising from the occurrence of specified loss-producing events to an insurer who, by pooling individual independent risks, reduces the overall risk.

Not all risks are insurable. Among the limitations are the size of individual losses and of accumulated losses from natural and man-made catastrophes that an insurer can withstand without imperiling its solvency (Berliner 1982, pp. 36–37). The boundaries of insurability can be extended by spreading large risks among a number of insurers. One method is through coinsurance arrangements, which allow several insurers to take shares in the insurance of large industrial risks. Alternatively, reinsurance enables a direct insurer to transfer a part of the risk he has accepted to a reinsurer who undertakes to meet an agreed part of any claims that may arise on the original insurance (Carter 1983). The reinsurer may in turn reinsure part of his liabilities. Only through such international spreading of risks is it possible for domestic insurance markets to meet the demand for adequate insurance coverage for very large individual risks and for natural and man-made disasters.[1]

The Accumulation of Funds

Private insurance operates by pooling the premiums collected from policyholders to create a fund for the payment of claims. In the case of nonlife insurance, such funds are usually equal, on average, to between one-and-a-half times to twice the amount of the insurer's annual premium income. Because life insurance contracts generally extend over many years, life insurers accumulate substantially larger reserves to meet their liabilities to policyholders and so are an important source of funds for capital markets.[2]

Personal Saving

Life insurance, besides providing financial protection against the risk of premature death, has developed in many countries into an important form of long-term (mainly contractual) personal saving.[3] Consequently, life insurers have been embroiled in the financial services revolution, competing with banks and other institutions for savings and loans and in some countries developing into or being acquired by financial conglomerates.

The Benefits of Insurance: Summary

The transfer of risks through insurance reduces the adverse financial consequences for policyholders (and often for third parties too) of those losses that do occur and increases their sense of security (Carter 1979, ch. 2; Haller 1975). Business insurance contributes to the efficiency, development, and competitiveness of the industrial and commercial sectors of a country's economy. The substitution of insurance for highly liquid contingency reserves reduces both the cost of risk for all firms and the risk-financing disadvantages of small firms. With insurance, firms have more security and may be willing to undertake more hazardous activities—including innovations in processes and products—than they otherwise might. And insurers' loss prevention services contribute to safety in production and products.

The spreading of risks internationally can help to stabilize a country's balance of payments. Claims paid in foreign currencies can be used to finance imports of materials and goods needed to reconstruct buildings and plant after a major disaster and, in the case of losses that give rise to liabilities overseas (for example, air crashes), to cover the costs of compensation payable in foreign currencies.[4]

The Size, Structure, and Competitiveness of Insurance Markets

The size of national insurance markets, measured by premium expenditure as a percentage of GDP, ranges from less than 1 percent in many developing countries to more than 8 percent in some leading industrial economies (see table 6–1). Whereas in 1987 the United States accounted for 45 percent of the world's total premiums, the total expenditure on insurance in most developing countries is far less than the premium incomes of the world's principal insurance groups. (In 1986 the worldwide total premium incomes of the largest U.S., Japanese, and European insurance company groups were, respectively, $19.4 billion, $20.6 billion, and $9.9 billion.)

Domestic insurance markets differ widely in their structures and competitive behavior. State-owned insurance monopolies exist in the centrally planned economies and in thirty-eight developing countries (Bickelhaupt and Bar-Niv 1983, p. 83; UNCTAD 1980). Many other developing countries, after gaining political independence, have excluded foreign and foreign-owned companies from their domestic markets or permit only locally incorporated subsidiaries with substantial local shareholdings.[5] By contrast, the insurance markets of most industrial countries contain substantial numbers of domestic and foreign companies.[6] In many countries, however, a relatively small number of insurers dominates the main classes of business. Although many insurance companies operate abroad, there are fewer than a dozen American and European companies that are capable of providing clients with comprehensive insur-

Table 6–1. ***Expenditures on Insurance, Selected Countries, 1987***

Economy or group	*Total premiums (millions of dollars)*	*Premiums per capita (dollars)* *Life*	*Nonlife*	*Total premiums as percentage of GDP*
United States	406,652	678.6	989.6	9.07
Japan	241,069	1,460.7	513.8	8.69
Germany, Fed. Rep. of	81,353	594.9	735.0	6.40
United Kingdom	63,820	705.8	416.0	8.35
France	50,000	381.7	517.1	5.06
Italy	19,741	74.4	269.9	2.35
Spain	10,856	107.5	172.1	3.31
EEC	258,612	371.0	427.8	5.80
Switzerland	16,005	1,357.3	1,089.9	8.02
Korea, Rep. of	11,142	218.8	46.0	8.85
India	3,281	2.6	1.6	1.29
Taiwan	3,241	116.0	48.8	3.33
Brazil	1,522	1.7	9.1	0.86
Malaysia	963	29.1	29.1	2.98
Mexico	901	3.6	7.5	1.02
Egypt, Arab Rep. of	660	2.3	10.7	1.05
Thailand	653	6.6	5.6	1.35
Indonesia	642	0.9	2.9	0.92
Singapore	583	103.8	119.5	2.78
Colombia	510	3.1	14.0	1.53
Tunisia	162	1.3	19.9	1.57

Note: Expenditure is measured by premiums paid domestically, converted into dollars at end-1987 rates of exchange. EEC premiums are estimated as a percentage of GDP.

Source: Swiss Reinsurance Company, Sigma, vol. 3/89 (1989).

ance service worldwide. Examples are the American International Group and GIGNA Corporation in the United States, Royal and General Accident in the United Kingdom, and Zurich in Switzerland.

The presence of a large number of insurers in a market does not guarantee competitive behavior; in many countries competition is constrained by market leadership, collusion, or supervisory legislation. A feature of competitive insurance markets is the need for cooperation among rivals in providing insurance for large risks. Although several insurers may compete for the role of leading underwriter on a coinsured risk, the support of sufficient following insurers must be obtained to fully insure the risk (Carter and Diacon 1988).

Brokers, in those domestic and international markets in which they operate, reinforce price and product competition among insurers by making use of their market knowledge to obtain the contracts that provide the best value for their clients. Also, to some extent the principal industrial buyers of insurance are able to exert a countervailing power, not least because risk retention (possibly through the formation of a captive insurance company) can be a close substitute for conventional insurance for part of their risks.

The Economic Aspects of Production and Market Competition

Like other financial services, the production of insurance services traditionally has relied mainly on a combination of financial, human, and intangible resources. Although information technology is increasingly being employed in product design, risk evaluation, marketing, and administration, experienced management and skilled personnel remain the key to a successful insurance enterprise (J. Shelp 1986).

An insurance company requires sufficient capital to comply with the minimum capital and solvency requirements specified by the supervisory authorities of the countries in which it operates and to compete effectively. The security of an insurer is judged by brokers and knowledgeable buyers on the strength of its capital base, which also determines the size of risk it can underwrite and its ability to provide continuity of cover for clients in periods of heavy losses. Since solvency margins are normally related to premium income, the larger is an insurer's capital base, the more business it can write. And, the larger and more diversified (in terms of classes of insurance and geographic spread) is an insurer's portfolio of business, the more stable its claims experience tends to be and the relatively less it needs costly reinsurance or capital.

Although there are considerable problems in defining output for a multiproduct industry, the available evidence indicates that total average cost curves are L-shaped and that significant economies of scale are exhausted at premium income levels that are low in relation to total domestic premiums even in most developing countries (Geehan 1986; Praetz 1985). Differences in distribution systems, however, can influence sales costs, and some economies of scope may be achieved by diversifying into other classes of insurance or, possibly, into other financial services.

Developments in information technology exert conflicting influences on capital requirements. The scale of investment in computer hardware and software required to compete in the newly developing network-based marketplaces may be beyond the financial means of small insurers. Such investment can, however, reduce the need for extensive branch networks.

The efficiency, security, and competitive ability of an insurance company vitally depend on the quality of its underwriting, claims, and investment management, combined with detailed knowledge about clients, products, and areas. Nowhere is this more true than in international markets, as evidenced by the disastrous experience of the Insurance Corporation of Ireland on the London market in the mid–1980s and the large losses in the international reinsurance business incurred during the late 1970s and early 1980s by the Instituto de Resseguros do Brasil and the Korean Reinsurance Corporation and attributed partly to lack of experience and insufficient information (see Hill 1986; Wasow 1986b; Park 1986).

Highly trained and experienced underwriters are required to evaluate insurance risks, and for large industrial and commercial risks the services of actuaries, surveyors, engineers, and other specialists are needed too. Not only do policyholders judge an insurer by the way it handles claims, but expert management of claims—the largest cost item—is vital to cost control. Finally, the investment returns achieved by an insurance company on its funds, and so the premiums it can charge, depend on the quality of its financial and investment management and on access to well-developed capital markets.

Given the need for detailed client and market knowledge and for servicing before and after sales, insurers require a local presence in each country in which they operate if they are to write a substantial volume of business.[7] Local representation is particularly important for personal and small commercial insurance in that buyers have strong local loyalties and lack the knowledge and resources available to corporate buyers for seeking out the best markets.

Market behavior and the strength of the competition for different classes of insurance are influenced by such factors as market structure, barriers to new entry, and the practice of fixing premiums before the ultimate claims costs can be known. The last-named practice induces either collusion between insurers, making premium tariffs (often supported by supervisory regulations) a common feature of insurance markets worldwide, or price instability. A period of high profits attracts new entrants, which leads to price cutting and a fall in profits, causing a reduction in supply and eventually an increase in premiums. The danger is that a period of inadequate premiums may bankrupt some insurers.

The benefits of competition can be seen in lower premium rates, in innovations in products and distribution, and in declines in insurers' X-inefficiency or supranormal profits. Insurers operating in competitive markets are more inclined to supply products designed to meet consumers' needs. Corporate buyers benefit from the introduction of new types of insurance and the adaptation of existing products to meet changing conditions: the introduction of partial insurance arrangements that enable firms to finance their smaller losses internally and thus reduce their overall risk costs is an example.

The Importance of Trade to Nonlife Insurance

Increasingly, technological progress and legal and social developments are creating risks in both industrial and developing countries that are beyond the underwriting capacity of national insurance industries. For example, population growth and urbanization are expanding the size of conurbations and thus creating the potential for large natural and man-made catastrophes, such as the Mexico City and Bhopal disasters. At the level of individual risk, insurance of such risks as aviation product liability, offshore oil rigs, oil refineries, and satellite launches involves sums insured of about $1 billion, which exceeds the annual premium incomes of many developing countries (see table 6–1). The only way that the insurance industry can satisfy such demands is to spread the risk internationally, and in many cases only the principal international insurers and reinsurers possess the experience and knowledge required to underwrite such risks and to deal with large claims.

Trade in insurance yields other economic benefits. The transfer of insurance production and product knowledge and the spur to competition within national markets that trade generates improve the international competitive position of firms in other industries for which insurance is an important input.

International Insurance Transactions

International trade in insurance takes place both through crossborder movements of insurance services and through the establishment by insurers of production and marketing outlets in foreign markets. Although the latter is not foreign trade in a conventional sense but direct investment, like other financial services, a local market presence is important to a direct insurer. Since the 1950s, however, foreign insurers have been forced by trade protection legislation to withdraw from many developing countries, as evidenced by the changes in market structures shown in table 6–2 (see also Carter and Dickinson 1989).

It is difficult to assess the size of international insurance trade in relation to total business because of the difficulties of classifying marine and other trade-related insurance and the sparsity of published data on insurance trading activities. Therefore it is only possible to make broad estimates of the proportion of total business that is traded.

Establishment Business

The market shares of foreign insurers established in domestic markets range from zero in countries that have nationalized their industries or totally expelled foreign insurers to majority shares in a few countries such as Saudi Arabia. It is estimated that, as a percentage of total worldwide expenditure on insurance, 9 percent of nonlife insurance premiums and 4 percent of life insurance premiums are written by foreign insurers through local establishments (Carter and Dickinson 1989).

Cross-Border Trade

Cross-border trade is virtually confined to nonlife insurance business, which, over the past thirty years, has increasingly taken the form of reinsurance. The proportion of nonlife premiums remitted abroad varies considerably, from about 2 percent of domestic nonlife premiums for the United States to 40 percent in some Arab insurance markets (Ali 1985, ch. 6); overall cross-border trade probably accounts for about 4 percent of total world nonlife premiums.

Reasons for Barriers to Trade in Insurance

Several arguments have been advanced by national governments, by lobbyists for domestic insurance industries, and by UNCTAD in favor of trade protection for insurance services. The vigor with which protection has been sought has tended to be related directly to the degree of comparative disadvantage that national industries suffer in competing internationally. Broadly, the reasons given can be grouped in three categories.

Consumer protection. In all countries, because of the aleatory and fiduciary nature of insurance, governments have legislated to exercise prudential control over insur-

Table 6–2. ***Changes in the Structure of Insurance Markets, by Region, 1968–85***

	1968			*1985*		
	Number of companies		*Percentage of*	*Number of companies*		*Percentage of*
	Domestic	*Foreign*	*foreign companies*	*Domestic*	*Foreign*	*foreign companies*
Europe	3,590	1,580	28.6	3,419	1,086	24.1
North America	4,967	360	6.8	5,791	302	5.0
Latin America	749	257	25.5	690	82	10.6
Africa	229	674	74.6	334	115	25.6
Asia	382	705	64.9	543	367	40.3
Australia	408	195	32.3	289	145	33.4

ance enterprises in the interest of insurance consumers and others. Supervision usually embraces the solvency of insurers, the suitability of owners and managers, reinsurance arrangements, and permitted investments, but in many countries it also extends to the rating and terms of insurance contracts, marketing practices, and various other aspects of insurers' activities. In some countries insurance intermediaries are also supervised.

Economic reasons, such as:

- Avoidance of destructive competition that might lead to excessive selling costs and the insolvency of some insurers
- Development of local insurance industries to promote local employment and the diversification of the economy. (Here the infant industry argument is frequently invoked to shield from international competition industries that have been established for more than a quarter-century.)
- Retention for local investment of funds generated by insurance operations
- Reduction of the impact of insurance and reinsurance imports on the balance of payments.

Sociopolitical reasons, including:

- Reduction of the country's dependence on foreign suppliers of a key financial service, the withdrawal of which, perhaps in time of war, could adversely affect other important economic activities (Skipper 1987)
- Cultural or religious considerations. For example, Western forms of insurance organization are not acceptable to some Muslims.

Skipper (1987) adds the status quo factor—that is, some governments may not be convinced that their economies will benefit from trade liberalization and therefore, in the absence of strong evidence to the contrary, may believe that logic dictates maintenance of all existing barriers to trade.

In both industrial and developing countries local insurance interests, including state-owned insurers, are often an important force lobbying for trade protection. The motive is usually rent seeking by established insurers. The exclusion of more efficient insurers from local markets protects indigenous companies from new competition and enables them to continue to enjoy the benefits of higher profits or X-inefficiency at the expense of insurance consumers. The size of the gains from trade protection enjoyed by local suppliers at the expense of consumers depends on whether the protection afforded is in the form of a quasi-tariff or a quota restriction on foreign suppliers; the latter produces the highest costs for consumers (see table 6–3).

Generally, countries place fewer restrictions on foreign reinsurers than on direct insurers. This can split the opposition of international insurers and reinsurers to trade protection: the exclusion of foreign direct insurers from a country's domestic market presents international reinsurers with opportunities for increasing their market participation. The opposition to protectionist measures by those insurance groups that supply both direct insurance and reinsurance will therefore tend to depend on the size and nature of their involvement in particular markets, on whether proposed new measures are designed to create barriers for all foreign suppliers or only for potential new entrants, and on whether the restrictions will apply to all foreign or foreign-owned suppliers or are to be applied selectively according to the nationality of the foreign supplier or the nature of its operations.

Forms of Trade Protection

All countries impose some market entry or operating restrictions on existing and potential suppliers on grounds of consumer protection. Whether such restrictions are protectionist from a trade policy standpoint depends on whether they discriminate unfairly against foreign as compared with indigenous suppliers. But granting "national treatment" to foreign insurers may still not allow them to exploit to the full their advantages, and local consumers are thus denied the full potential benefits of trade. For example, supervisory control of premium rates and policy terms may preclude a foreign insurer

Table 6–3. ***The Effect of Market Entry Regulation of Premium Rates on Insurance Prices***
(European currency units)

Type of insurance	*Belgium*	*Denmark*	*France*	*Italy*	*Luxembourg*	*Netherlands*	*Spain*	*United Kingdom*
Term	380	225	285	392	355	195	294	150
House	118	144	195	253	220	164	135	266
Motor vehicle	494	436	413	942	671	354	758	316
Commercial fire and theft	1,296	2,023	3,587	4,896	1,204	1,412	1,765	1,797
Public liability	968	1,257	1,852	1,508	934	714	1,364	798

Note: Some of the differences in premiums may be explained by variations among countries in the potential loss expectancies of the risks insured. For example, differences in the incidence and severity of vehicle accidents influence motor vehicle premiums, and variations in accident frequencies and in laws affect liability insurance premiums. Differences in the taxation of insurers and of insurance premiums may also have some effect. But such factors alone cannot account for the wide differences in premiums shown above. In the case of term life insurance, a study undertaken for the European Commission found that much of the variation between British premiums and those charged in the rest of the Community comes about because British insurers are free to determine their own premium rates, whereas insurers in most other European countries are required by detailed supervisory regulations to use conservative mortality statistics and low interest rates in the calculation of premium rates (Carter and Morgan 1986).

Source: Price Waterhouse (1988).

from exploiting its cost advantages, innovating in premium rating, or introducing new products.

The obstacles to trade may be divided broadly into two categories (Carter and Dickinson 1989):

- Paraquantitative measures that directly restrict foreign insurers in supplying insurance services through local establishments or across national borders or that prevent a country's residents from buying insurance from foreign or foreign-owned insurers
- Paratariff measures that indirectly reduce the foreign supply of insurance and reinsurance by making it either less advantageous for foreign insurers to supply their services or more difficult or costly for local residents to purchase them

Industrial, centrally planned, and developing economies all provide numerous examples of both categories of restrictive measures (for details, see Bickelhaupt and Bar–Niv 1983; Skipper 1987). In some cases it is the discretionary manner in which laws are administered that poses the greatest obstacles to foreign insurers.[8]

Restrictions on Establishment

Restrictions on the right of foreign insurers to establish in a country are arguably the most serious forms of restriction on insurance trade (OECD 1983). Direct restrictions, of which there are many examples in centrally planned and developing economies, include both the total nationalization of a country's insurance industry and other laws that totally exclude foreign or foreign-owned insurers from establishing in national markets. Indirect restrictions can be grouped under the following headings.

Measures that adversely affect the degree of control companies can exercise over their business, such as:

- Domestication policies that require foreign insurers to operate only through locally incorporated subsidiaries, particularly when a majority of the shares must be held by a government agency or by local residents
- Employment restrictions on the use of expatriate staff
- Reinsurance regulations that restrict the placing of reinsurance with or through the global reinsurance arrangements of parent companies.

Measures that increase capital or operating costs or reduce investment earnings. Examples are minimum capital solvency, deposit, and investment regulations more stringent than those that apply to domestically owned insurers and the enforced ceding of reinsurance to a state insurer, even though it is not necessary commercially and the terms are worse than those obtainable in the open market.

Measures that restrict access to markets, including:

- The reservation of certain classes of insurance to state-owned or other domestically owned insurers
- Government insurance procurement policies that require the government and other public agencies to place their insurance only with state-owned or other domestically owned insurers
- The exclusion of foreign insurers from the advantages available from membership of local market associations.

Discriminatory taxation of branch offices or subsidiaries.

Exchange control restrictions on the remittance of profits.

Restrictions on Cross-Border Trade

Many countries, including industrial nations such as France, Italy, and the United States, prohibit residents from placing any insurance abroad with nonadmitted insurers (that is, insurers not licensed to write insurance business within that country) or allow them to do so only if insurance cannot be purchased locally. Most countries require compulsory insurance to be purchased only from locally authorized insurers. In addition, more than twenty developing countries require imports, and in some cases exports, to be insured locally too, and some reserve to a state reinsurer the exclusive right to place reinsurance abroad. The same result may be achieved by exchange controls that prevent the remittance abroad of premiums.

The indirect obstacles to cross-border trade include:

Tax rules that penalize either local residents who insure or reinsure abroad or the foreign insurers or reinsurers that write that business, by:

- Imposing higher taxes on premiums than apply to locally placed insurance and reinsurance
- Imposing withholding taxes on the profits assumed to be earned on premiums for insurance or reinsurance placed abroad
- Restricting the tax deductibility by residents of premiums for insurance or reinsurance placed abroad
- Taxing claims payments received from abroad from nonadmitted insurers.

Measures that restrict access to markets for foreign nonadmitted insurers, such as:

- Restrictions on advertising by nonadmitted insurers or on assistance by local brokers in the placing or servicing of insurance with nonadmitted insurers
- Unenforceability in local courts of insurance contracts arranged by residents with nonadmitted insurers.

Exchange control regulations that unduly delay the remittance abroad of premiums (or of claims payments or insurers' technical reserves) or permit it only at penal rates of exchange.

Insurance supervisory regulations that penalize insurers who place their reinsurance abroad—for example, by not allowing them to take credit for liabilities transferred to foreign reinsurers when calculating their solvency margins.

Trade Liberalization

Since the 1950s most if not all developing countries have increasingly protected their domestic insurance markets against competition from foreign insurers and reinsurers. Recently there have been a few examples of relaxation of trade restrictions by developing countries,[9] but the most important moves toward freeing trade have occurred within the EC.

Since most countries impose few trade restrictions on reinsurance, insurers can generally gain access to both the expertise of the principal international reinsurers and the underwriting capacity required for the insurance of large risks. But international reinsurance transactions cannot provide for consumers and national economies all of the benefits obtainable from the opening up of domestic markets to competition from foreign direct insurers.

It is apparent that some countries are better endowed than others with the skilled human resources and the supporting financial and other services required for the efficient conduct of insurance services in general and business insurance in particular (Walter 1988; R. Shelp 1986). Over time the balance of those differences may shift, as is the case with manufacturing industries, but regardless of subsequent adjustments in trading patters, trade liberalization for insurance would increase global welfare.

Trade negotiators must, however, recognize from the outset that with a fiduciary business such as insurance, governments do have a legitimate interest in protecting consumers from incompetent or fraudulent foreign operators, even if the measures to achieve that objective lead to some loss of efficiency; the nature and detail of such protectionist measures and whether they should extend to large corporate buyers of insurance is, however, a subject of debate.[10] In addition, developing countries have a special interest in building up indigenous insurance industries to foster economic diversification and to reduce the balance of payments costs of insurance imports. They should, however, recognize the implications of such policies for the international competitiveness of other sectors of the economy, the possibility that scarce highly educated labor may be better employed elsewhere in the economy (Carter and Dickinson 1989; Wasow 1986a), and the consideration that a modest long-term balance of payments cost may be a reasonable price to pay for reducing the destabilizing effects of a catastrophe or a series of large losses.

The Problem of Establishment

Not only is the freedom of insurers to establish in territories where they wish to conduct their business important to insurers; the socioeconomic costs are also lower for host countries than those of cross-border trade (see table 6-4). Invariably, foreign insurers established in a country find it beneficial to employ and train local labor both because labor costs tend to be lower than for expatriates and because local employees have a better understanding of the social and cultural environment and more business contacts.

For multinational trade negotiations, however, establishment poses unique problems that the Uruguay Round must try to resolve. Although the negotiators recognize that effective access to markets for the supply of services sometimes requires a commercial presence, GATT rules do not cover foreign direct investment. How far governments, including those that have entirely nationalized their domestic insurance industries, may be prepared to go toward granting the right of establishment to foreign-controlled insurance subsidiaries can be only a matter of conjecture.

Policy Measures

Walter (1988) has advocated that the objective of trade liberalization in the financial services sector be built on the concepts of:

- Equality of competitive opportunity
- The right to establish and invest in a viable commercial presence
- National treatment
- Effective market access

The same principles, together with transparency, also hold for insurance.

Given the resistance of many developing countries to including services in the Uruguay Round and the demand that can be expected for special treatment under any negotiated GATT like services framework, a case can be made that the industrial countries should concentrate on negotiations within the OECD, including the updating of the Code on the Liberalization of Current Invisible Operations. If industrial countries take the lead in liberalizing insurance and other services trade among themselves, their arguments in favor of the long-term benefits of freer trade will be more credible to developing countries.

After many years of inaction, the OECD Insurance Committee was reactivated at the beginning of the 1980s, and in 1983 a joint Capital Markets and Invisibles Transactions and Insurance Committee published a detailed survey of trade restrictions on insurance (OECD 1983). The report stressed that attempts to reduce restrictions on establishment should be given first priority.

A Program for Liberalization

Governments accept that the movement toward trade liberalization for services will need to be progressive and to respect national policy objectives. That was the line taken by the EC when at the beginning of the 1960s it commenced its program of creating a single market for insurance. The difficulties that have been encountered in moving toward the achievement of that objective provide lessons for wider multinational trade negotiations—not least of which is that after thirty years the process is still not complete!

It was proposed to achieve the common market in two stages: first, *freedom of establishment* to give Community insurers the right to open branches in other member states subject to the same conditions as national insurers, and, second, *freedom of services* to permit unrestricted cross-border trade between Community insurers and residents. From the outset it was recognized that supervisory and contract laws governing insurance services would have to be approximated to the extent necessary for the proper functioning of a common market. Therefore the first stage of the program, in 1963, was to implement the two freedoms for reinsurance, which does not directly affect ultimate consumers.

A key issue in regard to freedom of establishment was the adoption of uniform Community rules on the authorization of insurance companies, including minimum capitalization, and on the solvency regulations that are monitored by the supervisory authority of the country in which the insurer's head office is located. If an international agreement could be obtained on both these matters, it would go a long way toward eliminating the concern of national regulatory authorities regarding consumer protection. But the creation of equality of opportunity would also require the acceptance of the principle of transparency in regard to market entry and operating conditions and the granting to foreign insurers of the right to import the human and other resources they deem essential for carrying on their business efficiently.

Differences in the views of European governments regarding consumer protection continue to delay progress toward full freedom of services. Therefore the Community has now adopted directives to bring about by 1990 cross-border trade in business insurance for "large risks" (defined by size of company), on the grounds that large buyers do not require the same degree of protection as other consumers. As noted, the denial of access to international insurance markets has serious adverse implications for the efficiency and competitiveness of firms engaged in the production of other goods and services and thus for the consumers of those products and for national economies. The removal of barriers to cross-border trade in business insurance, including trade-related insurance, should therefore be the second priority for multinational trade negotiations.

Finally, although the supply of insurance has some unique characteristics, it would be sensible for negotiations to take place in a framework of liberalization of all services. If negotiations proceed on a sectoral basis, there is a risk that they will become bogged down in technical detail.

Notes

1. For developing countries, see UNCTAD (1977). As for industrial countries, a study of the effects of two (hypothetical) hurricanes that in 1984 caused $14 billion in insured property losses in the United States concluded that 42.4 percent of the total losses would have been borne by non-U.S. insurers (All-Industry Research Advisory Council 1986).

2. Ratios of assets to premiums vary among countries for a number of reasons, but in countries with well-developed life insurance markets that transact business with a large savings element, asset values can be more than five times larger than their total premium incomes. See Engberg (1986).

3. In the United Kingdom pure insurance contracts account for less than 10 percent of total life insurance premiums.

4. UNCTAD (1977) has reported that "some developing countries, aware of their shortage of foreign exchange, allow insurance covers of such risks to be effected in foreign currency . . . making it possible, in the event of a loss, to secure foreign currency necessary to obtain the replacements or to effect the repairs of damages."

5. For a list of developing countries that have nationalized their insurance industries see UNCTAD (1980).

6. For details of the structure of the insurance industries of seventy-two countries with competitive markets, see Swiss Reinsurance Company (1985).

7. Although all of the business of Lloyd's of London is underwritten in London, the presence of Lloyd's agents throughout the world and the business acquisition and information services provided by Lloyd's brokers and their correspondents abroad reduce for Lloyd's underwriting syndicates the disadvantages of not being locally established in the countries from which they acquire their business.

8. For example, in Norway, where the insurance supervisory authority can decide whether there are any benefits to be gained from admitting new companies, no new license have been issued to foreign companies since 1927.

9. Korea and Taiwan have embarked on a program of limited entry of foreign insurers to their markets.

10. For discussions of the differing attitudes of European governments toward protection of policyholders, see Carter and Morgan (1986) and Finsinger, Hammond, and Tapp (1985). As noted in the text, the EC now distinguishes between the needs of corporate and personal buyers of insurance.

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7

Construction

James Lee

This chapter discusses the trends and issues important to trade in construction services, particularly as they relate to the Uruguay Round of multilateral trade negotiations. Five topics are addressed: the role of construction in national economies; trends in trade in construction services; the main issues in this trade and the impediments to it; the applicability to the sector of several key concepts of the General Agreement on Tariffs and Trade (GATT); and prospects for progressive liberalization. (For a more extensive discussion of all the above issues, see Lee and Walters 1989.)

Construction is defined as the application of technology to the building of structures (such as houses) and productive facilities (such as factories) by combinations of skilled and unskilled labor, encompassing both public and private activity. It includes both new projects and renovations and repairs of existing buildings. Services are an essential element in international construction. Materials sold for construction abroad without attendant services are simply merchandise exports, but the combination of services with materials allows firms to bid on and undertake large-scale construction projects. Thus, services are a necessary component of participation in the international construction market and a catalyst for significant exports of merchandise, especially capital goods.

The Role of Construction in the National Economy

Construction differs from other industries in several ways. The first is sheer size. Construction output is large in relation to that of other industries, accounting for roughly 10 percent of global gross national product (GNP) and perhaps an even greater share of employment. Construction made up somewhat more than 10 percent of industrial country economic output in the early postwar period and somewhat less than 10 percent in the 1970s and 1980s. Members of the Organisation for Economic Co-operation and Development (OECD) averaged between 7 and 8 percent in the 1970s, but this period may have represented a temporary, although extended, trough. Levels were higher in the 1960s, largely because of demand for single-family homes. In developing countries the current share of construction in the economy ranges from 3 percent in Burma, Nepal, and Uganda to 8 percent in Algeria, Libya, and Yugoslavia (World Bank 1984, pp. 3, 11). In industrial countries employment shares are roughly similar to output shares; in developing countries employment shares ordinarily exceed output shares owing to the relatively higher labor intensity of construction.

Second, public and private demands for construction services are sharply divergent. Construction is closely related to investment, and since investment is often tied to business cycles, private demand for construction services fluctuates more than in most other industries—the peaks are higher than average and the troughs are lower. Typically, these fluctuations are more pronounced in developing countries. By contrast, the role of government in construction tends to stabilize public demand. In some countries local and central governments account for as much as half of demand and "can affect directly or indirectly almost all of the remainder" (Hillebrandt 1985, p. 8).[1] International lending institutions also play an important role in demand markets, again for reasons of public policy. Hence, construction decisions reflect policy as well as market forces.

Third, the construction industry has a distinctive structure. It has extensive linkages throughout the national economy, since it is an important purchaser of a variety of materials (Hillebrandt 1985, pp. 10–12).[2] But the linkages bifurcate according to the type of service provided—design or implementation. Design, which involves the conception of a project, is usually carried out by architects and engineers. It entails conceptual assessments, feasibility studies, designs for facilities, and project plans that use detailed drawings and specifications. Implementation includes procuring financing and supplies, mobilizing labor and equipment, and managing projects and is carried out by unskilled laborers and skilled craftsmen in conjunction with architects and engineers. Technical assistance and training in plant operation may also be included in the implementation of a construction project.

Fourth, construction is essential to the development process, and trade in it often reflects long-term investment and growth patterns. Construction is said to provide the infrastructure needed for development, act as a vehicle for the transfer of technology to developing countries, assist capital formation, supply the basis for backward and forward economic linkages, and provide large amounts of direct and indirect employment (see Kirmani 1988, pp. 23–32). Given these critical roles, many believe that freer trade in construction services, which would enable these benefits to be more fully realized, would be of tremendous utility to importing countries.

Trends in International Trade in Construction Services

The international construction market has emerged relatively recently, for the most part since World War II. Before then, the difficulties of long-distance transport largely restricted the construction industry to domestic projects, and the former colonial dependencies were for the most part captive markets for the industrial colonizers. But by the 1960s and 1970s the situation had changed dramatically. Lower-cost transport, the telecommunications revolution, and more rapid economic development in developing countries contributed to the internationalization of the construction services industry. Newly industrialized countries also became more competitive in providing foreign construction services. After 1973 foreign-exchange-rich oil-exporters provided a large new market.

International construction has become vitally important to the health of many domestic construction industries and the firms that comprise them. In fact, "the single statistic that reveals the most about the state of the construction export market is the ratio of foreign contracts to total contracts" (*Engineering News Record* 1987). Owing to the recent slackness of foreign markets, the worldwide ratio of foreign to total construction contracts fell from 42 percent in 1984 to 32 percent in 1986. Yet a sampling of the world's 250 largest construction firms shows a wide variety of foreign market dependencies. In 1986 Yugoslav firms obtained more than 75 percent of their total new construction contracts from overseas sources. Swiss firms depended on foreign sources for 65.6 percent of their new contracts, and for Turkish firms the figure was 63.7 percent. By contrast, firms in France, Japan, and the United States—the three nations with the largest number of new construction contracts—ranked fairly low in foreign dependency; overseas sources accounted for 13.2, 28.9, and 36.6 percent of new contracts, respectively.

Firms in the international construction market share three characteristics: size, breadth, and integration. In spite of its economic importance, international construction constitutes a relatively small percentage of all construction. Many construction projects are small in scale—building single-family homes or local roads, for example—and construction firms are also usually small. Most projects, therefore, are not ordinarily prospective markets for foreign companies. But large-scale overseas projects—for example, building airports and petrochemical processing plants—are undertaken by large firms or even groups of large firms in the international construction market.[3]

The firms are characterized by breadth as well as by size. Foreign construction projects require broad sets of skills, and contractors who undertake them must possess a special set of abilities.[4] As Hillebrandt (1985, p. 7) observes, "The construction economist needs the assistance of the designer, contractor, quantity surveyor, statistician and accountant, who will know more about various aspects of the construction process than he."

Finally, because of the advantages of combining funding and resources in large-scale projects, joint ventures are now common.[5] Many projects require extensive and broad capabilities (in labor, material, and capital), and thus firms must out of necessity integrate functions to some extent, often through joint ventures.

Design

The supply of international design services is dominated by firms from industrial countries.[6] Billings by these firms, however, were relatively flat in the mid-1980s. The $4.0 billion total in 1987 represented a slight (3 percent) increase over 1983–87, largely owing to an upturn in 1987 after decreases in most of the intervening years. In 1988 the international market grew by another 3 percent. France, the United Kingdom, and the United States saw a slight deterioration in billings over 1983–88, Japan and the Netherlands experienced slight improvements, and Canada more than doubled its market share (see table 7–1).

The United States accounted for about one-quarter of total billings for foreign design services in 1988. Canada followed with 16 percent, and the United Kingdom, the Federal Republic of Germany, the Netherlands, and Japan all had shares of between 6 and 9 percent. France's share fell to a mere 3 percent. In sum, the top seven

Table 7-1. ***Share of International Design Billings, by Supplier Country, 1983-1987***
(millions of dollars; figures in parentheses are percentage shares)

Country	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
Canada	269 (7)	287 (8)	266 (7)	204 (6)	518 (13)	672 (16)
France	361 (9)	234 (7)	239 (7)	306 (9)	260 (6)	139 (3)
Germany, Fed. Rep.	253 (7)	249 (7)	230 (6)	282 (8)	356 (9)	302 (7)
Japan	127 (3)	166 (5)	226 (6)	221 (6)	259 (6)	257 (6)
Netherlands	203 (5)	228 (7)	219 (6)	259 (7)	358 (9)	425 (10)
United Kingdom	592 (15)	454 (13)	463 (13)	481 (14)	451 (11)	440 (11)
United States	1,204 (31)	1,307 (30)	1,165 (30)	918 (32)	1,042 (26)	1,039 (25)
Others	841 (22)	809 (23)	832 (23)	869 (25)	774 (19)	884 (21)
Total	3,850	3,464	3,640	3,540	4,017	4,158

Note: Shares may not sum to 100 percent owing to rounding.
Source: Engineering News Record (various issues).

suppliers were responsible for 79 percent of overall international design billings. Other suppliers, many of them developing countries, made up the remaining 21 percent. Asia accounted for about one-quarter of the demand market, followed by Africa and the Middle East.

Implementation

Industrial countries also dominate the construction market, although to a lesser extent than in the design market. In 1987, as in 1986, $73.9 billion in new construction implementation contracts was awarded to foreign firms. This total was slightly less than the $81.6 billion awarded in 1985 and far below that of any other year since 1980. In fact, the total in 1987 was 45 percent less than in 1981 (see table 7–2). In 1988 the international market rebounded significantly, increasing by 27 percent to its highest level since 1981.

The reasons for the drop in 1982–87 include the debt crisis in Latin America, the collapse of oil prices and the consequent fall in oil revenues, and the war between Iran and Iraq, which constrained building throughout the Middle East during the 1980s—directly through the diversion of funds from construction to the military sector and indirectly through reduced earnings from oil exports.[7] The Middle East was by far the largest international construction market in the 1970s, and the recent cessation of hostilities between Iran and Iraq may permit expanded construction activity in coming years in the two countries and in the region as a whole. At present, Asia is the largest demand market for construction implementation services, followed by the Middle East and Africa; each region has about 15 percent of the market. By 1987 Latin America has fallen to roughly a third of its 1980 level, from $15.8 billion to $5.2 billion in new contracts, or about 6 percent of the current market.

The United States continues to claim the largest share of foreign contracts for construction implementation services. In 1988 U.S. firms held 25 percent of the total market, nearly one-half the U.S. share of the 1980 market. Next largest were Italy (14 percent), Japan (12 percent), France (12 percent), and the United Kingdom (10 percent). Together, European suppliers accounted for nearly $41.6 billion in construction contracts, about 50 percent more than the U.S. total. The Republic of Korea, which in 1980–83 had boom years when it accounted for roughly 10 percent of the international market, saw its share drop to 1 percent in 1988. The decrease was largely the result of overreliance on the Middle East, which had 99 percent of Korean contracts.

Design and Implementation Compared

The design and implementation service industries can be compared in terms of their absolute sizes worldwide and the relative differences in country shares.

Table 7-2. *Value and Share of Foreign Construction Contracts, by Supplier Country, 1981-1988*
(billions of dollars; figures in parentheses are percentage shares)

Country	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
France	12.1	11.4	10.0	5.4	6.7	7.1	8.6	11.1
	(9)	(9)	(11)	(7)	(8)	(10)	(12)	(12)
Germany, Fed. Rep.	9.9	9.5	5.4	4.8	5.4	5.5	5.9	8.1
	(7)	(8)	(6)	(6)	(7)	(7)	(8)	(9)
Italy	9.3	7.8	7.2	7.8	8.7	7.4	9.2	13.3
	(7)	(6)	(8)	(10)	(11)	(10)	(12)	(14)
Japan	8.6	9.3	8.7	7.3	11.6	9.4	9.9	11.6
	(6)	(8)	(9)	(9)	(14)	(13)	(13)	(12)
Korea, Rep. of	13.9	13.8	10.4	6.8	4.8	2.6	2.1	1.4
	(10)	(11)	(11)	(8)	(6)	(4)	(3)	(1)
United Kingdom	8.7	7.5	6.4	5.7	5.6	7.0	7.9	9.4
	(6)	(6)	(7)	(7)	(7)	(9)	(11)	(10)
United States	48.8	44.9	29.4	30.1	28.2	22.6	18.1	25.9
	(45)	(36)	(31)	(37)	(35)	(31)	(24)	(28)
Others	26.5	18.9	16.1	13.1	10.6	12.3	12.3	13.3
	(17)	(15)	(16)	(16)	(13)	(17)	(17)	(14)
Total	134.4	123.1	93.6	81.0	81.6	73.9	73.9	94.1

Note: Shares may not sum to 100 percent owing to rounding.
Source: Engineering News Record (various issues).

The implementation market is much larger than the design market, by a factor of twenty. This observation is not intended to downplay the importance of design. Most design firms, as a matter of practice, call for specifications that require the use of products made by their country's manufacturing sector and used by its construction implementation firms. Thus in many cases design is a forerunner to implementation.

In Germany, the United Kingdom, and the United States the shares of the design and implementation submarkets are approximately equal. In France and Japan, however, the implementation share is more than twice the size of the design share. Canada has a negligible share of implementation but is the second largest provider of design services. Some of these differences are attributable to the size of the economy and some to the structure of the economy. History, too, has obviously played a large role (see appendix 7–A).

Issues and Impediments

Services disciplines may be relevant to four generic issues that are central to the treatment of construction services in Uruguay Round negotiations: third-market competition (subsidies), regulatory concordance, market access, and labor movement. Following the discussion of these issues, some common practices that impede trade are identified.

Third-Market Competition through Subsidization

Competition through the provision of subsidies is sometimes referred to as "offensive protectionism." Currently, the primary area for competition in construction services is in developing countries. As opportunities have declined in these countries, competition has become so fierce that many exporters subsidize national firms to enhance their competitiveness, thereby creating inefficient markets. Government-provided risk insurance, the underwriting of feasibility studies, and the use of mixed credits are all overt forms of subsidization. The OECD Gentlemen's Agreement (more formally known as the OECD Arrangement on Export Credits) attempts to reduce these subsidy distortions by establishing minimum credit levels (35 percent) and by setting borrowing guidelines to ensure that market rates are in general alignment with official credit export rates. In spite of these efforts, the agreement has not solved the subsidies problem. The threshold level only acts to enforce the use of subsidization as a practice, and subsidies below a certain amount are not covered by the agreement. Finally, the lack of a formal system for notification has diminished the ability to monitor subsidy practices.

Regulatory Concordance

Regulatory differences between national and local jurisdictions can constitute effective barriers to trade, particularly in construction services. In industrial countries, market protection for construction services industries exists at several political levels: explicit "buy-national" policies at the federal or central level and, at subnational levels, explicit or implicit local requirements that effectively preclude participation in construction projects even by nonlocal domestic firms. These practices affect both the public and the private sector. For example, many government projects require that the contractor be located within so many miles of the actual construction site. This effectively limits foreign competition.

The purpose of protection is often to support small national firms that cannot compete with large multinational firms. Although most firms that participate in international construction are large—reflecting the size of most overseas projects—small firms often have an advantage in their own locales, where local regulations may favor them. For small firms the extension of liberalization of construction services trade to the local level could increase both domestic competition with small and large firms and international competition with foreign firms. Because preferential contract practices are not uncommon at the state and local levels, many small firms feel they have much to lose from an agreement that would liberalize trade in construction services.

Market Access

Access to markets is limited by barriers to trade-related investment, including establishment. The right of establishment refers to a firm's ability to set up foreign subsidiaries in other countries. Although it is not inherently a trade issue, the right of establishment becomes one when governments restrict participation in certain markets to locally established companies. This frequently occurs in service sectors such as construction, where there is often a need to establish a presence as an adjunct to foreign operations.

Labor Movement

Finally, trade in construction services may require professional access to the foreign market for presenting proposals, inspecting sites and other local conditions, overseeing the proper implementation of projects, and the like. Is it reasonable to read into this observation a much broader right to the wholesale movement of construction crews across national borders to work on construction projects? Is the denial of access to construction crews an unreasonable impediment to trade in construction services? The answer in each case is probably no, at least in a practical sense.[8] Although the current GATT disciplines can be extended to cover traded services products, they do not now cover the movements of factors of production such as labor. This area is normally regulated by national immigration policies.

Nonetheless, the liberalization of labor movements would have profound effects on the construction services industry. There is already considerable movement of labor, as demonstrated by the significant remittances of workers, which largely flow from industrial and oil-exporting countries to developing countries. But in these instances the labor movements are those of individuals, and employment is often secured because of labor shortages. With or without a GATT-like agreement, the trend toward using low-cost labor from developing countries will no doubt continue. Coupling the management, skilled labor, and financial resources of industrial country firms with the low-wage labor of developing countries would be (and already is) a means of keeping overall project costs low.

Liberalization of labor movements would not only affect the potential for freer movement of workers between industrial and developing countries; it would also allow freer movements among developing countries in cases where there are considerable income differences. There are many mechanisms for preventing job displacement among developing countries that could be explored.

Impediments to Trade

Protection of construction service markets is prevalent in both developing and industrial countries. Many developing countries, for example, protect their construction markets by sheltering infant industries, requiring a certain amount of domestic content, and making use of tax and procurement discrimination, restrictive licensing agreements, and other impediments. Two reasons have been advanced to explain the low level of construction services trade among industrial countries. The first is outright protection. As Stallson (1985, p. 85) notes, "There has been little trade in construction services between the advanced countries because each has a highly developed local industry with an inside track in bidding on major national projects." The second is that geographic distance from domestic sites in industrial countries in itself puts foreign firms at a competitive disadvantage, particularly when their labor rates and technical expertise are roughly equal to those of domestic firms.

Numerous practices act as impediments to trade in construction services. In some countries engineers are required to pass accreditation examinations given in the local language and must demonstrate knowledge of the local culture. Some government procurement regulations automatically award contracts to local engineers except when the domestic market cannot provide the needed services. In other places the prime contractor system forces foreign firms to act as subcontractors on all major projects unless advanced technology requires a greater degree of foreign participation. Some construction service exporters are allowed a tax deduction of a certain percent of foreign exchange earnings against future losses. One country has over the years required that only indigenous firms perform engineering and design work on certain projects. Many countries have "buy-national" programs, and on occasion governments finance prebid surveys and provide insurance against cost inflation.

The following practices are generally recognized as the principal impediments that restrict or distort trade in construction services:

- Government procurement
- Subsidies
- Barriers to investment
- Domestic content requirements
- Discrimination
- Personnel qualifications

Options for Liberalization

This section discusses problematic areas for the liberalization of trade in construction services. Important topics covered here are the relevant GATT-like principles, trading concerns outside the disciplines of the GATT, and prospective winners and losers from liberalization.

GATT Principles

The principles of the GATT are intended to ensure foreign firms the right to sell their products in domestic markets under conditions of nondiscriminatory treatment. This objective should be the goal for trade in construction services. Six GATT-like principles that pertain to trade in goods are relevant to trade in construction services: transparency, market access, government procurement, progressive liberalization, increasing participation by developing countries, and national treatment.

TRANSPARENCY. Personnel qualifications and technical standards vary from country to country and are discussed in formal and informal forums. In some cases these standards are not administered transparently, placing foreign firms at a competitive disadvantage. Where the lack of transparency is intentionally discriminatory, measures should be taken to provide equal access for foreign and domestic entities. Expansion of the principles in the GATT Code on Technical Barriers to Trade provide some guidance in this regard. But complete transparency may be difficult, if not impossible, to achieve in the construction sector. Many, if not most, countries have no well-developed regulatory apparatus able to collect and assemble into a single compilation all construction-related codes and specifications (local, regional, and national). Thus, efforts to increase transparency might well concentrate on the provision of essential information.

MARKET ACCESS. For construction services, issues of market access for labor and capital are extremely important. With respect to labor two types of entry might be allowed: short term (temporary) and long term, oriented toward a permanent presence. Similarly, access to the market for the purpose of investment may also differentiate between a temporary and a permanent presence. Permanent entry might be licensed on a renewable basis and temporary entry on a project-specific or bid-specific basis.

GOVERNMENT PROCUREMENT. Because of the crucial role of government in the construction industry, procurement issues have a large impact on international competition. Although allowances naturally need to be made for national defense and national interests, large-scale liberalization of procurement practices could lead to substantial gains in efficiency. Realistically, government procurement is one of the most protected interests in a country, and the likelihood of broad liberalization seems remote. Nonetheless, progress can be made in reducing discriminatory treatment, opening some areas to competition, and lessening administrative burdens.

PROGRESSIVE LIBERALIZATION. Progressive liberalization will require an obligation not to impose new barriers and a commitment to reduce those barriers that do exist. To provide for liberalization, the negotiations need to create rules and procedures for formulating disciplines. They also need to establish exceptions that take into account national policy objectives (particularly development) and provisions for further negotiations beyond the Uruguay Round. Exceptions may also apply to certain types of transactions; thus, in some cases only subsectoral liberalization will occur.

INCREASED PARTICIPATION BY DEVELOPING COUNTRIES. Because of the one-way nature of current trade patterns in construction services, there is a need to increase participation by developing countries. This implies the development of local capabilities. Domestic construction firms in developing countries may require greater technical assistance and access to new technologies to become competitive. It is important to distinguish between subsidies used by industrial countries to secure contracts and assistance provided to aid construction capabilities in developing countries. Further, set-asides and buy-national policies may need to be established in a way that permits certain levels on a temporary basis. International organizations may also need to increase the level of domestic preferences in the projects they fund to promote development objectives in construction.

NATIONAL TREATMENT. National treatment applies to discrimination in the application of laws to foreign and domestic firms. This principle stipulates that laws and regulations must apply equally to the operations of both foreign and domestic firms and that firms must be able to establish a permanent presence in the host country. Application of national treatment could have wide-ranging effects; it could conceivably apply to tax, investment licensing, financial, and other national policy concerns related to construction.

Trading Concerns Outside the GATT Disciplines

Because of the unique nature of construction and the trade problems associated with it, liberalization will require progress in areas outside the jurisdiction of the GATT. A number of examples come to mind. Financing of large-scale construction projects may require some acknowledgment of World Bank funding activities. Agreements to decrease the use of subsidies could follow some of the guidelines set in the OECD Gentlemen's Agreement. Labor movement issues would no doubt still fall under the purview of government immigration policies. Likewise, the establishment of disciplines on the repatriation of profits from overseas construction projects may well follow precedents set by various treaties of friendship, commerce, and navigation and by memorandums of understanding between countries.

In other sectors there are established entities that deal with regulation of international trade. For example, specialized bodies exist for air transport (the International Civil Aviation Organization) and telecommunications (the International Telecommunications Union). It may well be that similar international bodies are needed in construction services, particularly for resolving problems of transparency and market access. One purpose of these bodies might be to act as centralized clearinghouses for gathering information on country regulations and developing specifications related to construction.

Winners and Losers from Liberalization

Comparative advantage in construction services, on the whole, will remain with the industrial countries because of their substantial resources in skills, technology, finance, and management. There are some activities in which developing countries do have a comparative advantage, but the industrial countries are better situated to take advantage of liberalization because their construction industries are already much more internationalized than those in developing countries. Although it appears that liberalization of trade in construction services would lead to significant efficiency gains and thus promote development in many countries, the goal of increasing supplier participation by developing countries will remain elusive unless steps are taken to improve their competitive positions. Progressive liberalization should, therefore, take into account the level of development of individual countries.

Improvement of capabilities would necessarily involve the strengthening of developing country capacity to undertake construction projects through the development of local expertise. The World Bank already gives a 7.5 percent bidding preference to domestic firms. (This policy did not, however, completely achieve its intended goal of increasing domestic firm participation; see Kirmani 1987, p. 23). Developing countries may require, in addition, more explicit programs for improving local expertise and more information on market possibilities. Improvement of developing countries' ability to penetrate markets will also hinge on their access to distribution channels and information networks—both essential aspects of modern construction practices. There may also be a need for safeguards and other exceptions in construction for both economic and balance of payments reasons.

There will clearly be winners and losers among developing countries as a result of liberalization. Some countries, such as Korea and India, are in a better position to participate in actual projects; countries that lack the requisite skills and resources will probably only be able to export labor. Those that have a more mobile and educated labor force will have an advantage over those that do not. Moreover, those developing countries that have established domestic industries will be more advantageously placed in the new competitive environment than those that do not. Trade in construction services among developing countries themselves must also be addressed. Policies that promote the displacement of construction industry workers in one developing country by workers from another developing country may not be viable. In the end, however, the Uruguay Round negotiations are a package agreement, and it is to be expected that certain countries will be more competitive in some sectors and less competitive in others. Hence some tradeoffs appear to be inevitable in weighing the overall balance of concessions. But, on the whole, the developing countries ought to pursue negotiations in construction services.

Appendix 7–A. Trade and Specialization in Construction Services

Specialization and international trade have always gone hand in hand, and the development of an international construction industry has, over time, produced specializations. The United States has traditionally specialized in oil and gas construction projects—not surprisingly, for the country that developed modern petroleum extraction practices in the nineteenth century. Dutch firms are increasingly associated with water-related projects, such as the Bahrain Causeway, that are largely based on similar projects in the Zuider Zee. Swiss firms specialize in projects that require difficult tunneling because of their own experience with similar challenges in the Alps.

Among the developing countries, despite the lack of large-scale market penetration, areas of specialization are emerging. Korea has had the most success in entering the international construction design market. It exports construction design services to other parts of Asia and, primarily, to the Middle East. Korean firms acquired various construction skills through association with U.S. firms, first in rebuilding their country after the Korean war and then as subcontractors to U.S. firms in the Middle East. Accumulation of these skills eventually enabled Koreans to work on the more sophisticated parts of projects and to subcontract unskilled work to developing countries, such as Pakistan, the Philippines, and Thailand, with even lower wage rates. Korean firms focused on the Middle East and were very successful in doing so, but the drop in oil revenues showed the dangers of overspecialization. Korea's world market share dropped from 11 percent in 1983 to only 1 percent in 1988.

Other developing countries are also making inroads into the international construction market. Brazil exports "disembodied" construction services (for example, specialized software applications) that are mostly related to oil and mining and go primarily to other developing countries in Latin America and Africa. India exports design services in the consulting and technical fields of troubleshooting, management, and licensing. Firms from Brazil, China, India, and Yugoslavia rank among the 250 largest construction firms in the world.

Notes

1. The World Bank (1984, p. 40) discusses the importance of the government "as policymaker at the macroeconomic level and as an originator of demand and executor of works at the microeconomic level."

2. The industry links up with other economic sectors in the demand for raw, semiprocessed, and processed materials and the supply of infrastructure and plant throughout an economy.

3. Given some type of international framework agreement on services trade, however, smaller firms and projects may play an increasing role in construction services. Price Waterhouse (1985, p. 1) notes that the U.S. industry is composed of more than 25,000 firms, of which only about 400 directly engage in international projects.

4. Hillebrandt (1985) observes that "size of contract is clearly the major determinant of the number of firms who can undertake work. A large contract requires more inputs than a small contract, and only some of the total number of contractors in a country have these inputs available to them. Capital is particularly important in this connection."

5. According to Price Waterhouse (1985, p. 2), "Twenty-four percent of all [U.S.] firms who export AEC [architectural, engineering, and construction] services participate in joint ventures." Stallson (1985, p. 91), notes that joint ventures in this industry have increased, partly because host governments require foreign firms to join forces with domestic contractors and try to break up contracts among a number of suppliers to avoid single-source dependencies.

6. There are really no reliable sources of data on trade in construction services. Here, construction design is reported on the basis of billings and construction implementation on the basis of new contracts. Contract awards include the value of goods as well as services. This follows the accounting procedures of the *Engineering News Record*.

7. Still another factor has come into play in the international construction market: more and more construction work is being undertaken by developing countries themselves as their expertise in construction increases. The turnkey project is becoming a thing of the past, in line with the growing sophistication of developing countries' domestic firms.

8. Hindley (1987) notes that "[the right to relocate labor temporarily] is widely rejected as politically infeasible."

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8

Air Transport

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This chapter reviews recent developments in the air transport and tourism markets with the aim of identifying how these developments may affect policies on trade in air transport services. It is argued here that traditional principles for guiding trade negotiations, such as those of the General Agreement on Tariffs and Trade (GATT), have considerable relevance for air transport issues and especially for the concerns of the smaller developing countries.

Characteristics of the Industry

Tables 8–1 and 8–2 summarize some features of the air transport industry. Scheduled traffic accounts for about 90 percent of total traffic and charter flights for the remainder. Passenger traffic accounts for nearly three-quarters of all scheduled air traffic. Since 1978 total traffic has grown at about 6 percent a year; freight traffic has grown slightly faster, at 7 percent a year.

A little more than half of total passenger traffic is international (see table 8–2). Scheduled airlines account for about 90 percent of passenger transport. International transport of freight by air is more important than domestic traffic; about 90 percent of freight traffic is carried by scheduled airlines.

Table 8–3 shows the regional distribution of traffic. The main shift has been the decline in importance of airlines based in the United States and Europe, which now account for about 73 percent of total scheduled traffic, and the rise of airlines based in Asia and the Pacific. This shift is even more marked when only international traffic is considered.

Subsequent sections discuss some of the factors that will influence the rate of growth of airlines in different parts of the world and the scope for exports of their services. An important limitation on export growth is the regulatory system, which is described next.

The Regulatory System

Air transport services between any two cities are controlled by an air services agreement (ASA) between the governments involved. The bilateral strategy was adopted in 1944 following failure to agree on a multilateral exchange of market access. There are now about 1,800 bilateral ASAs.

The agreements specify:

- Which airlines will fly on the route
- The capacity each airline will offer
- The amount of capacity that airlines from third countries will be permitted to offer on the route.

The airlines that operate on a route usually include one or more designated airlines from each country on the

Table 8–1. ***World Airline Traffic, by Type of Service, 1978–87***
(billions of metric tons–kilometers logged)

Service	*1978*	*1983*	*1986*	*1987*
Scheduled				
Passengers	84	107	131	143
Freight and mail	29	39	48	53
Nonscheduled	15	14	18	20
Total	129	160	197	216

Source: ICAO (1988).

Table 8–2. ***World Airline Traffic, by Type of Service, 1987***
(percent)

Service	*International*	*Domestic*	*Total*
Passengers[a]	48	53	100
Scheduled	39	52	91
Nonscheduled	9	1	10
Freight[b]	74	26	100
Scheduled	68	22	90
Nonscheduled	6	4	10

a. Percentages are calculated on the basis of passenger revenue kilometers logged. Figures may not sum to total because of rounding.
b. Percentages are calculated on the basis of freight metric tons-kilometers logged.
Source: ICAO (1988).

route, as well as airlines from third countries. Most of the capacity on the route is provided by the end-point carriers. A country's imports of air transport services are thus determined by quantitative controls, and these "import quotas" are allocated to specific foreign firms. The use of country-specific quotas for each "product" (in this case, each route) is similar to the provisions of the Multifibre Arrangements (MFA).

Fares on each route are ultimately subject to government control. Traditionally, target fares were negotiated by the airlines themselves and were then referred to the governments for approval. Increasingly, fares are set in the marketplace, and there is less government involvement. Now, once capacity is fixed, market forces set the levels of fares that will fill the seats. Previous attempts to set fares as well as capacity often required government action to counter market forces. The result was a high level of "discounting" and a huge enforcement problem. The increasing number of airlines in the marketplace and the increasing number of substitute routes (see below) have made control of capacity difficult and control of fares even more so.

Various formulas are used to fix capacity. Some depend on rules based on the traffic loads on a route. In other cases capacity is fixed rigidly in advance and then renegotiated at regular intervals, or capacity is reviewed after an interval at the request of the country that has experienced a decline in capacity share.

The designated airlines are required to have substantial local ownership and control. In many cases the majority owner is also the national government, and then the typical policy is to designate only that one airline as the international carrier.

Why Regulate?

An original motivation for the systems of agreements was to prevent any one country from exploiting the market power inherent in its control over landing rights. The argument is still frequently made that without agreements one side could regulate unilaterally, for profit or for strategic purposes. It is also argued that if airlines were allowed to operate freely, particular airlines, even without explicit government action, would come to dominate the market. At the time the regulatory system was set up, this concern was focused on U.S. airlines, as it still is.

A problem with the current system has been the slow pace at which new suppliers are admitted. New suppliers—unless they have large domestic markets or are important destinations—lack bargaining power and have to resort to diverting traffic from other routes to build up market share. This strategy has been applied successfully—by the ASEAN carriers, for example—but the nature of the regulatory system suggests that the market share of new competitive suppliers is less than it would be without the regulations.

Table 8–3. ***Share of Scheduled Passenger Traffic, by Home Region of Carrier, 1978 and 1987***
(percent)

Region	*1978*	*1987*
Europe	34	30
Africa	3	2
Middle East	3	3
Asia and Pacific	13	17
North America	42	43
Latin America and Caribbean	5	5

Note: Figures are for total domestic and international scheduled traffic, by home-base reigon of carrier.
Source: ICAO (1988).

Consumers lose from the regulatory system because of the barriers to trade that it creates. On the supply side, there are also losers, notably the rapidly developing countries. Data on airline costs suggest that a combination of low wages and high skill levels creates favorable conditions for a highly competitive airline. A number of the rapidly industrializing countries in Asia and the Pacific found themselves in this position and were able to compete in the market, contributing to a rise in their traffic share (table 8–3). As industrialization and growth continue, wage increases, for this industry, tend to offset the accumulation of skills, and competitiveness tends to decline. Countries in the rapidly industrializing stage of development, especially those with small domestic markets, are therefore shut out of the international market by the regulatory system, and they are the main losers. Thus, the shift in the structure of the market toward the Asia and Pacific carriers would have been even larger without regulation.

As noted above, there are similarities between some features of the MFA and the system for regulating international trade in air transport. Both systems are currently under pressure to reform. The next section surveys forces operating for reform of the air transport system.

Developments in the Market

Market developments that will have important implications for the evolution of the regulatory system include:

- The increasing density of traffic, especially in the Pacific, owing to the increase in travel and tourism
- The increasing number of competitive airlines
- The use of vertical integration in the tourist industry as a strategy for controlling and monitoring service quality (the same strategy is also relevant for the freight market)
- The increasing role of the computerized reservation system (CRS) as a strategic tool for airlines
- The development of new twin-engine and four-engine aircraft capable of long-distance flights
- The increased demand for point-to-point services and the wider options for supplying these services, which have increased the number of international gateways and substitute routes
- The trend toward privatization
- Recognition of the importance of networking and of access to mass markets, which has led to the integration of domestic and international services and the multiple designation of international airlines.

Market Density

Tourism arrivals in the Asia and Pacific region have grown at a fast rate, especially in the past decade. The rate of growth has been much higher than in the rest of the world, and the region's share of world tourism traffic is rising rapidly. In 1970 the Asia and Pacific region accounted for about 3 percent of total tourist arrivals; by 1985 this share had risen to 11 percent. It is generally expected that over the next decade tourism in the region will grow at rates 25 to 30 percent greater than the world average—for example, at 7 percent a year compared with forecast rates of just over 5 percent for world traffic. This suggests a strong positive relationship between economic growth and the demand for travel services.

Rapid growth in travel volumes means that routes are generally denser and can support more airlines. There are also more routes on offer. For example, flights to Europe from East Asia are now offered via Hong Kong, Korea, Japan, and all the countries of the Association of South East Asian Nations (ASEAN). This is a dramatic change from the 1940s, when traffic volumes tended to be thin.

Economic development is also likely to be associated with increasing density on the supply side. In the Pacific region, for example, economic development has produced waves of competitive newcomers that have challenged the position of established suppliers. In the late 1970s carriers based in the ASEAN countries gained access to routes to Europe by offering competitive stopovers. Northeast Asia also has competitive carriers—for example, Korean Airlines. The market is much more competitive than previously, both within a route and between substitute routes.

Vertical Integration

In its corporate organization, the tourism industry tends toward vertical linkages. A feature of travel demand is that travelers find themselves buying services in unfamiliar countries, perhaps incurring excessive search costs or paying excessive prices. The value of economizing on time in travel creates a role for the intermediary who can arrange an itinerary and deliver the services promised. Predictability of the type of service to be provided is also a selling point with consumers.

To ensure service quality, many tourism firms have sought ways to monitor and control more effectively the supply of complementary services by other enterprises. An extreme option is ownership of the other firm; other methods of forming vertical linkages involve holding only partial equity or none at all.

Vertical integration has been facilitated by technological changes on the supply side, including computerized booking systems and the connection of local systems with existing international systems.

The immediate advantage of integration is that if a system is accepted by a travel agency, flights of that system's owners will be presented first in response to a query. The development of local systems, which is well under way in the Asia and Pacific region, is also seen as a defense against reliance on the larger U.S. and European systems, which would disadvantage local carriers. The proliferation of systems and the apparent ease of communication among them suggests, however, that the significance of this particular advantage will decline over time. Indeed, it is in the travel agents' interest to be able to access as wide an information base as possible and not be restricted to any one system.

Perhaps the longer-term advantages of these systems will be that they can substitute for equity links in coordinating services and generating networking advantages. They are able to maintain carrier identity in the home country and avoid complications in negotiating capacity under the national ownership requirements of the ASAs. At the same time, they facilitate the creation of competitive systems of airlines. For example, when an agent requests a routing, a flight number will be given, but the service will actually be provided by a combination of carriers.

Another important technological change is in aircraft operating ranges. The development of twin-engine aircraft that can operate over long ranges has widened the scope for more point-to-point services and less hubbing on thin routes. This strategy has obvious advantages for serving particular tourist markets, and it can help to ease constraints on capacity in existing airports.

Privatization

In a rapidly growing market, the provision of air transport services is a critical link. Some forecasts suggest that traffic will grow faster than capacity and that as a result resort operators will integrate into airline operations to control access to services. The interest of both sides will contribute to a widening of shareholding in many airlines.

In addition, growth will require the purchase of extra capacity. As a result of technical changes that have cut fuel consumption and of lower fuel prices, the share of capital costs in total operating costs has risen rapidly since the 1970s. Airlines will be reviewing the financing of their acquisition of equipment.

Debt finance, which was favored by government-flag carriers, tends to place a large demand on earnings and to raise debt-to-equity ratios too high. Thus there are strong demands for extra capital injections by current owners or—that failing because of fiscal constraints on governments—a broadening of the capital sources. This matches the interest by other service suppliers in buying into the industry. These pressures from the marketplace and from within the government-owned companies indicate a rapid extension of the privatization moves that are already under way. In the Asia and Pacific region, airlines subject to privatization include Air New Zealand, Philippine Airlines, SIA (Singapore), and MAS (Malaysia); Cathay Pacific (Hong Kong) has already been floated off from its parent company.

Moves to change the ownership structures are proceeding much faster than moves to alter the regulatory environment. That sequencing is appropriate. In addition to assisting the airline to develop a structure suited to a more competitive environment, it removes an obstacle to regulatory reform. Previously, government ownership, fears that subsidization would lead to "unfair practices," and the perception in some countries that retaliation was required were significant complications in the development of an open trade regime for the industry.

Networking

Experience in the U.S. market illustrates the economies of establishing a large feeder network.

- Feeder traffic supports a higher level of traffic in any one local market, increasing a carrier's share of departures and attracting a higher share of local traffic. (A carrier with a relatively higher share of departures will have a more than proportionate share of the market.)
- By managing the timing of feeder flights, a carrier may be able to support flights that are off-peak in some local market and so achieve higher overall load factors.
- By combining traffic from different origins, airlines may be able to offset variability in demand in any one sector and increase the load factor.
- In a hub-and-spoke system, feeder routes can be combined at the hubs and consolidated onto larger aircraft with lower unit operating costs.

The economies of networking have generated several issues, including allocation of capacity on international routes and access to domestic points. In addition, Asian carriers have expressed concern about the bargaining power of European compared with Asian airlines. They fear that the United States and Europe will exchange domestic rights, permitting airlines in both countries to develop more efficient networks in Europe and the United States and to become stronger and more competitive in markets outside their own regions. Finally, the economics of networking have led to pressures for integration across market sectors, which in turn has created new opportunities for multiple designation of airlines.

The Emergence of the Megacarriers

Rapid growth in the travel market, the economies realized by the extension of networks, and the value of vertical linkages involving tourism firms and airlines are likely to lead to the creation of systems of firms in the air transport industry. Services, instead of being assembled by consumers, will be packaged by the consortiums, whose activities can be coordinated by means of the CRS.

The development of the consortiums may extend further, to the emergence of "global airlines" or "multinational corporations" in the airline industry. At present this step is restricted by ASA rules on national ownership, but the diminishing role of government ownership will broaden the scope for ownership links. These links may also be valuable because they facilitate monitoring the performance of other members of the group.

This development could diminish the importance of the issue of accommodating new suppliers—an issue of special interest to newly industrializing countries, which, as noted above, are likely to be highly competitive suppliers of air transport services. The reason is that a typical strategy of a multinational corporation will be to locate production in the most competitive locations, and this would naturally involve the new suppliers as their competitiveness increased. The alternative strategy, where ownership ties are restricted, is to use a series of subcontracting arrangements.

The appearance of megacarriers has implications for reform of the ASAs. The pace of reform will be determined by the attitudes of various groups that have an interest in aviation issues—primarily established suppliers, new suppliers, national policymakers, and the tourism sector. As a result of the developments outlined here, there may be an alignment of interests between new and established suppliers, especially in the Pacific, where traffic volume is growing rapidly. The established suppliers will have an incentive to encourage the entry of the new suppliers rather than to discourage it, as has been the case.

Established suppliers may not need to decrease their absolute size, and they could even grow; their share of flying operations, however, may fall. They would become the managers of the system, earning far higher proportions of their profit from commission sales than from production. This new role for the established suppliers would ease the structural adjustment pressures from the emerging new suppliers.

The new consortiums will find the old regulatory system increasingly burdensome. Regulations, by making the creation of ownership links more difficult, will pose a barrier to forming new networks or subcontracting services to low-cost members of the group. The divisions between market segments—domestic and international, for example—will be a source of frustration. The result could be a radical change in the way the system operates.

Policy Issues

Many of the original motivations for regulation are no longer relevant. Traffic is denser, and there are now more airlines in the market. There are more gateways and more routes that are close substitutes, at least in the eyes of consumers. The moves toward privatization are diminishing concern about unfair competition from subsidized airlines. In short, the market has become more competitive.

The interests of the tourist industry are being given more weight in many countries. A regulatory system that inhibits growth of capacity in the import-competing air transport industry is criticized by the tourist (or export) sector, which is a consumer of its services. There may be a perception at a national policy level that at least one locally owned and protected airline is needed to obtain some share of the benefits of a tourism boom. Usually, however, more efficient fiscal instruments are available for this purpose. Furthermore, this argument is uncomfortably close to the position that the original regulators of air transport were trying to avoid—the exploitation for national benefit of the market power provided by control over landing rights. But the effect of the emergence of the megacarriers on the competitiveness of the market is an important policy issue that will have to be considered.

Within the ASAs, countries can influence the competitiveness of their local markets by:

- Promoting fare discounting—if necessary, with the use of more flexible rules on fare setting
- Reviewing rules on fixing capacity—for example, moving to reviews of capacity after the event
- Leaving open the option of multiple designation of local airlines
- Permitting foreign entry into domestic markets
- Easing the rules on the extent of foreign ownership of designated international carriers.

Some countries are already unilaterally using these variations on the standard ASAs. Thus it is not necessary to establish a uniform market structure and rule of conduct under the bilateral system. The bigger problem will be to ensure that local carriers have an equal opportunity to pick up passengers in ASA partner countries and in other countries. Moreover, the issues involved in market access have been expanded. Previously, the main issues concerned capacity; now there is increasing concern about access to complementary services for both airlines and their passengers.

The market access dilemma occurs because efforts to increase the degree of competition for local passengers reduce the country's bargaining power in relation to access for its airlines in foreign markets. The country "surrenders" conditions relating to market access that might be used to bargain for similar conditions at the other end of every route. From the point of view of the local air transport industry, concessions have been made without obtaining sufficient aviation benefits in return.

GATT-like principles may be useful in managing this dilemma in that they can give a country an external standard against which to evaluate its access to foreign markets. The extent to which GATT-like principles are already embodied in the ASAs is reviewed in the next section.

GATT Principles

The GATT-like principles discussed here in relation to air transport services are nondiscrimination, most favored nation treatment, national treatment, transparency, and safeguards and provisions for settlement of disputes.

Nondiscrimination

Nondiscrimination is said to be a feature of ASAs, and indeed the agreements often contain explicit statements of nondiscrimination among foreign suppliers in access to complementary services, such as airport facilities. (Whether foreign suppliers are treated the same as nationals is a separate issue and is discussed below.) But nondiscrimination in negotiations about capacity is another matter. If a country used the same set of rules for fixing capacity in all its ASAs, the ASAs would not be discriminatory. In practice, however, the rules vary—for example, according to the acceptance of multiple designation or the use of different systems for setting capacity. In this respect, the ASAs are discriminatory.

Most Favored Nation Treatment

Even if the rules for negotiating market access were not discriminatory, the ASAs still would not satisfy the most favored nation condition, since the allocation of rights to supply capacity are specific to particular countries (and even firms) on any one route. In other words, if trips between two points are defined as the "product" for the purpose of these negotiations, there is discrimination among foreign suppliers of that product; some airlines from other countries can fly the route and others cannot. The exchange of traffic rights is not governed by most favored nation principles but by a "balance of benefits" on the route.

National Treatment

Under the ASA system the national treatment principle applies to such items as landing charges and air navigation fees—once access to the market has been obtained. Thus the principle is important for exporters who have gained access to the national air transport system infrastructure in an importing country. Although market access is a critical issue, principles on market access need to be supported by rules on national treatment because of the difficulty of avoiding the problem within the ASAs. An example is the rule that government officials must fly with a national airline. Other issues concern complementary services, including access to computerized reservations systems, access to ground handling services, landing and other fees, and access to landing slots.

The national treatment principle at present does not cover rights of establishment because there are generally limits on foreign investment in local airlines. An extension in this direction would facilitate market access. The principle also does not extend to access to points in the domestic market, where local carriers, although still often subject to restrictions, have an advantage over foreign airlines.

Transparency

Currently, all ASAs are registered with the industry organization, the International Civil Aviation Organization (ICAO). The published agreements contain the general rules on setting capacity and the like. But there are often side agreements that are not published and that provide details on rules used to set capacity and on other forms of cooperation, such as revenue pooling. The system would be truly transparent if all aspects of the agreements were published.

Safeguards and Settlement of Disputes

Issues about competition with low-wage countries usually arise in discussions concerning third-country carrier market access and diversion of traffic through offers of cheap stopovers or other discounts. Subsidy issues can be handled bilaterally within the ASAs—in the case of dumping, for example, by renegotiating capacity or the rules for capacity fixing. The ASAs specify consultation processes and include the right to terminate an agreement and negotiate a new one.

This bilateral system of disputes settlement has the disadvantage that disputes will be settled according to the bargaining power of the two parties. A "rules-oriented" system of settling disputes, such as the GATT tradition of using panels and third parties, ensures that general principles are adhered to in the resolution of any dispute.

Summary

The procedures and rules of the ASAs embody the principle of nondiscrimination only to a limited extent, and they do not meet the most favored nation condition. They do include national treatment provisions—although not with regard to investment and access points—but these provisions are difficult to enforce. The ASAs include some safeguard provisions and a means of settling disputes, but the procedure is subject to distortions through the effects of relative bargaining power. ASAs are visible, although not completely transparent.

There are several options for trying to extend the influence of the traditional GATT principles into the air transport system. Doing so, it was argued above, would help to resolve the national treatment issues, which are becoming relatively more important. Market access issues are also significant, but developments in the marketplace suggest that some of the problems relating to access by new suppliers will dissipate.

The issue, then, is how to incorporate GATT principles into the air transport negotiating system. A first step is to reassert the relevance of GATT principles to trade in services, including air transport, and in so doing to support any moves toward more liberal approaches that arise because of pressure from within the market. This could be done initially within a general agreement on services, although many countries may be unwilling to endorse a general agreement for all services, especially regarding services such as air transport for which negotiating institutions already exist. The value of the GATT approach is that it can complement those institutions in a way that resolves some dilemmas, particularly those relating to complementary services. In the long run this may require some more elaborate statement of how the principles apply to air transport.

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9

Maritime Transport

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It has become increasingly apparent that many previous conceptions and analyses of trade and commercial problems in developed and developing countries provide an inadequate treatment of the influence of transport costs. Although both theory and practical policy studies recognize that different types of barriers work against penetration of export markets, past analyses have largely concentrated on the influence of artificial (government-imposed) trade control measures such as tariffs and quotas. Transport costs may have been neglected because easily accessible data on their incidence was lacking or because it was presumed that freight costs were relatively unimportant as compared with tariffs. A series of empirical investigations undertaken in the late 1970s showed that this latter point was erroneous, as nominal freight rates facing many developing country exports were two to five times higher than post-Tokyo Round tariffs (see Yeats 1981 for a survey). Another reason for the relative lack of attention may have been the (again erroneous) assumption that transport costs pose a natural barrier and as such are not subject to policy control.

Considerable evidence has now accumulated showing that many of these preconceptions must be reevaluated. For example, empirical analyses of liner conference freight rates conclude that shipping charges are often administered prices that are unrelated to the underlying cost of carriage. As an illustration, Deakin (1974) found that

> Shipping conferences do not set prices with reference to social, or even private cost, at least not predominantly. Rather they fix their prices with regard to the strengths or weakness of demand for the carriage of particular types of goods, using the principle generally referred to as charging what the traffic will bear.

Similar conclusions have emerged from studies of liner conference pricing practices by Bryan (1974) and by Lipsey and Weiss (1974).

As far as the relative importance of freight costs is concerned, empirical studies have demonstrated that, contrary to the assumption often made, maritime transport charges frequently pose a more important obstacle to both developed and developing countries' trade than do most favored nation tariffs. Investigations by Yeats (1976, 1977a) for Indonesian and Indian exports to the United States are representative of these studies. They show that the average ad valorem transport cost for all products was approximately two to three times the pre-Tokyo Round tariff rates. Furthermore, some specific products, such as Indian nonferrous metal ores and Indonesian light consumer goods, had nominal freight rates of more than 50 percent. Brodsky and Sampson (1979) demonstrate that ad valorem transport costs for exports to the United States by ten Latin American countries were far more imposing barriers than were tariffs. Sampson and Yeats (1977, 1978) reach similar conclusions for Australia and the United Kingdom, while McFarland (1985) shows that the average freight factor for U.S. imports of crude materials averages more than 30 percent.

Several recent investigations have also shown that the structure of maritime freight rates can have important detrimental effects on the composition of trade, since ad valorem transport costs often rise with fabrication and work against the local processing of domestically produced raw materials.[1] Nominal transport costs for trade among developing countries reach levels exceeding 100 percent on some total aggregate trade flows (Prewo 1974). As a result, maritime freight costs are a significant constraint on increased South–South trade.[2]

Aside from the role of these studies in altering the traditional view of the influence of transport on trade, other factors have lent shipping problems great national importance. Because of their persistent balance of payments problems, many developing countries have long been concerned with the outflow of foreign exchange for invisibles. Chief among these transactions are payments for shipping, which have been estimated as absorbing

Table 9–1. *World Seaborne Trade, by Country Group, 1970 and 1987 (Estimated)*
(percent)

Country group [a]	Share of world trade, by country groups: Goods Loaded [b] Petroleum Crude	Products	Dry cargo	All goods	Goods Unloaded [b] Petroleum Crude	Products	Dry cargo	All goods	Share of world shipping tonnage by country group registration[c] GRT	DWT
Developed market economies										
1970	2.0	27.1	60.0	31.1	80.4	79.6	79.1	79.9	83.9	86.6
1987	16.4	27.5	65.3	45.5	72.1	82.3	62.3	67.9	65.8	68.1
Nonmarket Europe and Asia										
1970	3.4	8.0	8.1	6.1	1.7	1.1	5.8	3.5	8.9	6.6
1987	9.4	17.7	6.2	8.6	3.5	0.8	10.0	7.0	12.2	9.9
Developing economies										
1970	94.6	64.9	31.9	62.8	17.9	19.4	15.1	16.6	6.7	6.3
1987	74.2	54.8	28.5	45.9	24.4	16.9	27.7	25.1	20.9	20.9
Africa										
1970	22.5	2.3	9.1	15.2	1.7	4.7	3.6	2.9	0.4	0.3
1986	21.8	8.1	5.0	10.6	5.9	2.3	4.6	4.7	1.3	1.2
Latin America and the Caribbean										
1970	12.2	35.4	13.8	16.0	10.5	5.6	4.4	7.2	2.9	2.7
1986	11.7	12.2	13.8	13.0	5.5	4.1	4.4	4.7	4.1	3.9
Asia										
1970	56.9	27.0	8.1	31.3	5.5	8.5	6.7	6.4	3.4	3.3
1986	40.9	34.8	9.6	22.4	12.1	9.4	18.5	15.5	14.0	14.4
Europe and Oceania										
1970	n.a.	0.1	0.8	0.4	n.a.	0.6	0.4	0.2	n.a.	0.7
1986	n.a.	0.3	0.7	0.4	0.7	1.0	1.0	0.9	1.4	1.4

n.a. Not available.

Note: DWT, deadweight tons; GRT, gross registered tonnage.

a. For 1970, Developing market economies includes Yugoslavia; for 1987, Yugoslavia is under Developing economies, Europe and Oceania.

more than 20 percent of developing countries' export revenues. For example, Yeats (1981, table 1.2) tabulated the share of total export earnings that selected developing countries paid to foreign carriers for imports and exports in 1977 and found that these payments account for 25–35 percent of export revenues for such countries as Bangladesh, Benin, Cameroon, Haiti, Mauritania, Morocco, Niger, and Togo. For Burkina Faso, Chad, Jordan, Mali, and Somalia the payments were 33–60 percent of total export earnings. Government policies favoring national shipping lines are also important; Eyre (1987) estimates that the financial costs of these measures are more than ten times higher than any associated developing country gains (see table 9–2, below).

Industry Characteristics and Important Institutional Factors

An important element that influences the view of most developing (and some developed) countries concerning liberalization of maritime transport services lies in the general imbalance between those nations' participation in world trade and the volume of shipping tonnage actually under their ownership. Because developing countries own a small share of the world fleet, they normally have little direct influence on decisions concerning freight rates, which many studies have shown to be administered prices, or concerning the quality and types of transport services provided for their import and export trade. This can have an important impact on their ability to achieve national trade and development objectives. As an indication of the heavy reliance of developing countries on foreign-owned ocean transport, table 9–1 provides a breakdown of the origins and destination of world seaborne trade for selected years. Developing countries originated approximately 47 percent of all tonnage in 1987—slightly more than the developed market economy countries—yet the combined registration of their vessels was only about 21 percent of the world fleet. In Africa the differences are even more striking; these na-

Table 9–2. ***Estimated Initial Losses from Cargo Reservation Schemes in Selected Developing Countries***

Country	*Shipping balance of payment gains (millions of dollars)*	*Cargo carried by other lines (percent)* [a]	*Logistic payment losses (millions of dollars)* [b]	*Ratio of losses to gains*
Argentina	34	50	98	2.88
Brazil	50	55	371	7.42
Chile	5	69	85	17.00
Colombia	11	50	86	7.82
Ecuador	8	60	41	5.13
India	72	58	309	4.29
Indonesia	40	78	362	9.05
Korea, Rep. of	52	50	894	17.19
Malaysia	23	80	480	20.86
Mexico	7	75	502	71.71
Pakistan	17	85	186	10.94
Peru	10	60	57	5.70
Philippines	37	80	224	6.05
Spain	47	55	667	14.19
Turkey	28	75	257	9.18
Uruguay	12	85	61	5.08
Venezuela	10	70	221	22.10
Total	463	—	4901	10.58

— Not applicable.

Note: Shipping balance of payment gains assume that home–flag ships operate without any form of subsidy. Logistic payment losses are the extra earnings (rents) of non–national–flag ships attributable to the higher rates and poorer services associated with the cargo reservation scheme.

a. Percentage carried by other than the home flag, as reported by the U.S. Maritime Administration, *Maritime Subsidies*, February 1983, supplemented by data from Seatrade and Bremen Institute.

b. Dollar value of losses incurred by each country because of inflated freight costs associated with cargo reservation provisions. The figures include costs of various logistic operations (customs documents, bills of landing, export permits, and so on).

Source: Adapted from Eyre (1987). Useful information on the economic costs associated with United States cargo preference schemes can be found in U.S. General Accounting Office (1982, 1984).

tions account for about 11 percent of all goods loaded, yet their combined ownership (registration) of world shipping is less than one–tenth this figure. The increasing capital-intensiveness of several sectors of marine transport (particularly containerized shipping) has been an important factor working against participation by developing countries.

The differences in trade origins and fleet ownership reflected in table 9–1 combine with two other significant institutional factors in maritime transport to form the basis for many international disputes. The first factor is the longer-term overcapacity that has existed for many shipping services, especially in tanker operations. This problem will no doubt make attempts to liberalize the sector more difficult. The second factor is the institutional nature of the liner conference system. Although an unambiguous distinction cannot always be made, shipping economists have found it useful to group maritime transport services into three distinct markets, for liners, tramp shipping, and tankers or bulk carriers. Tramp, bulk carrier, and tanker services are generally contracted in more open markets. They have not been such points of contention among trading countries as have liner conferences, which often operate under oligopolistic regulations that have caused great friction between exporters and shipowners (see appendix 9–A). In addition, the dominance of market economy developed countries in the ownership of this tonnage suggests that efforts to liberalize trade in maritime transport services will meet the greatest difficulty on issues relating to liners.[3]

Stated simply, liners are ships that service a given route under a predetermined time schedule. The routes and timetable may be completely predetermined in that normally no flexibility is allowed except for time lost through accident or bad weather. When two or more liner companies service a particular trade route, the competition is invariably limited by agreements covering freight rates and other aspects of competitive behavior. These agreements are known as liner conferences. In practice, internal competition among conference members is often restricted by agreements covering pricing, the allocation of cargoes and sailings, revenue pools, or the offering of joint services. Some conferences also attempt to resist outside competition by offering deferred rebates or dual rate contracts—that is, agreements that give lower rates to shippers who pledge not to use other shipping services. In addition to these arrangements, many conferences admit new lines only on the vote of existing members.

Admission to some "closed" liner conferences may therefore be difficult or even impossible, although for some types of cargoes and consignments liners may come into open competition with tramps.[4]

Other factors have also heightened both developed and developing countries' concerns regarding the influence of shipping on their trade problems. An important source of friction in the past has been the perception that liner conference freight rates discriminate against specific ports, countries, or products. In part, such charges originate from the observation of large differences in rates facing similar products transported over alternative routes.[5] Among industrial countries the United States has been particularly sensitive to issues involving liner conference discrimination, and a number of congressional investigations have been held on the subject.[6] Developing countries have voiced related complaints and have argued that liner conferences are insensitive to their industrialization needs in that they do not offer "promotional" freight rates for new exports. Studies conducted by the United Nations Conference on Trade and Development (UNCTAD) concluded that such promotional freight rates can mean the difference between success or failure for new export ventures. The North–South geographic pattern of shipping routes also poses problems for some developing countries, as existing liner routes often tie developing countries directly to one or a few metropolitan states.[7] It has also been suggested that existing liner routes limit the commercial contacts of developing countries and reduce their bargaining power in pricing their exports and imports. (Appendix 9–A lists some of the main characteristics of liner conferences that have often been serious points of contention between shippers and liner conference operators.)

Policy Approaches to Maritime Transport Problems

The institutional arrangements associated with the operation of liner conferences have been criticized for adversely influencing the foreign commerce of both developed and developing countries. Many of these criticisms are generally regarded as being so important that they would have to be addressed in any code or convention that attempted to liberalize barriers to trade in maritime services. Stated simply, the key objective of a liberalization effort in maritime transport services should be to provide countries with the benefits of increased competition, which should also serve as a form of protection from the abuses listed here.

- Discrimination—the charge that conference liners deliberately favor their own countries' exports and that shipping conferences discriminate against given ports or routes, against incoming as opposed to outgoing trade, against specific types of products, or against small versus large shippers.[8]
- Ad valorem freight rates that appear to escalate with the level of product processing, thereby deterring exports of processed commodities.
- Failure to offer promotional freight rates to help new products get established. Such rates could mean the success or failure of new export ventures.
- De facto discouragement by the existing (North–South) pattern of liner conference routes of trade among developing countries—trade that could have substantial beneficial effects.
- Liner conference admission policies that preclude entry of vessels of an exporting developing country. Problems associated with the restrictive membership regulations are augmented by the failure to provide adequate data on profitability, cost of carriage for actual products, and other operating practices (see appendix 9–A).

To resolve these and related problems, many countries have adopted an approach that involves measures for stimulating the growth of national fleets. UNCTAD has tabulated some of the reasons that developed and developing countries have advanced for promoting their own fleets.

- To prevent disruption of service during hostilities. A country dependent on foreign shipping faces the risk that its trade may be disrupted during wartime. Even a nonbelligerent country, like Argentina in World War II, may experience severe disruption in trade owing to changes in the supply of shipping capacity.
- To reduce economic dependence. A country that has no national fleet must rely on foreign shipowners. Commercial profitability is normally the primary consideration for individual shipowners, and, should a given country's trade not provide sufficient profits, transport services might be withdrawn or might be provided in old or unsuitable vessels or only at high prices.
- To influence conference decisions. A country that has its own merchant fleet can claim the right to participate in liner conferences that affect its trade and is thus in a position to influence conference decisions concerning freight rates and maritime transport policy.
- To foster economic integration. In countries with a long coastline or with inadequate internal transport and communications, national shipping may be the only effective link between regions.
- To promote exports. Some developing countries have used national-flag ships to promote trade in new

products or with new partners. Their experience, according to UNCTAD, shows that national lines take a more sympathetic view toward promotional freight rates, which can be of key importance in these ventures.

- To diversify employment. Domestic construction of national fleets may have important linkage effects on employment and secondary production.

One approach for achieving the above objectives and resolving grievances involving maritime transport was the adoption in 1974 of a United Nations Code of Conduct for Liner Conferences (see appendix 9–B for a list of signatories). The code was intended to deal with numerous aspects of liner conferences, but its most notable provision is article 2(4), which concerns sharing conference trade among member lines.[9] There are two basic elements: (a) in liner trade between any two states, the national shipping lines of those states shall have "equal right to participate in the freight and volume of traffic generated by their mutual trade" and (b) third-party lines shall have "the right to acquire a significant part, such as 20 percent, in the freight and volume" of that same traffic.[10] The 20 percent figure is not a fixed absolute; it is merely given as an example of what a "significant part" of the trade might be.

To most efficiency-oriented economists, the code's cargo reservation provisions are subject to serious misgivings, since they represent a classic beggar-thy-neighbor device. Eyre (1987) shows that, to the extent that these provisions make shipping more costly, they can lead to substantial balance of payments losses for countries adopting such schemes while Bennathan (1989) shows they have increased freight rates for Chile's importers and exporters. The basic problem here is that in trying to achieve the national objectives listed above, the code set limits to new competition that led to relatively higher freight rates and the transfer of monopoly rents to some of the more efficient members of the code's cargo reservation provisions. Eyre has argued that the code has brought about substantially higher freight rates on many African–European trade routes. The higher rates were needed to keep less-efficient domestic lines operating, but they led to important monopoly gains (rents) for European-owned vessels. Table 9–2 summarizes recent projections of the direct balance of payments losses for seventeen countries that have formal cargo reservation schemes. Total losses from the cargo reservation schemes are more than ten times the accompanying gains. These figures are based on Eyre's (1987) estimate that, on average, freight costs of carriers involved in the reservation schemes are 20 percent higher than those of other "efficient" liners. It should be noted that these "inflated" freight rates (the result of the reservation schemes) also have additional adverse effects on trade, employment, and the balance of payments to the extent that they have linkage effects outside the export sector.

There appears to be a growing concern among economists that cargo reservation schemes are a costly and ineffective way of obtaining some of the desired objectives of the code. For example, Wijkman (1979) notes:

> There is little doubt that the cargo reservation formula outlined in the code is an inappropriate instrument to attain the assumed goals of the Liner Conference Code of Conduct. If its aim is primarily promotional, i.e., to develop merchant marines in developing countries, then direct subsidies to liner companies by governments with maritime ambitions are more efficient. If the aim is primarily regulatory, i.e. to eliminate monopoly profits in international liner shipping, then rate regulation is more efficient and equally feasible. If the aim is to provide a more equitable distribution of income in general or a fairer distribution of tax revenue and rents from an international common property resource, then appropriately designed vessel-licensing systems are more efficient. Finally, if the aim is to improve the balance of payments of developing countries, protective measures to promote a domestic merchant marine are appropriate only in exceptional cases.

Neff (1980) also argues that the cargo subsidy approach is far preferable as a means of encouraging national fleets, since it brings the cost of such operation out into the open and need not have detrimental effects on the overall level of trade.

Negotiations on Maritime Transport: The Basic Objectives

Efforts to liberalize international trade in maritime services should recognize several key points relating to this objective. First, the substantial overcapacity and longer-term structural adjustment problems facing providers of marine transport services will undoubtedly heighten the difficulties encountered in liberalization efforts. Second, distinctions must be made between different types of marine transport services when planning future action. Specifically, markets for bulk carriers and tankers operate under relatively competitive conditions, whereas liner conference services and coastal shipping operations are often highly restricted by government and private measures. These latter operations will undoubtedly be the focus of marine transport liberalization efforts in the multilateral negotiations.

The third, and perhaps key, point is that any negotiations on marine transport services will have to strike a balance between two different and potentially competing objectives. First, they must attempt to remove existing obstacles to trade in this service sector so that countries can achieve the benefits of increased competition. Such an objective may often conflict with cargo reservation schemes (which can be a costly and inefficient means of pursuing national maritime objectives), as well as with diverse national regulations that apply to coastal trade. The negotiations must also recognize that there are often important conflicts between existing institutional arrangements in marine transport (particularly liner conferences) and the trade and industrialization objectives of many developed and developing countries. Progress in the marine transport sector will require an approach that accommodates these diverse concerns.

Given these broad considerations, an important question concerns the specific goals that should be pursued in the Uruguay Round negotiations. White (1988, pp. 92–99) suggests five objectives to be given priority.

The first concerns regulations dealing with *rights of establishment.* Here there is a need to establish principles for the foreign ownership of domestic business offices, dockside facilities, and related equipment that a foreign carrier may need to conduct local business or offer specialized services. Issues concerning the right of establishment may be of great importance if a foreign carrier intends to extend its operations beyond the main international port of entry to further transport of goods in coastal trade. If international carriers are denied local facilities for cabotage to smaller (coastal) ports, they could be placed at a significant competitive disadvantage on all operations with respect to national carriers.

A second important issue concerns *competition and dealings with state monopolies.* In some developing countries, domestic exporters may be formally or informally required to utilize state-owned shipping companies for maritime transport services. The Uruguay Round negotiations should address this problem, since such restrictions can place foreign carriers at an important competitive disadvantage.

A related issue is the concept of *national treatment.* Article 3 of the General Agreement on Tariffs and Trade (GATT) requires that imported goods receive treatment that is equivalent to domestically produced merchandise after barriers at the border have been cleared.[11] Subsidies available only to national carriers, cargo preferences, bilateral agreements, and cargo reservation provisions are clearly at odds with the GATT concept of national treatment, at least as it has been applied to goods.

Issues relating to *standards* have been of major importance for international trade in such goods as some foodstuffs, transport equipment, and machinery, and standards should also be addressed in the negotiations on maritime transport services. These issues may become significant in the Uruguay Round negotiations in the context of container sizes, complementary transport equipment such as roll-on roll-off vehicles, port equipment, and safety, wage, and related personnel requirements. A potentially useful approach to resolving such issues is to attempt to extend the GATT Standards Code for goods to maritime transport and other services.[12]

Finally, the problem of *transparency* may become particularly important in cases in which tax subsidies or other financial measures directly or indirectly assist national carriers or in which informal procedures favor the use of these operators. As in the case of standards, the attempt to achieve increased transparency in maritime transport and other services can draw on extensive parallel GATT efforts regarding trade in goods.

Notes

1. Jansson and Shneerson (1978) estimated the long-run marginal cost (LRMC) of shipping various types of commodities and compared these figures with actual liner conference rates. The results showed a consistent tendency for LRMCs to lie above actual freight rates for primary and semiprocessed products, while the opposite effect was observed for consumption and investment goods. This led the authors to conclude:

> The principle of charging according to the value of service that is applied by conferences implies that high value commodities subsidize low value commodities. Excess freight factors escalate in a manner similar to tariffs. In comparison to a marginal cost-based system of charges, *shipping rates tend to encourage trade in raw materials and to discourage trade in processed commodities* [emphasis added].

In a related empirical analysis Yeats (1977b) also observed a tendency for ad valorem freight costs to escalate over many commodity processing chains.

2. There is an important interaction effect associated with the common practice of assessing tariffs on a cost-insurance-freight basis (c.i.f.) that compounds the difficulty some geographically disadvantaged countries have in overcoming adverse competitive effects stemming from their higher freight rates. Specifically, a c.i.f. tariff valuation base yields a higher duty collected on a country's exports if these items experience an unfavorable transport cost differential in respect to similar products exported from other nations. Yeats (1981, p. 144) shows that adverse freight rates may produce adverse tariff differentials of 5 to 10 points. This analysis suggested that developing countries would generally benefit from a shift to a free on board (f.o.b.) tariff valuation system such as that employed by Australia, Canada, and the United States, as opposed to the c.i.f. system used in the EC and Japan.

3. Concerning this point, an important distinction must be made between international shipping on the one hand and coastal shipping or cabotage on the other. In many countries coastal shipping is heavily restricted by national regulations that extend beyond products transported by tramp, tanker, or bulk carriers. Efforts to liberalize national regulations governing coastal shipping will no doubt encounter significant difficulties.

4. The primary difference between liners and tramp ships is that liners service regular shipments over a fixed route, while tramps do not have fixed routes but carry dry bulk cargo over long distances. One utilizes a tramp service by hiring a whole ship, whereas individual shippers may transport only a small portion of a liner's cargo capacity. There are some construction differences; liners are usually able to generate higher speeds, and their holds are often compartmentalized. Within the liner group a distinction is often made between "break bulk" and container ships. A break bulk ship is designed to carry a heterogeneous cargo, each consignment being separately packed with no uniform pattern. In contrast, container ships utilize standard unitized packing devices that allow much of the loading to be done in the absence of the mother ship itself. Significant differences exist between liners and tramps, on the one hand, and tankers and bulk carriers, on the other. The latter are highly specialized ships designed to carry a limited range of cargo such as ores or petroleum.

5. As a general proposition, discrimination in maritime freight rates or services may be held to exist when the charge for a particular product contributes more (or less) to the costs and profits required to provide for its shipment than can be explained by some objective method of allocating costs and profits. A detailed study by Fashbender and Wagner (1973) has demonstrated the difficulty of documenting actual cases of discrimination. These authors provide numerous examples that show how large differences in freight rates for similar products transported over different liner routes of roughly similar distances can often be accounted for by such factors as port operations, differences in volumes shipped (if economies of scale are important), or the types of vessels and cargo-carrying systems actually employed. See also UNCTAD (1969, pp. 308–22), which reached similar conclusions.

6. For example, the Joint Economic Committee of the U.S. Congress concluded (1965, p. 1):

> The international ocean freight rate structure is weighted against United States exports. Our exports bear most of the costs of vessel operation, even in trades where imports approximate exports in value and quantity.

In its finding no. 3 the committee also noted that a group of liner companies acting in concert can discriminate against nations by their operations and by the structure of the charges they adopt.

> Most ocean freight rates are set by steamship conferences whose basic purpose is to set freight rates and sailing schedules. But some go beyond price fixing and include pooling arrangements whereby each member is guaranteed a share of cargo or revenues. United States flag lines are outnumbered in all but 7 of the more than 100 active conferences involved in United States foreign trade. In substance foreign lines, some of which are government owned, determine freight rates, sailing schedules, and other conditions vital to the expansion of American commerce.

The monopoly power of the conferences seems to have weakened considerably on North–North trade routes since the committee made its report, but it is still a significant factor in many developing countries' trade. Useful comprehensive statistics on long-term trends in the U.S. oceangoing fleet can be found in U.S. Department of Transportation (various years).

7. Dell (1966) provides useful examples of how institutional factors, such as the geographic pattern of liner routes, works against some developing country intratrade:

> The high cost of transport between Latin American ports has seriously impeded the development of area trade: in many cases it is cheaper to ship goods from Europe or North America than between points within the region. For example, the freight rate for lumber shipped from Mexico to Venezuela was $24 per ton as compared to $11 per ton from Finland to Venezuela, even though the distance is three times greater. From Buenos Aires to Tampico, Mexico the ocean freight rate for chemicals was $54 per ton for direct shipment; but if the goods were transshipped in New Orleans the rate was only $46, while transshipment in Southampton, England, brought down the rate further to $40, despite the tremendous increases in distances involved. Nor is it simply a question of high costs. Goods shipped from Porto Alegre in Brazil to Montevideo actually reach their destination more quickly if sent via Hamburg [Federal Republic of Germany]. In fact Uruguayan wool is shipped to the United States by way of Hamburg even when there are ships available going directly to New York.

8. The difficulties associated with establishing empirical proof of these charges is demonstrated in Fashbender and Wagner (1973). Other studies that have tabulated lists of complaints by developing countries against liner conferences include Richards (1968), UNCTAD (1969), and Valente (1971).

9. For countries participating in the formulation of the UNCTAD Code, there appeared to be general agreement concerning the issues to be addressed. These are (a) abolition of the power of conferences to decide on the admission of new lines; (b) allocation of cargoes within conferences on an internationally agreed basis rather than by private arrangements (the traditional way); (c) transparency of the levels of conference freight rates and the processes of conference decisionmaking; (d) restriction of the power of making unilateral decisions on matters vitally affecting the trade and economic prospects of countries; and (e) establishment of an independent tribunal to which parties with complaints about the operation of the liner system could have recourse. No doubt these concerns will have to be addressed in any new (GATT-related) efforts to liberalize trade in maritime services.

10. The distinction between a national shipping line and a national-flag line should be noted. A national shipping line is defined in the code as "a vessel-operating carrier which has its head office of management and its effective control in that country and is recognized as such by that country." That is, there must be a genuine link between the carrier and the states. Vessels registered under flags of convenience do not qualify as national shipping lines. This requirement places a natural limit on the extent to which developing states will be able immediately to increase their share of world liner traffic at the expense of developed countries. National shipping lines may, however, make use of chartered tonnage.

Article 3, para. 4 states: "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favorable than that accorded to like products of national origin in respect of all laws, regulations, and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution, or use."

12. See Stern and others (1986) for an assessment of the various codes for goods trade that were negotiated in the Tokyo Round. It appears that many of the principles and procedures contained in these codes could be extended to trade in services.

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Appendix 9–A. ***The Basic Features of Most Self-Regulated Liner Conferences***

Feature	*Comment*
Relations between member lines	
Membership	Closed, with confidential criteria for the admission, withdrawal, or expulsion of members.
Share of trade	The basis for allocation of cargo shares is usually confidential.
Pooling	Confidential cargo or revenue pooling agreements cover the share of cargo or revenue due to each member line; sometimes there is provision to ensure the carriage of low rated cargo.
Sanctions	Agreements often provide for sanctions against breaches of the agreement by member lines.
Self-policing	Self-policing machinery normally exists to ensure compliance with conference agreements.
Publication of conference agreements	The conference agreement governing operations is generally a confidential document.
Relations with shippers	
Loyalty arrangements	Loyalty arrangements comprising fidelity clauses with shippers (dual rate systems, contract systems, or deferred rebate systems) are generally employed.
Dispensation	There are generally no arrangements for giving loyal shippers reasonably prompt dispensation to use nonconference vessels.
Publication of tariffs and related regulations	No provision for publication is usually made. U.S. Maritime Law regulations provides an important exception on U.S. trade.
Consultation machinery	There is general concentration of authority at conference headquarters.
Representation	There is generally no representation of merchant interests concerning the setting of rates and other conference operations.
Freight rates	
General freight rate increases	Freight rates are imposed unilaterally; the basis for freight rate charges is usually confidential. There are usually no specific provisions for determining freight rates and usually no procedures for prior consultation. The time of notice is not generally specified.
Specific freight rates	There are procedures for determining freight rates on new cargo items and handling requests from shippers for reductions of specific freight rates but no procedures for consultation on increases of specific freight rates.
Promotional freight rates	There are usually no specific provisions for determining promotional freight rates.
Surcharges	Surcharges are generally imposed without prior notice and often without specific justification.
Currencies and exchange rates	Procedures for consultation existing in the United States and Western Europe in connection with floating exchange rates do not seem to operate effectively, and consultation procedures with developing countries are virtually nonexistent.
Other matters	
Outside competition	There are devices to prevent or eliminate outside competition.
Averaging of freight rates	There is generally provision for the averaging of freight rates over port ranges.
Quality of service	There is generally no provision for the type or other characteristics of the shipping to be used.
Adequacy of service	The responsibility for providing adequate service usually rests with individual lines.

Source: Tabulated by Yeats (1981) from UNCTAD documents.

Appendix 9–B. ***Contracting Parties to the Convention on a Code for Liner Conferences, as of 31 May 1988***

Algeria
Bangladesh
Barbados
Belgium
Benin
Bulgaria
Cameroon
Cape Verde
Central African Republic
Chile
China
Congo
Costa Rica
Côte d'Ivoire
Cuba
Czechoslovakia
Denmark (except Greenland and the Faore Islands)
Egypt
Ethiopia
Finland
France
Gabon
Gambia
German Democratic Republic
Germany, Federal Republic of
Ghana
Guatemala
Guinea
Guyana
Honduras
India
Indonesia
Iraq
Jamaica
Jordan
Kenya
Kuwait
Lebanon
Madagascar
Malaysia
Mali
Mauritania
Mauritius
Mexico
Morocco
Netherlands (for the Kingdom and Aruba)
Niger
Nigeria
Norway
Pakistan
Peru
Philippines
Republic of Korea
Romania
Saudi Arabia
Senegal
Sierra Leone
Sri Lanka
Sudan
Sweden
Tanzania
Togo
Trinidad and Tobago
Tunisia
Union of Soviet Socialist Republics
United Kingdom of Great Britain & Northern Ireland (on behalf of the U.K., Gibraltar and Hong Kong)
Uruguay
Venezuela
Yugoslavia
Zaire
Zambia

10

Professional Services

Padma Mallampally

Professional services may cater to producers of commodities and other services or directly serve the needs of final consumers. Feketekuty (1986) defines professional services as the application of knowledge and skills by experts to meet clients' needs. A study prepared for the Organisation for Economic Co-operation and Development (OECD) describes professional services as

> the provision of intellectual or specialized skills on a personal, direct basis, based on extensive educational training . . . some take a broader view and would include most forms of cultural, artistic, or intellectual endeavor as professions. It is also recognized that the definition is not static, and that occupations over time can rise to professional status. (Arkell and Harrison 1987, p. 4.)

The professional services sector, taken as a whole, is distinguished more by the characteristics of the service provider than by the service output. Professional service providers have recognized expertise (as attested by their education, training, experience, and often, certification or licensing) and enjoy considerable independence and personal responsibility. Professional services thus cut across several other service categories grouped by type of activity, product, or user. For instance, professional services of one kind or another are an essential part of producer services such as construction and engineering, trade, financial services, transport, and communications, as well as consumer services such as tourism, entertainment, and health care. Given this overlap, classifying certain service activities separately as professional services implies that the principal element in these services, whether they are provided to producers or to consumers, is the interaction between professional individuals and recipients. Examples that come readily to mind are legal and medical services.

The cutoff point with respect to the degree and nature of expertise and skills that separate professionals from other service providers is unclear. Existing typologies based on international or national classification systems for economic activities or products are not very helpful in determining what to include. Table 10–1 presents an illustrative list that is fairly broad in scope.

One group of services of considerable interest for the multilateral trade negotiations is professional business services, such as accounting, legal services, management, consultancy, market research, architectural and engineering services, and computer-related services (including hardware-related consulting, installation, data processing, and the development and implementation of software).[1] In many of these activities firms located in developed market economies have a clear comparative advantage and engage in international transactions, often through transnational service corporations that began by catering to their corporate clients when the latter extended their activities abroad.

Several developing countries, however, are also rapidly strengthening their domestic and international capabilities in such business services as software services, data processing, project management, and consultancy. The inclusion in the multilateral trade negotiations of these services, as well as of certain nonbusiness professional services such as those provided by doctors, nurses, and teachers, could be of interest to developing countries. Developing countries with large numbers of educated people may also be able to build up capabilities at the lower (or less knowledge-intensive) end of many professional services. If the dividing line with respect to skills is not drawn too rigidly, this would broaden their range of interest considerably.

In the context of the multilateral trade negotiations, any consideration of international transactions in professional services must address cross-border trade, foreign direct investment, and the international movement of persons. Few professional services are traded through cross-border transactions in the service output alone. This chapter attempts to examine the significance and

Table 10–1. ***The Liberal and Intellectual Professions***

Actuary
Agronomist
Analyst
Animated cartoonist
Architect
Archivist
Artist
Auctioneer and valuer
Auditor
Author

Biologist
Broker

Chemist
Chiropractor
Composer
Computer scientist
Conference interpreter
Consultants of various kinds
- Legal consultant
- Property consultant
- Marriage guidance counselor
- Organization and method consultant
- Tax consultant
- Consulting engineer

Criminologist

Decorator
Dentist
Designer
Dispensing optician
Doctor (general practitioner or specialist)
Document researcher

Economist
Engineer (various disciplines)
Estate agent
Estate manager
Estimator

Geologist
Graphologist
Guide

Interior designer

Journalist
Judicial officer

Landscape gardener
Lawyer

Masseur
Midwife

Notary public
Nurse

Optometrist
Osteopath

Pharmacist
Photographer
Physicist
Physiotherapist
Practitioner of dentistry
Process-server
Psychologist
Publicist

Sales representative
Sculptor
Social worker
Sociologist
Sports instructor
Stage manager
Statistician
Stockbroker
Surveyor

Teacher
Topographer
Town planner

Veterinary surgeon

Window dresser
Writer

Note: This list is not confined to the traditionally limited number of professions in the strict sense of the term, such as advocates, notaries, judges, doctors, and architects. It was drawn up by the Commission of the European Community to represent the collectivity of liberal and intellectual professions in the present state of development of science, technology, and social institutions. These are occupations which, irrespective of the legal status (salaried or self-employed) of those who pursue them, are characterized by independence and personal responsibility and are not primarily economic in their content.

Source: Reproduced with minor modifications from Nusbaumer (1987, p. 85).

nature of international transactions in selected professional services, the existing regulations that influence those transactions, and some of the main issues relating to the application to professional services of the key principles that would form the basis for liberalization.

Professional Services in National Economies

As a nation develops, professional services are needed to support the growth of the manufacturing sector of the economy and of the infrastructure and social services that determine the quality of life. It is difficult to quantify on the basis of currently available empirical evidence exactly how important professional services are in the global and national economies. For the OECD countries taken as a whole, business services, social and community services, and recreational and cultural services, including both free-standing services and those directly linked to the production of goods, together represented 7 percentage points out of the 45 percent of value added accounted for by the market services sector during 1980–84 (Blades 1987). It is estimated that business services account for about 5 percent of the gross domestic product (GDP) of the European Community and that their output makes up 5 to 10 percent of all intermediate inputs into the productive branches of the economy (Commission of the European Community 1988). Furthermore, employment in professional services has been growing rapidly. In the United States during 1982–87 employment in "business and professional services" and legal services, which together account for 20 percent of services employment, has grown at 6 percent or more a year; employment in services in general grew at about 3 percent a year and employment in the goods-producing sector at 2.5 percent a year (Sinai and Drury 1988). In five other industrial economies (Belgium, France, the Federal Republic of Germany, and Sweden) employment growth rates in business services were 24 percent or more during 1979–86, as against growth rates of 10 percent or less in total employment (UNCTC 1989b). Similar approximate indicators of the relative significance of professional services for developing countries are, unfortunately, not readily available.

International Transactions in Professional Services

In addition to being intangible and nonstorable, professional services are intensive in human capital or skills, and their delivery often requires close interaction between the producer and the customer. International transactions in professional services therefore involve much more than pure cross-border trade. Such services as education and entertainment can be embodied in goods—books, tapes, or computer discs, for example—and traded across frontiers, but under present practice this would normally be classified as trade in goods, not services. Some cross-border trade in professional services is conducted through transborder data flows on international communications channels, and this is likely to increase rapidly as a result of the dynamic growth in telecommunications. But the expertise involved in most professional services extends well beyond the pure information component, and pure cross-border trade probably represents only a small part of international transactions in these services. In other words, the value of services delivered or received through the movement across borders of individuals (as sellers, buyers, or both) and the temporary or permanent establishment of production facilities in other countries must be taken into account to get a correct picture of the international market for professional services. But although the value of services sold or purchased through the movement of producers or customers for limited periods of time is generally included under cross-border transactions between residents and nonresidents (that is, as exports and imports reported in balance of payments statistics), data on sales by foreign affiliates are lacking for most countries.

In recent decades international transactions in services have grown rapidly as a result of growing worldwide trade, investment, and interdependence in the goods sector as well as in services themselves. It is not known precisely to what extent professional services as a group have shared in this growth, but available information shows that despite extensive barriers there is a sizable amount of international activity through the establishment of foreign affiliates in certain professional services such as accounting, management consultancy, and market research (see UNCTC 1989a). Data on sales by foreign affiliates of U.S. companies confirm its importance. Data for the United States also indicate that in certain other professional services, such as education, health, and legal services, there is considerable trade in the form of direct export (or cross-border transactions as defined for balance of payments purposes); see table 10–2.

Products and Markets in Selected Professional Services

This section describes operations and trends in several professions that are significant for international trade in services: accounting, law, computer services, and health care. An attempt is made, drawing on available data and studies, to examine the nature of international transactions in those services and their significance for developed and developing countries.

Table 10–2. ***U.S. Trade in Selected Professional Services, 1983***
(billions of dollars)

Service	Foreign revenues of U.S. firms: Direct exports	Affiliate sales	Total	U.S. revenues of foreign firms: Direct imports	Affiliate sales	Total
Accounting	0.2–0.5	3.7–4.5	3.9–4.5	...	0.7–0.9	0.7–0.9
Education	1.6–2.3	0.0–0.1	1.6–2.4	0.1–0.3	...	0.1–0.3
Engineering	1.1–1.6	4.0	5.1–5.6	0.1–0.3	0.9	1.0–1.2
Health	1.0–2.5	1.1	2.1–3.6	...	0.4	0.4
Legal	0.0–2.0	0.1	0.1–2.1	0.0–1.0	...	0.0–1.0
Management and consulting	0.6–1.4	1.2	1.8–2.6	0.0–0.5	0.1	0.1–0.6
Software	2.5–2.6	3.2–4.4	5.7–7.0	0.0–2.2	0.0–0.2	0.0–2.4
All services, except banking	61.0–75.1	87.5–97.3	152–169	44.0–56.3	68.5–74.8	113–131
All services, including banking	n.a.	n.a	161–178	n.a	n.a	118–147

... Zero or negligible.
n.a. Not available.
Source: OTA (1986, pp. 41, 42).

Accounting Services

The principal services provided by the accounting industry are auditing and accounting services and tax-related services. In the United States auditing and accounting are estimated to account for 50 to 75 percent of the major accounting firms' revenues (OTA 1986, p. 48), and it is likely that this share is similar in other countries. In providing auditing and accounting services, accountants seek to ensure and improve the integrity of financial information reported by the clients and advise clients on the organization of their record-keeping and financial control systems. Auditors provide corporations and other organizations with an independent opinion that the financial statements prepared by these bodies fairly present the operational results and financial position of the business, in accordance with specified accounting standards. In most countries publicly held corporations are required to issue independently audited financial statements on the basis of audits conducted by certified public accountants (CPAs), who have passed uniform national qualifying examinations. In the United States and some other countries requirements for certifying accountants, enforcing accounting standards, and setting limits on the scope of accountants' activities are largely determined by the profession itself (in the United States by the American Institute of Certified Public Accountants). In other countries governments assume significant responsibility for this regulatory function.

Tax-related services provided by accountants to individuals and organizations include consultation, tax planning, and preparation of tax returns required by various taxing authorities. These services are estimated to account for 15 to 25 percent of the revenues of the principal accounting firms in the United States.

Many large accounting firms also engage in management consulting and have diversified into areas beyond the traditional ones. These lines of business—including the planning, design, and installation of computer systems for processing business transactions and the provision of information to management—evolved from the financial information and advisory services provided in the accounting and tax areas and from the modern applications of computers to management needs. The range of services offered by some major business firms also includes strategic planning, market and feasibility studies, tailored business research, and merger and acquisition assistance (Rossi 1986, p. 137). OTA estimates that management consultancy accounts for slightly less than 10 percent of the revenues of the principal accounting firms in the United States.

In developed market economies the accounting services business has been internationalized to a significant degree, mainly through the activities of the largest firms. This process began in the nineteenth century, when European accounting firms followed their clients as the latter undertook investments and activities abroad, mainly in the colonies. The roots of this process lay in the intimate knowledge that accountants and auditors build up with respect to their clients' operations and financial transactions, in their mutual trust, and in the advantages of continuing such a relationship. The tremendous growth of U.S. transnationals since the 1950s has created a similar demand for overseas auditing, accounting, and other advisory services from U.S. accounting firms. This pattern of growth has now been

Table 10–3. ***The International Activities of the Largest Accounting Firms, 1986***

	Number of foreign affiliates			*Number of staff*		*Fee (millions of dollars)*	
Firm name and home country	*Total*	*Developed countries*	*Developing countries*	*Total*	*Percentage foreign*	*Total*	*Percentage foreign*
Arthur Andersen (United States)	141	82	59	36,117	44	1,924	30
Coopers & Lybrand (United States)	397	249	148	38,500	65	1,695	50
Peat-Marwick (United States)	297	168	129	32,183	55	1,672	35
Ernst & Whinney (United States)	332	211	121	28,800	56	1,492	39
Klynveld Main Goerdaler (Netherlands)	498	396	102	30,894	n.a.	1,137	89
Binder, Dijker, Otte (Netherlands)	294	258	36	13,027	n.a.	531	n.a.
Dearden Farrow (United Kingdom)	193	137	56	5,717	84	211	86
Spicer and Oppenheim (United Kingdom)	227	166	61	7,775	72	263	75

n.a. Not available.

Note: The firms included are the top firms from each of the three countries included in a list prepared by UNCTC of the twenty largest firms worldwide. The data for different firms may vary in terms of coverage of member, representative, correspondent, and affiliate firms. For details, see UNCTC (1989a), p. 196.

Source: UNCTC (1989a), pp. 194–95.

supplemented by the search for new opportunities in foreign markets. OTA estimates that direct exports plus affiliate sales by U.S. accounting firms amounted to $4.0 billion–$4.5 billion in 1984. (Sales in the United States by foreign accounting firms are estimated at less than $1 billion.) The OTA data also suggest that affiliate sales account for 90 percent of the total foreign revenues of U.S. accounting firms and an even higher proportion of the U.S. revenues of foreign accounting firms. This highlights the importance of the direct relationship with clients necessary for the delivery of accounting services.

The international activities of selected top accounting firms are shown in table 10–3. These firms have established extensive networks of affiliates in developed as well as developing countries. The typical organizational form for these activities has been to join forces with existing local entities, creating a network of national affiliates that are owned and managed locally but are linked to an international organization that retains coordinating and standardizing responsibilities. To some extent this pattern has emerged because of local regulatory requirements that branch offices be set up in partnership with locally licensed accountants, but it has also been influenced by the need to involve local professionals with an intimate knowledge of the language, culture, business practices, and laws of the host country.

The international network provides a legal framework under which certain training and development costs can be shared, personnel can be exchanged, and a unique brand of accounting methods can be offered worldwide. As a result of the strong advantages built up by the large firms through this system, there is a high degree of market concentration; according to one estimate, in 1983 the world's nine largest firms probably controlled more than one-third of the world's accounting business (Noyelle and Dutka 1987, p. 39). Available data point to considerable concentration in the accounting market in that large companies, including transnational corporations, are audited by the largest affiliations (see Bavishi and Wyman 1983, pp. 135–39). This is, however, not the case in other segments of the market, where competition for the business of small and medium-size firms is intense (Noyelle and Dutka 1987, p. 113). Consequently, numerous small and medium-size firms, as well as independent professionals, are active in both domestic and foreign markets. Furthermore, although international transactions are dominated by firms from the developed market economies, increasing participation of firms from developing countries such as India and Tunisia has been observed in international transactions in accounting services (UNCTC 1989b).

Nevertheless, the present pattern of international transactions in accounting indicates that the comparative advantage in this industry lies with firms from the United States and the United Kingdom and some other European countries, where the coordinating offices of the main accounting networks are located. The competitive advantages enjoyed by these firms include access to transnational clients, expertise, experience with the standards required by transnational corporations' home countries, and, in some cases, internationally known brand names. Economies of scale and scope endow these networks with additional advantages, such as extensive information capabilities and development of new products, that not only accrue to users but are likely to be passed on rapidly within the network and enjoyed by national affiliates, yielding benefits to the countries in which accounting transnationals operate. An important benefit is likely to lie in the training and professional education in which large accounting transnationals invest. This transfer of soft technology can, under appropriate conditions, be diffused to other national entities, strengthening their capabilities and competitiveness and possibly resulting, eventually, in overseas sales for the host countries. This factor is likely to be of great interest to developing countries in assessing the benefits and costs of liberalizing international transactions in the accounting subsector.

Legal Services

Legal services include the representation of clients in civil and criminal courts, the negotiation and preparation of legal documents, and other legal consultation and advice. In the United States all these activities are included under a single category—the practice of law—and, except in New York and a few other states that allow foreign legal consultants to practice, are reserved for locally licensed lawyers. In other countries, such as the United Kingdom certain areas of law are reserved for qualified local lawyers, but others, especially those of a consultancy type, can be undertaken by nonlawyers as well.

The available information suggests that national legal services industries are highly competitive, even in the United States; there the sector has been growing rapidly since 1979 and some very large firms have emerged. Most firms are, however, relatively small; U.S. practices often have one or two lawyers and receipts of less than $100,000 a year. Business clients accounted for 49 percent and individuals for 44 percent of the U.S. legal service industry's total revenue; the remainder represented government purchases of legal services and other sources of income (OTA 1986, p. 82).

International transactions in legal services take two forms: services provided to customers in foreign markets and services provided to foreigners in domestic markets. As in many other services, national clients with transnational activities are a significant source of foreign demand for the services of a given country's legal firms. Owing to the nature of national regulations governing the legal profession, services provided abroad by lawyers and legal service firms are generally confined to legal consultation, often on their home countries' laws. Such activities include provision of legal advice, participation in negotiations, and preparation of documents.

U.S. and British law firms have tended to extend their operations abroad by opening their own branch offices, whereas European business law firms rely extensively on loose network affiliations that provide referrals. In addition, private lawyers work in foreign firms as counsel for transnational corporations or travel abroad on a temporary basis. Access to sophisticated telecommunications equipment that facilitates contacts with clients and home country office has increased the tradability of legal services and the mobility of lawyers.

The principal overseas business of transnational legal services firms is located in a few large international banking centers such as London, Paris, Brussels, Hong Kong, and Singapore, where firms cater to the legal work required in the preparation of financial and related documents. Although comprehensive data concerning international transactions, even of the largest firms, are unavailable, international transactions in legal services are assumed to be dominated by the large U.S. and British firms. A 1983 survey of the 200 largest U.S. law firms showed that 50 of them had one or more offices abroad, in developing and developed countries (Crabb 1983). According to OTA estimates, foreign revenues of U.S. legal firms amounted to more than $2 billion in 1983, while U.S. sales of foreign law firms were about half that amount. Direct exports and imports—that is, cross-border transactions—are the predominant mode (see table 10–2). Thus, despite the obstacles posed by the country-specific nature of legal practice and the opposition of local law firms to the establishment of foreign law offices, there appears to be a fair amount of international transactions in legal services, at least as far as some developed countries are concerned.

The growth of the international market for legal services is difficult to foresee, given the existing national regulations on entry of foreign firms and the relatively limited nature of international legal services activity at present. It has been suggested that the evolution of the legal market is likely to depend on the evolution of additional relationships between banks and law firms. Recent reports also suggest that developments such as mergers and takeovers, privatization, and relaxation of restrictions in some countries have generated new demand for international legal services (*New York Times*, May 12, 1988). In any case, it seems likely that the trend toward increasing internationalization of legal services in the industrial countries will continue. Information is not available however, as to whether similar forces are at work for the legal services of developing countries.

Computer Software and Software Services

In recent years there has been a tremendous growth in the worldwide information industry and the market for computer services, including computer systems and software, data processing, and related advisory services. The development and use of software for a wide variety of applications is leading to a growing demand for the services of computer professionals, who are involved in software development as well as in the actual provision of services related to use of software. These services are particularly important in the case of customer-specific software, where consultation and training are important factors.

At present, the world market for standardized and packaged software—the most rapidly growing and profitable sector of the industry—is dominated by the United States and a few other developed countries. The large investment required, the costs of distribution, and the risks work to restrict entry into the packaged software segment of this sector. Companies and individuals from both industrial and developing countries are, however, developing software to suit specific needs and modifying software packages for clients abroad. Such services are seen as an important potential source of foreign exchange earnings for some developing countries, such as India and Brazil. For instance, India's somewhat special combination of a well-developed system of higher education, links with educational and technological establishments in developed countries, emphasis on industrialization, and widespread use of English has led to the emergence of a large pool of scientific and engineering talent capable of providing software services abroad. In recent years India has emerged as a visible provider of professional software services to developed countries (see Srivastava 1989).

To date, the principal mode of delivery of these services—accounting for 80 percent of overseas earnings by Indian software companies—has been delivery to clients on site. The close contact this permits with the client, as well as the constraints with respect to international communications at the present stage of their development in India, favor onsite production. Offshore production (in India) and delivery of "separated" software to foreign buyers have been limited, although some major American companies have moved some software-developing activities to India. Establishment of local affiliates by Indian firms has not yet played a role in the delivery of Indian software services to foreign markets.

Exports of computer software and software services from India are projected to be about $200 million in 1990. This is still a minuscule proportion of the world market, which is estimated at perhaps a thousand times that amount. Assuming supply availability, future growth is likely to depend on the ease with which large numbers of software professionals can move across borders and on the development of alternative delivery modes. Nevertheless, the industry provides a good example of the opportunities that could emerge for developing countries, at least for a period of time, in service areas that are experiencing rapid growth in international demand for specific skills.

Health Care

Health care—primarily provided by doctors, dentists, and nurses—is an important segment of the services sector in developed countries and also in developing countries, many of which include it in their public investment allocations as a basic service for the community. Although data are not available, there are likely to be substantial differences in the capital-intensity and research-and-development-intensity of medical services in developed and developing countries. The structure of the health care industry also varies significantly among countries; private institutional and individual providers dominate in some countries, whereas publicly provided services are significant in others.

International transactions in health services take several forms: cross-border movements of physicians, nurses, and related professionals, cross-border movements of patients or consumers, and international activities of hospital managers, consultants, and others involved in the planning, design, and operation of health care facilities. U.S. experience suggests that although health professionals from developed countries often work abroad under aid, development, and exchange programs, they rarely go abroad on their own to establish individual practices (Feketekuty 1986, p. 36). Several large health management companies, especially U.S. concerns, entered the international market in the early 1970s, however. These companies drew on their considerable comparative advantage in technology and management expertise to deliver a variety of services ranging from the design, construction, and operation of health care systems to the provision of auxiliary services to individual hospitals. Such companies may establish branches, subsidiaries, or joint ventures. They are active primarily in Western Europe, the Americas, the Middle East, and the Pacific area (UNCTC 1989a, p. 28).

Exact data on the purchase of health services by patients from other countries is lacking. The available information indicates, however, that such movement occurs not only from countries with less developed medical facilities to sophisticated medical centers in Western countries but also within developing regions.

The delivery of health services through the movement of providers themselves is likely to be of most interest to health professionals of some countries. Doctors and nurses from some developing countries with a relatively abundant supply of medical skills have moved in fairly significant numbers to both developed and developing countries in which there is a demand for their services. Such moves may be for a limited time, as in the case of many South and Southeast Asian doctors practicing in the Middle East, or may be more permanent, as in the case of Indian, Filipino, and other physicians who have migrated to Europe and the United States. (In 1976 stringent visa and qualifications regulations went into effect in the United States, making such moves more difficult.)

In the case of health services, where there are visible differences in the cost of services as well as in the range and quality of services available, the efficiency benefits to both consumers and producers from free international transactions seem obvious. Nevertheless, numerous protectionist forces arise from considerations relating to preserving health professionals' income levels, protecting existing health care firms, and, in developing countries, preventing the depletion of skilled personnel, who are often trained at public expense. Other, and equally important, considerations concern protection of consumers, which leads to strict regulation of entry through accreditation or licensing procedures.

Restrictions on International Transactions in Professional Services

Restrictions on international transactions in professional services are mainly imposed at the level of the firm or the individual provider (Feketekuty 1986, p, 34) to hinder the establishment of local production facilities or the physical presence of foreign professionals. The most important such measures include restrictions on foreign direct investment, reservation of certain professional activities for citizens, certification and licensing requirements for professions, and immigration rules and regulations. Other barriers are less significant or less common. Rules that limit the scope of activities permitted to firms in a particular professional category generally apply to national as well as foreign providers; they are particularly relevant to accounting firms that have diversified their services. Restrictions on the use of firms' international names do not seem to be widespread (Noyelle and Dutka 1987, p. 63). Foreign exchange controls on international payments and transfers affect the ability of international firms to conduct transactions through affiliates' activities as well as directly with clients. The practice in some countries of limiting permitted transfers to a certain proportion of capital investment poses a particular difficulty for professional services firms, which are typically labor-intensive. Restrictions on transborder data flows can affect firms' ability to conduct transactions through affiliates and directly.

General or industry-specific rules that prohibit or limit foreign equity participation can hinder the ability of firms to establish affiliates abroad. Although most developed market economies are relatively open to foreign direct investment, a number, including Australia, Austria, Canada, France, New Zealand, and Norway, require prior authorization for certain types of inward investments, which may act as an impediment to foreign direct investment (OECD 1987). Several developed countries also exclude or limit foreign ownership in sectors such as banking, insurance, telecommunications, and broadcasting, which have a significant professional component. There seem to be few restrictions on foreign direct investment in professional services as such, possibly because regulations relating to the movement or licensing of foreign professionals effectively limit the delivery of foreign professional services.

In developing countries rules and regulations regarding the establishment of foreign affiliates are generally, although not invariably, stricter than in developed countries with respect to entry control, screening, and the degree of foreign ownership permitted. Most developing countries limit the range of activities in which wholly owned affiliates of transnational corporations can be established and stipulate minority foreign ownership in many areas or reduction in foreign ownership over time. In several developing countries service activities such as finance, transport, posts and telecommunications, and public services, including health and education, are closed to foreign direct investment. Although it is difficult to identify specific restrictions regarding foreign direct investment in professional services, in some countries certain professional activities are specifically reserved for entities with majority national ownership, (accounting, law, and architecture in Thailand) or for fully nationally owned enterprises (legal services in the Republic of Korea, in which foreign investment is normally restricted).

One of the most directly protective regulations that affect international transactions in professional services is the requirement of citizenship as a prerequisite for practicing certain professions. Many developed countries (for example, France, Germany, Japan, and Switzerland) restrict important areas of legal practice to citizens, mainly on the reasoning that the lawyer is an "officer of the court" and that these duties are so related to a vital public institution that they cannot be entrusted to the citizens of another country (Crabb 1983, p. 6). These countries do allow noncitizens to engage in direct legal consultation, but even then there are regulations concerning whether the foreign lawyer may advise on home country law, international law, or local law.

Another significant impediment to the mobility of the individual professional arises from licensing requirements in the regulated professions, such as accounting, legal services, architecture, and medicine. In most countries both local and foreign providers of such services are carefully regulated through requirements concerning length and type of education and qualifying examinations. The purpose of these regulations is to ensure the quality of the service and to protect clients. In most cases the regulations tend to discriminate against foreign providers, as countries are reluctant to give credit for education and training received in other countries.

In countries such as the United Kingdom and Japan, although access to the local bar is not limited by citizenship, the requirements for further study, examinations, and clerkship or training periods effectively serve as deterrents. In accounting most countries are fairly liberal in granting foreign auditors the right to practice, permission being based on partial or total equivalency for diploma and work experience gained abroad. Nevertheless, countries may prescribe that practicing accountants be residents of the host country for a certain period of time, place undue emphasis on matters having little to do with professional competence, and impose unreasonable bureaucratic delays in procedures and examinations for foreigners (Rossi 1986, p. 157, reporting on a survey of accounting firms by Arthur Andersen). Health care is another area in which professionals face rigorous certification requirements in host countries: to practice in the United States, for instance, a foreign doctor must obtain a certificate from the Education Committee for Foreign Medical Graduates. The conditions include the committee's approval of the applicant's foreign medical school diploma, a rigorous test of facility in the English language, and tests on medical and clinical sciences. In addition, the doctor must complete a residency in the United States and pass a state licensing examination (Feketekuty 1986, p. 4).

Immigration rules and requirements are also a formidable barrier to international transactions in professional services. Visas and work permits are particularly important for the licensed professions, since most countries link the right to practice to residence as well as to certification requirements. Visas are often issued on the basis of whether individuals can meet licensing requirements. The number of foreign entrants into the practice of a service activity, whether temporarily or for a longer period, may also be controlled by denying entry outright or by requiring entrants to go through a long and complicated approval process. In 1977, for instance, objections by the Japanese bar to the entry of an American lawyer led to a freeze on visas for foreign lawyers wishing to open offices in Japan as well as for those who wished to consult with Japanese clients. Only after a counterprotest by the U.S. government and a number of reports, studies, and proposals did the Japanese government pass, in 1986, the Foreign Lawyers Practice Bill, which allows foreign lawyers to practice on a limited basis in Japan if reciprocity is maintained (Noyelle and Dutka 1987, p. 76).

In the accounting profession, Arthur Andersen member firms reported difficulties in transferring professional personnel into foreign locations in sixteen countries (eight OECD member countries and eight developing countries) out of twenty-seven surveyed (Rossi 1986, p. 154). In software and management consultancy, professionals from various countries have complained that under existing ad hoc arrangements countries can rewrite at will the rules for granting temporary business visas (UNCTC 1989b, p. 40). In the health care professions, foreign doctors wishing to enter the United States face stricter immigration barriers since 1971 because requirements for issuance of visas to foreign doctors have been tightened on the grounds that there is no longer a shortage of physicians in the country.

Liberalization Concepts and International Transactions in Professional Services

The nature of professional services makes it difficult in most cases to draw a clear line between alternative modes of delivery—cross-border trade, establishment of foreign-owned or foreign-associated enterprises, and movement of professional persons. Transactions in professional services generally require the physical proximity of the provider and the client or consumer. Thus some of the concepts that were formulated during the Uruguay Round and were incorporated in the midterm agreement assume special dimensions and significance in the area of professional services.

The most important considerations have to do with the concept of market access. Access of professional services to international markets will in many cases require the right of establishment or the right of firms or individuals to set up and operate undertakings in other countries. The right of commercial presence or the right to set up an agency or representative office would facilitate not only cross-border trade but also trade conducted through short-term movement of persons and might be relevant for services that can be delivered through temporary relocation of professionals—for example, management consulting, market research, and computer software services. But for many others, including accounting, legal and medical services, and other licensed services that require continuous contact with the market and the client, temporary relocation is nearly impossible or is quite inadequate.

Consideration of the right of access in the sense of full-scale establishment and long-term presence could bring a range of foreign direct investment and labor movement issues within the framework of the multilateral trade negotiations. Whether this will indeed be the case will depend on how trade in services is defined and how "cross-border movement of factors of production where such movement is essential to suppliers" is interpreted. The ministerial declaration on negotiations on trade in services, adopted at the midterm review meeting of the Uruguay Round specified certain factors for further examination in this connection, including cross-border movement of services and payments, specificity of purpose, discreteness of transactions, and limited duration (GATT 1989b, p. 38).

In the case of professional services the concept of market access must also include the right of individuals to practice, which includes mutual recognition of educational qualifications and licensing. This would require harmonization of or at least some agreement with respect to broad principles relating to educational standards and professional practice in different areas. Such an approach would also seem necessary if the principles of national treatment, most favored nation treatment, and nondiscrimination are to be applied.

If the broad interpretation of trade to include cross-border movement of factors of production is applied to trade in services, the need for transparency is particularly obvious for professional services. Ensuring transparency may in fact be a formidable task. The parties involved would need information on laws, regulations, and guidelines relating not only to trade but also to foreign direct investment and to accreditation or licensing of professional individuals.

International transactions in many professional services have been dominated by large firms from a few developed market economies. Many countries, especially in the developing areas, will face issues relating to service quality, educational standards, licensing, immigration and labor movement as they consider freer trade regimes. Hence the concept of progressive liberalization seems of special relevance to trade in professional services.

It is widely recognized that liberalization of trade does not mean deregulation. The right of countries to regulate the professions through rules formulated by governmental or professional bodies to ensure quality standards and protect consumers, as well as for other socioeconomic reasons such as ensuring the growth of the domestic sector and employment, remain important. Thus, although regulations that represent obstacles to international transactions in professional services could be re-examined to see if their protectionist content could be reduced without affecting the attainment of national policy objectives, it cannot be assumed that all or even most obstacles will be eliminated in the long run.

Finally, the basic theme of the current negotiations on services—the promotion of "the economic growth of all trading partners and the development of developing countries"—requires that the special interests of developing countries be addressed. This would mean the incorporation of measures to provide increased access to developed country markets for professional services that could be exported by developing countries. Such measures might deal with provision of improved information regarding markets and opportunities and recognition of educational and professional qualifications. Perhaps more important, attention must be given to measures for strengthening the domestic capabilities of professional service industries in developing countries. One possibility would be to increase developing countries' access to professional services technology by linking the granting or renewal of firms' establishment rights to their training efforts.

Concluding Remarks

Professional services are significant in the economies of both developed and developing countries. Many of these services are highly regulated with respect to domestic as well as international transactions. Liberalization of trade in professional services is therefore likely to have important consequences for both groups of countries.

Freer trade in professional services can be expected to improve the efficiency of resource allocation in accordance with the principle of comparative advantage. This would mean that buyers, whether producers or final consumers, would pay lower prices for importable professional services. Because a number of professional services are in fact intermediate inputs into the production of goods and other services, this should lead not only to lower prices for consumers of the imported services but also to lower production costs in several industries, which might in turn enhance their export capabilities. In addition, the fact that delivery of many services requires the establishment of affiliates, the participation of individual professionals from the exporting countries, or both could provide opportunities for the transfer of technology (or skills and knowledge) to the recipient or host economy. This should be of particular significance for developing countries, which are likely to be importers of professional services involving relatively advanced skills from the industrial countries.

On the export side, countries would gain in terms of larger markets and higher prices for their exportable services. Available information on the present pattern of trade (including cross-border transactions, services delivered through short-term movement of buyers and providers, and sales by affiliates) suggests that in many knowledge-intensive professional services the comparative advantage lies on the side of the developed countries. Some developing countries are making their presence felt in international markets for highly skilled professionals in certain areas, and, given the range of services involved, there may be further scope for such involvement. For many developing countries, however, interest is likely to lie in the export of professional services that are relatively labor-intensive or that involve practitioners who are less highly skilled.

Given the variety of services involved and the fact that different professional services are likely to be of export interest to different countries, efforts toward trade liberalization must take into account several factors if they are to be relevant to developing as well as developed countries. These factors include differences in skill and labor intensity of different professional services, in their modes of delivery, and in the relative roles of firms and individual practitioners in their trade. The existing distribution of competitive advantages in professional services makes issues related to mobility of professional individuals of greater concern to developing countries than those related to establishment or foreign direct investment, on which the developed countries place considerable emphasis. Incorporation of both these concerns in a balanced manner is therefore a major task in the formulation of an international framework covering international transactions in professional services.

Note

1. It is interesting to note that the proposed reference list of service sectors prepared by the GATT Secretariat in the context of the discussions of the Group of Negotiations on Services contains a subgroup entitled "professional services" only under the category of business services. See GATT (1989a, p. 4–1).

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11

Telecommunications

G. Russell Pipe

Telecommunications has been revolutionized in the past thirty years. Until the 1960s only a limited range of basic services—mainly telegraph, telephone, and telex—was available to residential and business users. These services were usually provided by government-owned and -operated public telecommunications organizations (PTOs). Telecommunications services were traditionally considered a natural monopoly. Because of the large economies of scale involved in production, efficiency demanded that one producer provide services for an entire country. As public utilities, the PTOs strove to provide universal service—to achieve the greatest possible penetration of installed telephones among the public at large.

New technologies based on digitization (the convergence of computer and telecommunications technologies) have greatly expanded the range of basic services and have created a cluster of enhanced, or value added, services. These technological changes have removed much of the theoretical rationale for the case that telecommunications is a natural monopoly, and several countries have introduced competition in the provision of certain services. Basic services—those associated with universal telephone service—are usually maintained on a reserved, or monopoly, basis whereas enhanced or value added services are open to competition. It is these enhanced services, utilized mainly by businesses, that are usually considered tradable. They are at the core of the Uruguay Round negotiations for three main reasons.

First, the greatest potential growth in telecommunications is in value added and information services offered commercially to business users by PTOs or other providers and used in intrafirm networks set up by companies for their own worldwide operations. Countries' policies regarding these burgeoning new services may significantly influence growth in other service sectors. Thus the sector has become integral to economic development and to trade in services.

Second, the current multiplicity of telecommunications services makes possible greater mobility in the location for delivery of manufactured and service products. Companies seek to base computer communication centers in countries that offer a liberal regulatory environment and capabilities that are both low cost and technologically advanced. These considerations have become important for financial, transport, tourist, and other services. Many companies are regionalizing their data processing operations, and countries are accordingly taking steps to give themselves a competitive advantage and attract these hubbing activities. National rivalries are now largely between developed countries, but the insensitivity of telecommunications to time and distance is enabling such developing countries as Jamaica, Morocco, Singapore, and Thailand to position themselves to capture far greater international traffic.

Third, in most developing countries there is a greater inflow than outflow of communication traffic, generating significant foreign revenue for the government. Governments and PTOs do not want to jeopardize this important source of revenue. A number of developing countries, however—including Argentina, Jamaica, the Republic of Korea, Malaysia, Mexico, Morocco, Singapore, and Thailand—are investigating whether lowering international tariffs and relaxing certain regulatory conditions may actually bring about an increased volume of traffic and, consequently, higher net balances. Countries that position themselves to become such centers are likely to be assured of considerable growth and positive balances in international traffic.

Recent Developments

Available estimates for some member countries of the Organisation for Economic Co-operation and Development (OECD) show that the telecommunication sector's proportion of gross national product (GNP) is comparable to the share of the steel or the textile sector. Even these figures underestimate the importance of the sector owing to the difficulty of evaluating private sector investments related to telecommunications and of separating domestic from international income. In 1980–84 the share of transport, storage, and communications in gross domestic product (GDP) was 7 percent in developed countries and 6 percent in developing countries (GATT 1988–9, pp. 23–30).

Because of their potential central role in the Uruguay Round, the market for value added network services deserves particular attention (see table 11–1). Although a definition is difficult to establish, value added network services are basically services that use the basic telephone network to manipulate information in voice, video, or data form. Strong growth trends are expected in national markets, but it is not clear what percentage of these services is internationally traded.

Technological Change

Digitization—the encoding of information in a binary form rather by means of the analog method, which uses wavelike representations of sounds—has vastly increased the speed and reliability of telecommunications. The new digital environment exhibits two outstanding characteristics: service convergence, which means that any and all services can be furnished through the same storage and transmission medium, and connectivity and interoperability, which means that multiple users,

Table 11–1. *The World Market for Value Added Network Services*
(billions of dollars)

Country or region	*1988*	*1989*	*1990*	*1995*
United Kingdom				
Information services	0.680	0.866	1.039	1.813
Processing	0.038	0.066	0.096	0.172
Messaging	0.090	0.144	0.215	0.403
Other	0.022	0.040	0.064	0.112
Total	0.830	1.116	1.414	2.500
France				
Information services	0.225	0.270	0.372	1.075
Processing	0.034	0.054	0.081	0.292
Messaging	0.046	0.074	0.170	0.450
Other	0.019	0.024	0.034	0.190
Total	0.324	0.422	0.570	2.070
Germany, Fed. Rep. of				
Information services	0.240	0.310	0.391	0.910
Processing	0.025	0.040	0.060	0.215
Messaging	0.030	0.052	0.080	0.280
Other	0.014	0.018	0.025	0.140
Total	0.309	0.420	0.556	1.545
Other European countries				
Information services	0.505	0.679	0.875	1.342
Processing	0.048	0.077	0.115	0.413
Messaging	0.033	0.066	0.350	1.677
Other	0.027	0.035	0.048	0.269
Total	0.613	1.857	1.388	3.701
United States				
Information services	4.400	6.250	8.200	12.320
Processing	0.404	0.661	0.982	3.046
Messaging	0.930	1.240	1.580	2.920
Other	0.229	0.326	0.477	1.983
Total	5.963	8.477	11.239	20.269
Japan	1.700	2.750	4.000	9.150
World	9.739	14.042	19.254	39.172

Source: Systems Dynamics, value added network service monitor.

whether real persons or devices, can process and share resources across network boundaries (Butler 1988; Pipe 1989, pp. 10–17). Currently, all types of data travel on highly defined and standardized paths, which make up what has been described as the world's first electronic highways.

This transformation in telecommunications has led to lower barriers to market entry for manufacturers of equipment and providers of data services; declining cost structures in other industries for the processing and transmittal of information; and new services and new ways of delivering traditional services. In 1983, for example, it cost $12,000 to $14,000 per month to lease the U.S. half of a private transatlantic voice channel; today the cost is $4,000 to $5,000 (Wellenius and others 1989, pp. 7–12). New satellites and submarine cables will further reduce these charges.

Market Forces

Private entrepreneurs and large international users have been instrumental in creating and adapting new services to fit their particular needs. A combination of technical advances, reduced transmission costs, looser regulatory restrictions, and growing user demand for sophisticated new services has led to the creation of many value added networks and other specialized information services that operate internationally. These new data services

> permit instantaneous, long-distance interactive interactions via transnational computer-communication systems. More specifically, by collapsing time and space (at decreasing costs), data services permit certain services to be produced in one place and consumed in another place. . . . The result is an increase in the transportability and, consequently, tradability of certain services—they can be delivered via the telecommunications network (Robinson, Sauvant, and Govitrikar 1989, p. 3).

The fusion of computers and communications has created an array of transactional services. Multinational and some national enterprises are using telecommunications services for a wide variety of transactions within firms and among user groups of related firms. Examples of networks of related businesses are the international banking network (Society for Worldwide Interbank Financial Telecommunications—SWIFT) and the airlines data system (Société Internationale Télécommunications Aéronautique—SITA). Transactional networks are "intended to increase the efficiency of transactions by reducing the amount of time and the number of independent steps it takes to complete, verify, and settle a transaction. . . . The same information that is carried over a network to trigger a transaction can serve to initiate payment, verification and settlement procedures" (Bruce, Cunard, and Director 1988, pp. 185–86).

Electronic data interchange (EDI) is a new and rapidly expanding form of intrafirm transactional service. In North America large retail clothing and food stores are rapidly introducing EDI systems. The European Community (EC) is sponsoring research on the development of standardized EDI systems. Application of these systems could decrease the time and costs of customs documentation and other frontier formalities, which, it has been estimated, add 10 percent to the cost of cross-border trade. The ports of Hamburg, Rotterdam, and Singapore have already used EDI to cut clearance time to less than an hour.

Basic Services: From Public Utility to Service Industry

The trend toward regulatory change in telecommunications affects facilities, services, and customer equipment. The telecommunications infrastructure consists of cable, satellite, and microwave transmission systems, switching systems, and other equipment that are used to perform basic telecommunications functions. Japan, the United Kingdom, and the United States allow competition in the provision of facilities and basic services. As of June 1989 Japan had forty-seven type I carriers—providers of services through their own circuits and facilities. Other countries are gradually opening such basic services as mobile telephony to competition. The European Community's telecommunications policy calls for PTOs to retain exclusive rights over monopoly basic services until 1992; whether these rights will be extended beyond that date is to be reviewed by the Commission in 1990 or 1991.

The transformation of telecommunications from a monopoly public service to a highly commercial sector has led to the restructuring of several PTOs and the opening to competition of some of their previously exclusive operating responsibilities. This is occurring in both developed and developing countries, although lack of infrastructure in many developing countries is a significant impediment to modernization of services and regulatory policies. Institutional and regulatory restructuring is taking place along three lines:

- Separation of telecommunications from postal services. This gives telecommunications organizations full responsibility over their operations and ends their subsidization of the losses of postal services.
- Separation of regulatory from operational functions. A government ministry or special regulatory agency

is responsible for supervising telecommunications service operators and, particularly, the operators of the national telecommunications transport network.

- Diversification of sources of telecommunications services. It is now widely accepted that value added services, because they provide a variety of specialized communications and information services, should be open to competition. Because a maximum degree of flexibility and minimum restrictions exist in several countries, these services are able to build efficient global networks (ITU 1989, pp. 33–5).

It is widely accepted, in developed and developing countries alike, that PTOs, even those that are publicly owned, should operate as commercial companies. This means that they must focus on costs, pricing, and services in relation to costs, and that subsidies should be limited. Internal organization and management must emphasize customer service, cost awareness, financial discipline, and productivity in staff performance (ITU 1989, pp. 33–35). The ITU recommendations are mainly addressed to developing countries, many of which are in the early stages of considering how to cope with rapidly changing technology, demands for new services, regulatory questions, and the growing economic role of telecommunications.

In the past, business users have often been charged artificially high tariffs in order to subsidize residential subscribers, offset postal service deficits, or transfer monies to the state's general revenues. Developing countries are now challenged to reconsider these long-standing practices and determine whether restructuring telecommunications to be more open and more commercially attractive to foreign enterprises and investors will better serve their development and trade objectives. Objectives for the sector include improving the national telecommunications infrastructure and its ability to offer an array of modern business services and strengthening service industries so they are viable domestically and competitive in international markets.

Value Added Services: Regulatory Alternatives

Enhanced, or value added, services are provided by companies that lease transmission facilities from a network operator. A value added service provider is one that combines basic services with computer processing applications that use the subscriber's information or information from other sources.

There are several policy options for competition in services, as suggested by Wellenius and others (1989, pp. 19–23).

1. Unrestricted competition in all kinds of basic and value added services
2. Unrestricted competition in all services except telephone services
3. Monopoly on basic services and competition in value added services
4. Monopoly on basic services and some value added services.

A consideration in choosing a regulatory structure is the amount of protection in the form of monopoly provision for basic services to be given the general public (residential customers). Unrestricted competition in all kinds of services (option 1) imposes no restrictions on resale or shared use and gives users and competing service providers the greatest freedom in using network services. Option 2 reserves telephone services (which typically generate 80 to 90 percent of the revenues that a PTO receives to finance all its social and political obligations). That approach is flawed, however, because advances in technology, such as the introduction of facsimile, are continuing to upgrade and expand the capabilities of telephone services.

Integrated services digital networks (ISDNs) are rapidly being introduced in Europe, Japan, and North America. They provide a combination of digitized services (voice, data, video, and broadcasting) through a single optical fiber circuit. If voice telephony is maintained as a basic service reserved for exclusive provision by PTOs, will ISDNs be defined as a "new basic service" or as a cluster of enhanced services? Organizations of users—such as the International Telecommunications Users Group (INTUG), a confederation of business telecommunications users in twenty-three countries—have argued that PTOs should be obliged to be flexible in regulating ISDN services and should not attempt to use standards or tariffs to force users to depend heavily on public networks.

Option 3 is also unsatisfactory to many value added service entrepreneurs and users because it relies so heavily on decisions of regulatory authorities, which may stress political rather than objective, technical considerations. It is not clear whether resale by value added services would be permissible. It can be argued that the amount of basic transmission to be allowed in a value added service before it is regarded simply as a basic service or resale of a basic service can be decided arbitrarily because of the lack of theoretical bases for judgment.

Option 4—perpetuating a monopoly on a basic service and opening some value added services to competition—is the current situation in most countries. The 1992 objectives of the European Community, as set forth in the 1987 Green Paper on Telecommunications, includes restructuring the telecommunications sector of EC members to conform in most respects to the first option.

International Arrangements

Traditionally, national PTOs were chartered to provide telecommunications services to all types of customers, and international telecommunications was organized according to bilateral agreements between PTOs. (This situation is in contrast with that in such sectors as banking and insurance, in which multinational enterprises have been established.) Technical and operating standards as well as accounting principles have been developed by committees of the International Telecommunication Union (ITU), and accordingly, a high degree of connectivity has existed between national entities.

International telecommunications services are provided through joint arrangements between PTOs. International networks operate almost exclusively on a cooperative basis with no customer-to-customer contact; the originating carrier never deals directly with residents of foreign countries. Privately constructed facilities are, however, being established to link a limited number of countries by means of undersea cables and communication satellites. These new facilities, such as the global digital highway being constructed by Cable & Wireless and the PANAMSAT and Orion satellite systems, will operate country to country, no longer relying on joint arrangements. But in the foreseeable future the traditional cooperation between PTOs can be expected to continue in most countries.

Toward a New Attitude

Attention to the trade-related dimensions of telecommunications originated with research on services by the GATT Secretariat and Contracting Parties during 1982–85. Even after the Uruguay Round was launched, the telecommunications community appeared to be largely unaware that its specialty might become important for a new trade regime. This was partly because many telecommunications managers in PTOs and user organizations have a technical orientation and view telecommunications largely as a transparent conduit for the transmission of messages—as an enabling technology for all types of applications rather than as an end in itself.

The transformation of telecommunications into a motor for economic growth is generally recognized by telecommunications specialists and has been the catalyst for many of the regulatory reforms described above. Less recognized and accepted at the outset of the deliberations of the Group of Negotiations on Services (GNS) was the idea that telecommunications services should be considered central to a framework agreement on services. Telecommunications specialists may have been preoccupied with introducing new services and with regulatory matters, and they may have been reluctant to concede the suitability of trade policy experts to decide crucial matters concerning the sector and how it should be governed in the future.

A 1988 survey of telecommunications officials and trade experts provided some insights on the question of the tradability of telecommunications services.[1] The results were unexpected. Basic telephony services (transport services) were considered tradable by 45 percent of respondents, basic services (in an ISDN environment) by 55 percent, enhanced (value added) services by 82 percent, and enhanced (value added) information services by 84 percent. The high proportion that considered basic telephony tradable contradicted many earlier analysis that placed basic services outside the realm of trade.

Another survey question was whether jointly provided international voice, data or image services handled by two PTOs involve trade, since only an exchange of traffic takes place. Eighty percent, evenly distributed between all respondents, indicated that such services "lend themselves to be traded" (OECD 1988; Mansell 1989).

The tradability of communications services tended to be viewed according to the way they are used. Fifty-eight percent of respondents regarded intracorporate networks as being involved in trade, whereas the figure was 62 percent for closed user groups such as SWIFT and SITA, 76 percent for companies using EDI and other systems to communicate with customers and suppliers, and 90 percent for online and commercial information processing and retrieval services. Sixty-two percent of those responding considered services less tradable if they are provided by a monopoly rather than by multiple providers, whether public or private.

The survey also asked about the role of telecommunications services in international trade. More than 60 percent viewed telecommunications as an intermediate service that supports other services such as aviation, banking and insurance rather than as a clearly identifiable and defined sector. All groups of respondents viewed the role of telecommunications in roughly the same proportions, except for the Japanese, who saw telecommunications more as a clearly defined service sector.

Lessons from a Case: The Canada–U.S. Approach

The Canada–U.S. Free Trade Agreement embodies the concept of telecommunications network-based services (originated by the OECD) for determining the coverage of telecommunications services. An annex refers specifically to telecommunications network-based enhanced services and computer services. The definition of enhanced services is left to the telecommunications regulatory authorities of the two countries. The agreement recognizes a number of rights and obligations regarding the provision of enhanced services, including access to and use of basic telecommunications services of various types.

The Canada–U.S. agreement has been cited as a possible model for multilateral agreements on telecommunications. The agreement is limited to enhanced telecommunications and computer services, and it imposes obligations on service providers as well as extending rights to users of basic services. It largely ratifies the regulatory status quo between the two countries. As the Uruguay Round negotiations reach an advanced stage, some countries, even the United States, tend to support more comprehensive coverage of telecommunications services than is provided for under the agreement.

Application of the Montreal Concepts

A pivotal issue for negotiations on telecommunications services in the GNS was whether the discussion should be limited to telecommunications services—those offered by PTOs—and certain types of value added services or should be broader, covering access to and use of national telecommunications transport services. Considerable emphasis has been placed on telecommunications as a transactional service that facilitates the delivery of other services such as banking and travel services and so enables suppliers and users of those services to execute market transactions more efficiently and effectively. Liberalized access to and use of specialized telecommunications services are vital to such advanced applications (GATT forthcoming).

The Montreal ministerial declaration stipulated that several concepts and principles must be examined in the preparation of a framework agreement. They include national treatment, most favored nation treatment, market access, progressive liberalization, and increasing participation by developing countries. In addition, the need for safeguards and exceptions must be considered.

National Treatment

In the case of telecommunications, the principle of national treatment may not be so much to ensure the equality of treatment within national markets as to allow firms to enter foreign markets and to accord equal treatment to all enterprises operating in a national market. Licenses, ownership rules, and other restrictions have been employed to keep out competitors to national PTOs. A services agreement may extend the national treatment principle to foreign enterprises that are not established in a country's territory. National treatment of nonestablished entities would imply that the same regulatory conditions must be granted to nonestablished foreign service providers. Applying national treatment to nonestablished telecommunications services may, however, be especially difficult, since the provider may have no real knowledge as to how users apply the service.

Most Favored Nation Treatment

International telecommunications services are established according to bilateral agreements. If most favored nation treatment were to be applied to this sector, thus introducing a multilateral dimension, considerable realignment of existing arrangements—in particular, of international charging and accounting practices that originated in an era of monopolies for all types of services—might be necessary. Today questions are being raised as to whether the present long-standing system is hindering rather than facilitating international trade (Ergas and Paterson 1989). A multilateral services trade regime, however, should take into account existing international commitments, especially because they may affect nonsignatories of the services agreement.

Market Access

It is not possible to delink the principle of market access from other provisions in the Montreal declaration. In simple terms, market access means the degree to which the ability of service providers to offer a service in a foreign market is affected by entry barriers or other requirements. It embraces access to and use of distribution systems, and telecommunications networks are specifically identified. The ministerial declaration states that access rights imply that "foreign services may supply according to the preferred mode of delivery." By explicitly linking rights of access to mechanisms for the delivery of services, the ministers underscored the key role of telecommunications, which undoubtedly will be chosen as the delivery vehicle by companies in most sectors.

Market access in the context of telecommunications services has been referred to as the right to plug into national telecommunications networks. In operational terms, access to the distribution system of a host country has been taken to mean the ability to lease telecommunications circuits to transport information both within and among countries, reasonable and nondiscriminatory pricing of services, freedom to choose attachment equipment, flexibility as to interconnection standards, and rights to process and store information (United States 1988, p. 11). Many developing countries are cautious about granting such rights because of the advantages for transnational corporations, especially in the remote delivery of services from operational bases in developed countries. But developing countries that help to facilitate market access through telecommunications channels will have the same rights to exploit domestic and international links to market their own products and services in developed countries.

Progressive Liberalization

Progressive liberalization has been defined as the facilitation and promotion of trade across borders and the stimulation of international competition, especially by increasing market access, but with due respect for national policy objectives. National policy objectives may call for telecommunications to retain a public utility character and universal service mandate or for the sector to be an engine of economic development and a conduit for international trade. Regulatory reform in Europe, Japan, New Zealand and the United States has expanded the zone of commerce and trade to cover most if not all telecommunications services, but in all countries regulatory and legislative bodies are asserting the interests of private residential customers.

For the telecommunications sector the challenge of progressive liberalization may be to prepare new rules to deal with international competition—rules for guiding competition among countries that choose to permit competition in various segments of the telecommunications system, and rules for connecting competitive telecommunications networks in countries that permit competition with national telecommunications monopolies in countries that do not (Feketekuty 1989, p. 260). Will such rulemaking be limited to liberalization of cross-border trade in telecommunications, or will it require major reforms in domestic telecommunication market structures? This is a complex question that cannot be answered without taking account of the other principles in the agreement.

Increasing Participation by Developing Countries

International studies commissioned by the ITU have concluded that developing countries are unlikely to achieve economic growth and mount service export programs without an adequate telecommunications infrastructure. Mobilizing the necessary capital, human resources, and technology to reduce the tremendous gap between developed and developing countries is a long-term challenge. Because telecommunications offers developing countries a shortcut to entering foreign markets with service exports, countries that decide to sign the services agreement may be faced with the necessity of addressing urgent infrastructure problems.

Satellite technology offers the possibility of bypassing local telephone systems and transmitting all types of messages by means of mobile earth stations. To a large extent, satellite communications make the geographic remoteness of land-locked and island countries irrelevant. A growing number of developing countries are capitalizing on their skilled manpower, favorable wage rates, and low overheads to mount small information-based services for offshore customers. Remote data processing, such as keypunching, for foreign customers is well established in Barbados, Korea, and the Philippines. Software development has become an export industry for India; orders and custom products are delivered electronically to Europe to save delivery time. The creation of special telecommunications trade zones, or teleports, may be an incentive for certain developing countries to capture a small portion of the world data services markets.

Genuine difficulties are certain to arise in ensuring that development benefits flow from the services agreement. Simply calling for "improved access to distribution channels and information networks" for developing countries, as in the ministerial declaration, is not enough; developing and developed countries alike will have to expend considerable effort and costs. The most effective and viable ways of accelerating telecommunications development may be for developing countries to give telecommunications more attention and larger financial allocations in national development plans, encourage developed countries to increase their contributions to the development programs of the ITU, and call for multilateral lending institutions to allocate greater resources to this sector.

Safeguards and Exceptions

Telecommunications is a critical feature of the national infrastructure and the engine of economic development. Short-term safeguards for this sector may be appropriate under a services agreement. But the benefits of progressive liberalization and other principles should not be unnecessarily reduced by the introduction of safeguards and exceptions. There are several questions that governments should consider in deciding whether to push for exceptions. Would efforts to make telecommunications services more commercial and cost-based be compromised by exempting subsidies from coverage? Are technical standards in telecommunications appropriate for exclusion, or would standardization be better treated under existing GATT codes? Is the concept of dumping relevant to the potential underpricing of telecommunications services? Should public procurement of telecommunications services be included in the government procurement code or applied according to certain stipulations and conditions?

The Regulatory Situation

In the 1970s the notion that telecommunications is a natural monopoly began to be challenged, and the economic and trade dimensions of the sector emerged. It is undeniable that the strict, comprehensive regulatory policies that have existed in telecommunications constrained private entrepreneurs seeking to offer enhanced services. The concept of appropriate regulation in the services agreement may help determine the proper but not excessive level of regulation of telecommunications services.

Assessing National Opportunities

The potential role of telecommunications in a multilateral service agreement is formidable. Assessing risks and opportunities is likely to be a complex and difficult exercise because of serious definitional problems concerning the direct and indirect effects of covering particular services under the agreement. The indirect consequences for liberalization of exempting value added services may have significant implications for other service sectors. Considerable methodological and statistical work also needs to be undertaken to determine the size and characteristics of national and international telecommunications markets.

It must be recognized, nevertheless, that the pace of Uruguay Round negotiations leaves little time for a systematic evaluation of the potential impacts of different policy choices on this sector. National capitals are necessarily the focal points for formulating trade policy on services, and this process should increasingly involve consultations with appropriate ministries and private organizations. Since telecommunications is a core service with many cross-sectoral implications, ministries of communications (or their equivalents) should be consulted for their technical, economic, and regulatory inputs into national policymaking.

A challenge of particular importance to developing countries is reconciling the trade and development aspects of an agreement. Telecommunications is a powerful tool for development that can be exploited by developing countries as a vital conduit for many kinds of service exports. Serious consideration should be given to devising mechanisms that will accomplish tangible results, to obtaining infusions of capital, to strengthening the existing international telecommunications system, and to encouraging greater access to technology.

The Uruguay Round negotiations on services have not only focused on the tradability of telecommunications services but have also lent urgency to the necessity of reforming telecommunications regulatory policy in most countries. In the course of the negotiations, telecommunications has been recognized as the essential core service—the motor for delivering most information intensive services. Some GNS delegations have argued that trade in services should be defined as transactions that involve cross-border movement of data and information, including access to the services of public telecommunications services and domestic distribution systems.

The centrality of telecommunications services to development and trade is likely to become an important element in comparative advantage among developing countries. Several countries, including Argentina, Senegal, and Singapore, have seized telecommunications as a major tool of development and trade expansion. This has led them to modernize their domestic infrastructures and liberalize their market structures. Organizations ranging from the ITU to the World Bank have called for reforms in telecommunications regulatory authority, a market situation for enhanced services, and greater rights for business users.

In many respects, developing countries face a narrowing zone of choices in telecommunications policy. This should not be viewed as inappropriate or undue pressure, for it is clear that prudent modernization of telecommunication regulation and services will benefit the national interests of all countries.

Notes

1. A questionnaire prepared by TDRS Inc. was sent to 502 individuals residing in forty-eight countries who had professional responsibilities in international organizations, national governments, businesses, higher education and research, journalism, and consultancy. The respondents were selected according to their interest or involvement in telecommunications or trade policy. A total of 197 responded, about 50 percent from Europe, 35 percent from North America, and 15 percent from Japan. Trade negotiators at missions in Geneva were included in the European group of respondents (*Transnational Data and Communications Report* November 1988, p. 5).

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12

The Tradability of Services

Karl P. Sauvant

Services often have to be produced when and where they are consumed. For this reason, the possibility of transporting, and hence of trading, many services is limited, and foreign direct investment or labor movements are often required to bring them to foreign markets.

This situation is changing fundamentally as the increased application of data services made possible through the merger of telecommunications and computer technologies permits a number of services (especially business services) to be produced in one location and simultaneously consumed elsewhere. The potential for growth of trade in services and the conditions for realizing this potential are of particular importance to the Uruguay Round, especially as regards the treatment of data services and their recognition as a core service. This chapter focuses on the impact of data services on the tradability of services and on some of the implications associated with increased tradability.

Some services are easy to trade—international transport and tourism are examples. But since most services are intangible and nonstorable, they are difficult to transport and trade. Most business services—banking and financial services, insurance, engineering, data services, accounting, consultancy, advertising, public relations, legal services, research and development, market research, management, and architectural services—fall into this category. Until recently, they had to be consumed when and where they were produced. In contrast to the situation with manufactured goods, the time and space of their production and consumption could not be separated. One implications of this was that the principle of comparative advantage had only limited applicability for international trade in services.

In spite of these inherent obstacles, trade in services has reached considerable proportions—approximately $560 billion by 1989 (see GATT 1989). During most of the 1980s trade in services grew even faster than trade in manufacturing goods.

Owing to the nature of services, the main vehicle for growth in international transactions in services has been foreign direct investment rather than trade in services. As table 12–1 shows, the growth of both outward and inward

Table 12–1. *Selected Developed Market Economies, 1981–87*
(average annual percentage growth)

Country	Services GDP [a]	Trade in services [b]		Foreign direct investment in services	
		Exports	Imports	Outward	Inward
Canada	8.7	7.6	9.2	15.2 [c]	10.0 [c]
Germany, Fed. Rep.	4.7	3.8	3.8	11.3	9.2
Japan	15.7	5.7	8.8	29.3	21.9
Netherlands	3.8	3.9	4.2	16.8 [d]	11.6 [d]
United Kingdom	9.7	9.0	9.9	38.5 [e]	17.8 [e]
United States	8.6	6.8	9.9	9.6	20.6

Note: Based on national currencies, current prices, except for data for Japan, which are based on dollars.

a. utilities, trading, construction, transport, communications, and other services.

b. Private nonfactor services—shipment, travel, other transport, and other private goods, services, and income.

c. 1980–86.

d. 1980–84.

e. 1981–84.

Sources: United Nations, Department of International Economic and Social Affairs, data base; IMF balance of payments statistics, vols. 37 and 39; and various national sources.

foreign direct investment for the principal industrial countries during the 1980s was considerably higher than the growth of gross domestic product (GDP) of services and of exports and imports of services. The overwhelming share of the growth of foreign direct investment in services took place in finance (including insurance) and trade (UNCTC 1989). By the end of the 1980s services had become the largest single foreign direct investment sector; it accounted for approximately 40 percent (about $400 billion) of the world's stock of foreign direct investment and between 50 and 60 percent (about $60 billion) of annual flows of foreign direct investment. As a result, foreign direct investment has become the main vehicle for the delivery of services abroad. For example, in 1982 U.S. exports of private nonfactor services were about $33 billion, as against approximately $178 billion of sales by U.S. affiliates abroad. Similarly, U.S. imports of services in the same year amounted to about $33 billion, compared with about $125 billion of sales by foreign service affiliates in the United States (Sauvant 1986a, p. 20).

The limited tradability of many services is an important reason why foreign direct investment, which increased rapidly in the 1980s, has been more important than trade in the internationalization of the service sector. The impact of data technologies is likely to change this pattern.

The Impact of Data Services

The 1980s witnessed the rapid development of data technology—technology that is grounded in microelectronics and operates on the basis of digital signals. One consequence of this technology has been the convergence of computer and telecommunications technologies and the emergence of data services: data processing, information storage and retrieval, software, and digital telecommunication services. Data services are rapidly expanding industries, both domestically and internationally (Sauvant 1986b).

Data services are also fundamentally changing the manner in which other services are delivered to foreign markets because they permit instantaneous, interactive, long-distance transactions by means of transnational computer communication systems—systems that link computers with one another for communications purposes. By collapsing time and space, data services make it possible for certain services—the information-intensive services—to be produced in one place and consumed simultaneously in another.

Retail banking provides an illustration. In the past, customers had to go to a bank to transact their business—to inquire about checkbook balances, to transfer funds, or to obtain funds. The services were typically produced and consumed face-to-face, when the customers were in the bank. Trade through mail, telephone, telex, or travel was not impossible, but it was typically cumbersome, time-consuming, impractical, and expensive, especially when interactive transactions were required. Today, a substantial number of banking services can be obtained through automated teller machines (ATMs), which are linked up into national and international networks. The banking services that can be provided in this manner now nearly amount to a full branch service: customers can use ATMs to pay bills, deposit cash and checks, buy travelers' checks, transfer money, order checkbooks, and obtain "fast cash" and immediate balance statements. Furthermore, such services as lending to firms, consumer finance, mortgage lending, securities underwriting, currency bond trading, foreign exchange services, brokering, cash letters, and fund collection and disbursal services are increasingly becoming available electronically. These banking services can now be obtained through computer communication systems; they are consumed in one place while they are being produced elsewhere.

Transnational corporations have gone the furthest in developing transportability. Many of these firms, and especially the largest ones, have established internal transnational computer communication systems that are used to assist a wide range of corporate activities, including financial management, marketing, distribution, inventory control, and accounting. Parent firms, for instance, can undertake all accounting services for their foreign affiliates or can handle their financial management. Many transnational corporations have, in fact, become dependent on the transnational use of data services to manage their operations better and more efficiently and to exploit new business opportunities. Take American Express, for example.

> Today American Express could not function without the capacity to move information across national borders with speed, accuracy, reliability and security. We rely on our international systems to allow us to provide a wide range of services: authorization of credit card transactions, replacement of lost or stolen travellers' cheques, travel reservations and other travel services, banking transactions by our international bank, and trading in securities, bonds and a host of other financial instruments.
>
> International communications also have made it possible for American Express to develop new services for our cardholders and for the establishments that accept the American Express card.
>
> Another new product that is the direct result of information-age technology is the automatic teller

> machine, which enables our travelling cardholders to withdraw cash or travellers' cheques in a rapidly growing number of outlets around the world. (Spero 1985, pp. 6–7.)

A recent study concluded that transnational corporations have become "dependent on computerized flows of information to conduct their business today—and will be more so tomorrow" (Business International 1982, p. 2).

The use of data services in conjunction with transnational computer communication systems makes it possible for a whole range of other services to be provided internationally within transnational corporations. This means that the services involved have become more tradable, albeit only within firms.

Closed user group networks extend this possibility to the sharing of services among certain firms, particularly in service industries that are information-intensive and especially dependent on the exchange of information. Most prominent among these networks are the Society for Worldwide Interbank Financial Telecommunications (SWIFT) and the Société de Internationale Télécommunications Aéronautiques (SITA). SWIFT, an interbank data network for international banking transactions, became operational in 1977 and by 1988 linked nearly 2,600 users in 60 countries, including about 95 percent of the world's top 500 banks. Between 1978 and 1988 the number of messages carried annually increased from 21 million to 255 million (SWIFT Annual Report, various issues). SITA is a worldwide network of leased lines that in 1988 carried nearly 500 billion characters among 336 airlines in more than 100 countries (SITA Annual Report, various issues). Closed user group networks have emerged in insurance, shipping, and hotels and have become the backbone of international transactions in their respective industries. Membership is required in order to benefit from the services being provided.

There is no reason why the international provision of information-intensive services should remain limited to transactions within transnational corporate networks or among firms that are members of certain closed user groups. Once the technical problem of transportability has been solved (at acceptable cost), all the services that are already being traded within firms or among members of a user group can also be made available to third parties, at arm's length and on a commercial basis. Thus the increased application of data services is making a whole range of services tradable, in that service products can be delivered over a distance. In this manner, trade options are created for firms that in the past could not serve foreign markets or had to serve them through foreign affiliates or the temporary movement of labor. This option may become particularly important for such information-intensive services as banking and other financial services, insurance, consulting and engineering, many professional services, research and development, education, and data services themselves. Network-based trade in banking has already reached considerable proportions.[1]

Implications

The emergence of data services, by creating a substantial network-based trade option where before there were no or only very limited choices, is fundamentally changing the manner in which information-intensive services can be delivered to foreign markets. Data services are therefore a core service; they not only constitute industries in their own right but also provide the means for overcoming the inherent obstacle to trade in many services—the intangibility, nonstorability, and hence nontransportability of these services. This section explores some of the implications of this fundamental change.

Comparative Advantage and the International Division of Labor

Increased tradability means, first of all, that information-intensive final services (bill payments, insurance policies, software, and so on) can be delivered abroad by way of telecommunication lines. It also means that individual components in the services production chain can become tradable and that specialization can take place, as in manufacturing. The production process of information-intensive services can be split up, individual service components can be produced in countries that have a comparative advantage because of, for example, lower costs, and these components can subsequently be sent to the place where the final product is required.[2] The concepts of specialization and comparative advantage thus become fully applicable to the production and trade of information-intensive services—not only final services but also semifinished ones.[3]

To take an illustration of the impact of data technology, a New York insurance firm has established an affiliate in Ireland to process insurance claims.[4] A transatlantic telecommunications line links the affiliate to the parent company's data processing center in the United States. Insurance claims collected in the United States are shipped daily by air to Ireland, where they are processed. The claim information is then sent through transnational computer communication systems back to the United States, where checks are printed and explanations of benefits are mailed out. There were two motivations for moving a part of the firm's operations abroad: lower labor costs and difficulties in finding enough skilled workers to process insurance claims at home.

For many services, the possibility of an international division of labor in the production of information-intensive services has existed up until now only in a very limited sense. Increased tradability is therefore bound to have profound implications for supply patterns and for the structure of service industries. The corporations that are the first to take advantage of the potential offered by the new data technologies may be the first to reach global economies of scale and may therefore acquire a substantial advantage with respect to local and other rivals.

Effects on the Nature of Foreign Service Affiliates

The possibility of splitting up the production process, specializing, and taking advantage of an international division of labor can have significant implications for foreign direct investment in services and for the nature of service affiliates abroad. Manufacturing firms can build transnational affiliate networks, and an intrafirm division of labor can allocate capital-intensive and skill-intensive activities to parent corporations and labor-intensive (and, in particular, unskilled-labor-intensive) operations to foreign affiliates, perhaps in developing countries. The high level of intrafirm trade between manufacturing parent firms and their foreign affiliates is a manifestation of that ability. Service firms also build transnational affiliate networks, but so far, precisely because of the low tradability of many services, it has not been as easy for them to split their production activities so as to match the factor proportions of subprocesses with the factor prices of host countries. Consequently, intrafirm trade in the services sector is considerably lower than in the manufacturing sector.

As a result (if U.S. data are indicative), foreign service affiliates, unlike their manufacturing counterparts, appear to be more like their parent firms in terms of skill levels, the use of soft technology, and physical capital intensity—they tend to reproduce abroad the factor proportions used at home (see table 12–2). Foreign service affiliates are more like miniature versions of their parent firms than specialized units in a worldwide production network; that is, they are more complete and free-standing than foreign manufacturing affiliates. Traditionally, foreign service affiliates are more valuable to their host countries than are their manufacturing counterparts in terms of skills, soft technology, and physical capital intensity but not in terms of exports.

Increased tradability may change this situation fundamentally. Affiliates no longer need to be free-standing miniature versions of their parent firms. Rather, they can fulfil specialized tasks in the framework of a global international (intrafirm) division of labor and trade the results of their labor through transnational computer communication networks. In the extreme case—in industries that are very information-intensive—some foreign affiliates may be reduced to terminal affiliates that merely enter data such as insurance or travel information while most of the value (for example, risk calculation and fare construction) is added elsewhere. That would represent a complete reversal of the current situation of foreign service affiliates and could have profound effects on the character, impact, and level of foreign direct investment in services and on its importance for host countries. At the same time, however, it would open new possibilities for substantial growth in network-based intrafirm trade in services.

The Potential for Network-Based Growth of Trade in Services

If the impact of data services is indeed of the nature suggested earlier, there is considerable potential for a dynamic increase in network-based trade in final and semifinished services, both among and within firms. In other words, substantial new business opportunities may arise for firms that take advantage of the possibilities offered by data services. The size of this potential is difficult to ascertain, and for many services, such as government, it is certainly negligible. But it is clear that, because of the limited tradability of many services to date, the relative importance of international trade in services does not reflect the relative importance of services in the domestic economy.

Thus, for instance, although the service sector accounts for 50–60 percent or more of the gross national product (GNP) of the developed market economies, it makes up only about one-fifth of the total trade of all countries. Trade in industrial products involves about 45 percent of world industrial production, whereas in services it is roughly 10 percent (Clairmonte and Cavanagh 1984, p. 224). The relatively low degree of internationalization of the service sector compared with that of the industrial sector is even observable in foreign direct investment (at least to the extent that U.S. data are indicative). By the mid-1980s the average foreign content of U.S. service firms (excluding banks) with investment abroad was considerably lower than that of their industrial counterparts: only about 17 percent of the total assets and sales and 11 percent of the total employment of these firms were abroad. By comparison, the figures for transnational manufacturing corporations were approximately twice as high, and those for petroleum firms were even higher than that (see table 12–3). Service firms are now

Table 12-2. ***Characteristics of U.S. Service and Manufacturing Transnational Corporations, 1982***

Variable	*Services*	*Manufacturing*
R&D intensity		
R&D expenditure as percentage of sales		
Parents	0.11	3.03
Affiliates	0.10	1.15
In developing market economies	0.13	1.31
In developing countries	0.02	0.46
R&D employment as percentage of total employment		
Parents	1.05	4.91
Affiliates	0.75	2.27
Skill level (compensation per employee, in thousands of dollars)		
Parents	24	30
Affiliates	19	17
In developed market economies	20	21
In developing countries	15	9
Capital intensity		
Physical capital intensity (thousands of dollars) [a]		
Parents	52	30
Affiliates		
By industry of parent	21	20
By industry of affiliate	26	20
Assets per employee (thousands of dollars)		
Parents	192	97
Affiliates	214	57
In developed market economies	164	65
In developing countries	348	39
Trade (percentage of sales)		
Parents		
Total exports	6.1	11.1
Exports to affiliates	1.3	4.3
Imports from affiliates	0.9	2.9
Affiliates		
Total exports	40.3	34
Exports to parents	4.3	8
Imports from parents	8.3	12

Note: R&D, research and development

a. Net property, plant, and equipment per worker.

Source: UNCTC (1989), p. 111.

Table 12-3. ***Share of Foreign Affiliates in Total Activities of U.S. Nonbank Transnational Corporations, 1984***

	Share of foreign affiliates in		
Industry	*Sales*	*Assets*	*Employment*
All industries	26.2	19.7	25.9
Manufacturing	27.3	24.4	30.3
Petroleum	41.7	34.2	31.1
Other industries	25.3	21.7	39.7
Services	16.6	11.3	16.9
Finance, insurance, real estate [a]	12.0	9.7	27.9
Trading	18.0	14.7	16.5
Transport, communications, public utilities	6.5	7.1	10.7
Construction	23.6	22.5	16.3
Professional business and other services	11.6	12.7	10.9
Petroleum-related services [b]	28.7	20.5	25.6

a. Includes holdings and financial affiliates of industrial corporations, excluding nonbusiness entities..

b. Oil and gas field services, petroleum wholesale trade, petroleum tanker operations, gasoline services stations, and the like.

Source: UNCTC (1989), p. 53.

engaging in more investing abroad than are industrial ones, but worldwide, the service sector is considerably less transnationalized than the industrial sector.

The point is not that within a few years the share of trade in services in total trade will be as high as the share of services in GNP or that the share of services production traded will be comparable to that for industrial production. But the comparisons do suggest that once the intangibility, nonstorability, and nontransportability of certain services are no longer obstacles to trade, there could be a dynamic expansion in trade in services.

Realizing the Potential

The extent to which this potential can be realized and exploited depends on a number of factors. Perhaps the most important of these are the ability to utilize the underlying technology, the availability of the required network infrastructure, access to transnational computer communication networks, and access to markets.

The ability to utilize the underlying technology, be it to export or import services or to manage transnational affiliate networks better, is the technological precondition for benefiting from the increased transportability of information-intensive services. Data technology as such is widely available in the international market. But the development of specialized application software (that is, the machine-readable programs, procedures, and rules that allow the electronic devices making up a computer communication system to perform certain tasks and so turn a stationary service into a tradable one) requires highly specialized skills, sophisticated hardware, considerable research and development, and extensive experimentation—all of which are very expensive.

In addition, the utilization of the underlying technology, and especially the application of digital telecommunications technology, require computer communication networks. In addition to merely transporting data, these networks have such value added features as packet switching, automatic rerouting, intermediate storage, compatibility services, maintenance-related support services, and electronic mail services. The operators of value added networks normally lease lines from basic carriers (for example, AT&T in the United States and post, telegraph, and telephone—PTT—systems in other countries) and combine them with computer equipment of their own, thus creating enhanced computer communication systems dedicated solely to the transport of data. International systems of this kind can be created by linking up national networks. This process is virtually complete among the industrial countries and is taking place in a growing number of developing countries, but the difference in coverage and sophistication is still considerable. The infrastructure, in turn, can be used to build specialized networks of, for example, the intrafirm or closed user group variety. In sum, transnational computer communication systems are of central importance for the growth of trade in information-intensive services: they are the electronic highways for world trade in services.

Computer communication systems are useful only if one has access to them. The technical aspect of access—for instance, which protocols to use in order to have a technical interface—is the province of the International Telecommunications Union and no longer presents a major problem. A related issue concerns the right to connect equipment to the telecommunications network—a right that is restricted in many countries. These technical and administrative matters have profound economic implications, not only because they can be barriers to trade but also because the choice of standards and the permission to connect certain equipment to a network can give considerable advantages to one firm over another.

There is also the question of access to the growing number of specialized private or quasi-private computer communication systems and the databases associated with them, most of which are of the intrafirm or closed user group type. For instance, airline computer reservation systems have become an important component of the airline industry and a lucrative source of revenue. If an airline has established such a system, should other airlines be permitted to list their flights on it as well, and if so, in what order? The significance of these questions can be seen from the following facts. In 1984 about three-quarters of the 21,000 United States travel agents were linked to computerized reservation systems, and four of the six most important systems gave preference to the airlines that owned them in listing flights on the computer screens. Travel agents make about 85 percent of their bookings on flights shown on the first screen and 50 percent on the flights shown on the first line of a screen.[5] Access to such specialized networks is therefore an important factor in the effective utilization of data technology—especially since such networks are likely to become more important in the future—and it is a precondition for benefiting fully from the increased tradability of information-intensive services.

The last factor is access to markets. A number of existing regulatory and administrative practices impede the delivery of data services via computer communication systems. Many of them are indirect and include primarily technical measures and regulatory and administrative practices. Most of them focus on the flow of data services as such, especially the provision of data processing, information storage and retrieval services, and software (Conference Board 1984). They are mainly imposed to encourage the growth of domestic data industries (the case of Brazil is particularly prominent here; see UNCTC 1983) and to increase the revenue of PTTs. But overall, the existing measures are relatively unimportant and do not represent major obstacles.

This situation could, however, change drastically as soon as the volume of services traded via computer communication networks reaches a sizable amount and national authorities begin to appreciate fully the importance of this development for the entire service sector. At that point the full arsenal of traditional trade instruments—including taxes and tariffs on data flows,[6] local content requirements, infant industry measures, and various other forms of protectionism—could well come into play to restrict or encourage network-based trade in services. Such a development would obviously hinder the growth of such trade and impede the realization of the potential promised by the increased tradability of information-intensive services. Logically, those who have the best chance to benefit from increased tradability have the greatest interest in establishing an international framework for trade in services in general and data services in particular. Such a framework would, most importantly, prevent the introduction of new barriers to transborder data flows.

This raises the question of who would benefit from the trade-creating potential of information-intensive services. The first to benefit would be firms from industrial countries, which have developed the application of these technologies furthest, have access to the required infrastructure, and they have created most of the existing networks. In addition, most transnational corporations—which use data services for intrafirm purposes—are headquartered in industrialized countries. But firms from developing and socialist countries stand to benefit as well because data services provide them with a wider range of options for obtaining the services needed for their development, be it in terms of the manner in which they can be obtained (import or foreign direct investment), the range of suppliers, or, more generally, information about international markets. Developing countries also have opportunities for developing exports of services that are information-intensive and in which they have (or can develop) a comparative advantage. These include software, information storage and retrieval, engineering services, and accounting—in principle, all the services the tradability of which has been increased through the application of data services.

For some services increased tradability may even help to sidestep, at least to a certain extent, the thorny question of labor movement. For instance, software specialists, instead of having to move to another country to produce their services, can provide the services from home through computer communication systems. A whole range of new opportunities is being opened up, and firms in all countries are potential beneficiaries. Still, the distribution of benefits, especially between developed and developing countries, appears to be uneven, precisely because the ability to use data technologies is unevenly distributed, the infrastructure is inadequate in developing countries, the networks are mostly located in developed countries, and hence the ability to export and import services via computer communication systems is uneven.

Not surprisingly, therefore, service firms from industrial countries and, subsequently, the governments of these countries, have taken the lead in efforts to establish a stable, predictable, and transparent international framework for trade in services—a framework that would permit the progressive liberalization of this trade. Logically, furthermore, this framework would have to cover data services as a core service, especially the enhanced digital telecommunications component (see Feketekuty 1988, 1989). The input of the private sector into relevant international negotiations—first in the framework of the Organisation for International Co-operation and Development (OECD), then in the framework of the Uruguay Round—bears this out. In the OECD these efforts led to the adoption of a Declaration on Transborder Data Flows in April 1985 (see Sauvant 1986) The declaration acknowledged that, to date, transborder flows of economic data are subject to few restrictions; it underlined the importance of transparency and stability of policies, regulations, and practices for investment and trade in this field; and it drew attention to the social and economic benefits to be drawn from access to data. Most important, the declaration established for the first time the principle that governments should avoid creating unjustified barriers to transborder data flows. In the Uruguay Round the private sector, especially in the United States, consistently stressed the importance of data services and the need to ensure an open international system for the flow of enhanced telecommunications services (see Robinson, Sauvant, and Govitrikar 1989). Only such a system would allow the full realization of the potential offered by the increased tradability of services.

Conclusions

Technological changes have opened new opportunities in the area of trade in services. Data services themselves have become more tradable, and because they are core services they help make other services more tradable as well. Firms in both developed and developing countries can benefit from these opportunities. But the awareness of these developments and opportunities is not widespread in either developed or developing countries. Raising awareness is therefore an important task, as is bridge building between, on the one hand, specialists in data services and, in particular, telecommunications and, on the other, trade policymakers and specialists.

A good part of this awareness raising, especially in developing countries, ought to focus on the importance of data technologies and their core nature, the need to master these technologies, and the necessity for strengthening the infrastructure through which access to world service markets can be obtained. Training, technology transfer, and investment in the telecommunication infrastructure are, therefore, priority tasks. Since the requirements in this field are beyond the capacities of many developing countries, a massive infusion of technical assistance is required.

Access to world service markets requires that the networks through which services can be provided be effectively open to all service providers—that is, not closed to some service providers or biased in favor of others. This issue increases in importance as enhanced telecommunications services in a growing number of countries are liberalized and as parts of the networks become privatized and hence closed to general usage. Service providers may increasingly face a situation in which the most sophisticated parts of the electronic highways for trade in services are not generally accessible. (In goods trade it is simply assumed that producers have access to the transport system—roads, railways, and airplanes—but this assumption cannot be made for network-based services trade.) To develop an equitable regime in this respect is, therefore, an important public policy task. But it is not an easy one, because many of the networks have been built or are being built through private investment, often precisely with the purpose of giving some firms or groups of firms an advantage over their competitors.

Access to world markets also requires that service providers have access to consumers. National development objectives must, of course, be taken into account too. To establish a framework that promotes these twin goals is an important international public policy task, and this is the objective of the current Uruguay Round of negotiations on trade in services, including data services. But access to consumers is only one aspect of access; additional conditions must be met before a network-based growth of trade in services can make a full contribution to the economic growth of all trading partners and to economic development. Furthermore, since the new opportunities in trade in services allow transnational service providers to have a considerable impact on economic development, an international public policy framework should contain not only rights for service providers but also obligations—regarding, for example, restrictive business practices, the impact on the balance of payments, training, and the like. In other words, the international framework should be holistic.

The increase in tradability may lead foreign service affiliates in information-intensive industries to become less complete and free-standing and may thus decrease their potential to contribute to host countries. Governments may have to examine whether the right of establishment should be complemented in certain industries by a "duty of establishment" to ensure that foreign service affiliates contribute to national development rather than becoming merely terminal affiliates.[7]

The precise nature of the new opportunities is still far from clear. Which services are becoming more tradable, to what extent, and in what manner? Which components in the service production process are becoming tradable and could conceivably be produced elsewhere? It is necessary to take a whole series of information-intensive service industries, select their principal products, examine the production processes for each, and identify the components that are becoming tradable through the use of data technologies. Such practical work, which requires technical cooperation that could be highly useful for developing countries in particular, could be an important task for regional and international organizations with an interest in ensuring that all countries benefit as much as possible from the increased tradability of services.

Notes

1. See the data on SWIFT above. This may also explain, at least partly, why the number of foreign offices of the largest 100 transnational banks barely increased, from 4,413 in 1980 to 4,660 in 1985; see UNCTC (1989, p. 75).

2. To a certain extent, this is the international extension of a process that has already taken place within countries. In the United States, for example, many service companies have moved some "back office" clerical, accounting, and data processing operations away from urban headquarters sites (such as New York), where office costs, housing costs and taxes are high.

3. The point is not that, so far, the concept of comparative advantage has not applied to services. Countries endowed with certain attractions (including scenery) obviously have a comparative advantage in tourism, countries with substantial unskilled labor may have a comparative advantage in the export of labor-intensive services such as construction, and countries with substantial skilled labor may have a comparative advantage in the export of software or engineering services. Factor endowments have always played a role, but within the confines of the limited transportability of services.

4. "The Growth of the Global Office," *New York Times*, October 18, 1988.

5. See "A Choice of Brands," *Economist*, August 25, 1984, p. 14.

6. Taxing data flows or putting a tariff on them may be difficult, but it is not impossible. The tax could be placed on the volume of data transmitted, as is done with long-distance telephone traffic, or (a more difficult alternative) on the value of the data transmitted. As with

shipments of goods across borders tax authorities could request that a bill of lading or customs declaration be added to each economically relevant data package sent. Such a "data bill of lading" could indicate the nature and value of the data involved. The technology for administering volume-sensitive or value-sensitive rates appears to exist. It is worth noting here that the GATT Valuation Code has set an international precedent for assessing certain services. The GATT Committee on Customs Valuation decided at the end of 1984 that it is permissible (as desired by developing countries) to include the value of software in the calculations when determining the value of a carrier medium such as a tape, although it is also permissible (as desired especially by the United States) to take only the cost or value of the carrier medium into account. As the chairperson of the committee remarked, "Indeed, if the technical facilities are available to the parties to the transaction, the software can be transmitted by wire or satellite, in which case the question of customs duties does not arise" (GATT 1984). But the issue is precisely the increasing availability of these technical facilities and the possibility that customs authorities may impose a tariff on transborder data flows. It may well be only a question of time before data flows are subject to taxes or tariffs.

7. This is, of course, the logic of the Brazilian policy on transborder data flows (see UNCTC 1983).

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Part III

Country Experiences and Perspectives

13

The United States

Bela Balassa

This chapter focuses on the effects that liberalization of trade in services may have on the United States. It examines U.S. "revealed" comparative advantage in services as indicated by the available trade data, barriers to exports of U.S. services abroad, and restrictions on imports of services into the United States. It concludes with a discussion of the position taken by the U.S. government and private interests with regard to liberalization of trade in services.

The Determinants of Comparative Advantage in Services

The best-known empirical investigation of comparative advantage in trade in services is a nearly decade-old paper by Sapir and Lutz (1981), who sought to explain international trade in services in terms of intercountry differences in factor endowments and country size. Freight, passenger services, and insurance were analyzed, and the sample of countries varied according to the availability of data. The authors hypothesized that comparative advantage in freight services is positively related to an economy's capital-labor ratio (on the assumption that shipping is capital-intensive) and to country size (because of the existence of scale economies in shipping). The results support the first hypothesis—that countries relatively well endowed with physical capital have a comparative advantage in freight services—but not the second.

Transport of passengers is also considered to be capital-intensive.The hypothesis that comparative advantage in passenger transport is positively related to the country's capital-labor ratio is borne out by the empirical results. It further appears that a positive trade balance in travel contributes to the export of passenger transport services.

Carter and Dickinson (1979) have suggested that in international trade in insurance the essential element "is a well-educated labor force, including a whole range of professional expertise in financial, legal, and technical subjects" (pp. 44–45). Here too, a size effect has been postulated. Sapir and Lutz found that human capital and scale are the factors that determine comparative advantage in insurance services. This conclusion applies to total insurance as well as to merchandise and nonmerchandise insurance. Total and nonmerchandise insurance appear to make relatively intensive use of higher education, whereas merchandise insurance appears to be relatively intensive of secondary education.

The implications of these results for the United States depend on the country's relative endowment of physical capital (for freight and passenger transport) and human capital (for insurance). Among the fifty-two countries studied by Sapir and Lutz, the United States ranks fifth in terms of the ratio of physical capital to labor, behind Israel, Switzerland, Sweden, and Norway. It appears, then, that the United States has a comparative advantage in freight services and in passenger transport. The country ranks seventh—behind New Zealand, Canada, Yugoslavia, Austria, the Republic of Korea, and the Netherlands—in terms of the level of secondary education, measured by the ratio of enrollment to the size of the relevant age cohort. It follows that the United States has a comparative advantage in merchandise insurance. Finally, the United States ranks first in terms of the level of higher education, measured by the ratio of enrollment to the relevant age cohort. This means that it has a comparative advantage in nonmerchandise insurance as well as in total insurance.

"Revealed" Comparative Advantage in Services

To shed light on the U.S. comparative advantage in a wider array of services, the concept of "revealed" comparative advantage has been used. This concept, originated by Balassa (1965), interprets a country's comparative advantage in terms of its relative trade performance (net exports). It has been widely used in investigations of merchandise trade.

Sapir and Lutz found that passenger transport and freight services are exported by capital-abundant countries and that the United States is such a country. The United States might therefore be expected to be a net exporter of passenger transport and freight services. But as table 13–1 shows, the United States has a net import balance in both passenger transport and freight that is not fully offset by its net export balance in port services. Further discussion of these items is not necessary in the present context, however, since regulations on transport services are similar in most countries.

Sapir and Lutz also predicted that the United States would be a net exporter of insurance. This turns out to be the case for primary insurance but not for reinsurance, in which the United Kingdom appears to possess traditional advantages.

The United States' large net import balance in travel largely reflects its comparative disadvantage in this labor-intensive activity. This import balance would be reduced to some extent if foreign exchange restrictions applied by a number of developing countries were eliminated.

Table 13–1. ***U.S. International Sales and Purchases of Services, 1987***
(millions of dollars)

Services trade	*Sales*	*Purchases*
With unaffiliated foreigners	66,482	66,256
Passenger fares	6,882	7,423
Other transport	16,989	18,164
Freight	4,700	10,999
Port services	11,575	6,360
Other	714	805
Insurance	2,285	3,168
Primary insurance, net	1,596	552
Reinsurance, net	689	2,616
Travel	23,505	29,215
Royalties and license fees	2,171	522
Business, professional, and technical services	4,270	1,425
Accounting, auditing, and bookkeeping	27	37
Advertising	108	140
Computer and data processing	629	61
Database and other information services	138	28
Engineering, architectural, construction, and mining, net	936	368
Installation, maintenance and repair of equipment	1,023	506
Legal services	148	56
Management, consulting, and public relations	379	50
Medical services	516	n.a.
Research and development, commercial testing and laboratory services	182	127
Other	184	52
Telecommunications	2,105	3,701
Financial services	3,731	2,077
Education	3,804	513
Film rentals	740	48
With affiliated foreigners	14,988	6,210
With foreign parents	2,923	3,150
Royalties and license fees	240	1,083
Other services	2,683	2,067
With foreign affiliates	12,065	3,060
Royalties and license fees	7,049	150
Other services	5,016	2,910
Total	81,470	72,466

Source: Ascher and Whichard (1989).

The large positive balance in royalties and license fees is not related to the Heckscher–Ohlin explanation of trade flows but is, rather, explained by the United States' technological advantages.

The United States has a large net export balance in business, professional, and technical services and for all items within the category except for accounting, auditing, and bookkeeping and advertising. (It has small import balances in these items.)

U.S. net exports in computer and data processing services are large: sales total $629 million and purchases $61 million. Software services (excluding custom programming) account for two-thirds of the total. This category consists of both prepackaged software and rights to use, reproduce, or distribute such software. Also in the computer and data processing services category are integrated hardware-software systems and system analysis, design, engineering, and custom programming services.

The United States has a net export balance in database and other information services, with sales of $108 million and purchases of $28 million. Business and economic database services and miscellaneous database services fall under this category.

Net export balances are also shown for engineering, architecture, construction, and mining (sales of $936 million and purchases of $368 million); installation, maintenance and repair of equipment ($1,023 million and $506 million); legal services ($148 million and $56 million); management, consulting, and public relations ($379 million and $50 million); research and development, commercial testing, and laboratory services ($182 million and $127 million); and other services ($184 million and $52 million). Sales of medical services amount to $516 million; data on purchases are not available but are likely to be small.

A seemingly abnormal case is telecommunications, in which U.S. sales are $2,105 million and purchases are $3,701 million. The imbalance is entirely attributable to telephone services, in which the United States has a large import balance; it has a net export balance in other telecommunications services. The net import balance for telephone services is a recent phenomenon that is explained by differential rates of increase in the volume of telephone calls and by differential rates of change in the cost of the calls. Between 1985 and 1987 the volume of telephone calls from the United States to other countries, measured in minutes, increased by 47 percent, whereas calls from other countries to the United States increased by only 27 percent (Federal Communications Commission 1988). In 1987 the volume of outgoing telephone calls totaled 3,153 million minutes, as against 1,567 million minutes for incoming calls. Moreover, about 75 cents of every dollar collected by U.S. carriers from international telephone calls is owed to the foreign carriers that terminate the telephone calls because the accounting rates used in transfers among the carriers have not been reduced along with the actual rates paid. If it were not for this discrepancy, the United States would not have a net import balance in telephone services (Federal Communications Commission 1988).

In financial services the United States has exports of $3,731 million and imports of $2,077 million. A careful study by Hilaire and Whalley (1986) confirms the U.S. export surplus. The authors applied estimates of the spread between deposit and lending rates for U.S., U.K. and Canadian banks and for banks in their largest partner countries to corresponding data on the assets and liabilities of domestic banks with nonresidents and of nonresident banks with residents. These yielded an estimate of the value of intermediation services provided by domestic banks to depositors and borrowers abroad, and by nonresident banks to domestic depositors and borrowers. The combined financial intermediation charge was apportioned between the parties to calculate the internationally traded components. The results show U.S. banking exports of $4.03 billion and imports of $3.04 billion, as against U.K. exports of $2.55 billion and imports of $4.40 billion and Canadian exports of $0.72 billion and imports of $0.42 billion. Thus the United States appears to have a revealed comparative advantage in banking services.

In education U.S. exports were $3,804 million and imports were $513 million. Exports in film rentals were $740 million and imports were $48 million.

The information provided so far concerns transactions with unaffiliated foreigners. Transactions within multinational corporations exhibit a large net export balance for the United States, with sales of $14,988 million and purchases of $6,210 million (table 13–1).

Barriers to Services Trade in the United States and Abroad

The U.S. *Report on Foreign Trade Barriers* (USTR 1989) reviews perceived foreign barriers to U.S. services exports in various countries. Some of its observations follow.

> Restrictive investment laws, administrative nontransparency, legal and administrative restrictions on remittances and arbitrary application of regulations and laws limit U.S. service exports to Brazil. Service trade possibilities are also affected by limitations on foreign capital participation in many service sectors (p. 20).
>
> The Indian government either partially or entirely runs most major service industries. Restrictions on

trade in services follow the same pattern and rationale as restrictions on trade in goods and foreign investment. Officials fear allowing more scope to foreigners would diminish control over strategic industries, adversely affect inefficient service monopolies and add a new drain on foreign exchange (p. 87).

Korea continues to maintain restrictions on some service sectors through a "negative list." In these sectors foreign investment is prohibited or severely circumscribed through equity participation or other restrictions. Those sectors of greatest interest to U.S. investors and service providers include professional services (such as accounting, legal and financial services) advertising, maritime transport, and telecommunications services (pp. 120–21).

This section reviews barriers to U.S. services abroad of the kind described above. It interprets services in a broader sense to include patents, trademarks, and copyrights. This is appropriate, since intellectual property involves service transactions.

A variety of products, including foodstuffs, beverages, pharmaceuticals, agrochemicals, chemical compounds, agricultural machinery, and metal alloys, are not patentable in one country or another. Some countries set conditions for patent protection—requiring, for example, that patented pharmaceuticals embody new technology. In several instances, especially for pharmaceuticals, only processes can be protected, and other producers may, consequently, enter the field with competing products that have been manufactured by different processes.

Patent protection is often available for only a short period, thereby limiting the firm's interest in the manufacture of the product. Obtaining patent protection may be a slow process that gives other producers an opportunity to establish themselves.

Continuous use of trademarks may be a requirement for their registration. The process of registering trademarks is often slow, and the enforcement of trademark protection has encountered problems. It may not be possible to register service marks (trademarks pertaining to services).

As for copyright, there have been disputes between the United States and other countries regarding the limitations imposed on the value of broadcasting and video material originating in the United States and regarding taxes on this material. Other disputes have concerned copyright laws. Some countries have no copyright laws for books or audio and video recordings. Others have such laws, but their practical application is deficient, and there is considerable pirating of copyrighted material. Furthermore, the duration of copyright protection is often very short.

Copyright of computer applications has become important in recent years. The Brazilian government has mandated that all data received from unrelated parties be processed in Brazil, and it has limited foreign equity participation in Brazilian information industries. In other countries no copyright protection exists for collective work such as databases and software, and database creators are effectively excluded from protection. Several countries provide no protection, or only weak protection, for computer software and programming.

In accounting and advertising, foreign accounting firms may not be allowed to operate unless they are in partnerships with domestic firms, and majority foreign participation may not be allowed in the advertising industry.

State corporations may have a monopoly position in insurance, and marine insurance for exports and imports may be reserved for domestic firms. Some countries require foreign insurers to cede 30 to 60 percent of all transactions to the state-owned reinsurance company and limit the equity that may be owned by foreign insurance companies. Finally, insurance firms may be prohibited from establishing subsidiaries and joint ventures with noninsurance enterprises.

The offer of what in U.S. terminology is called enhanced telecommunications services (in most other countries the term is value added telecommunications services) may be limited to a state-owned or state-franchised monopoly. Even where foreign firms are permitted to compete with state-owned telecommunications administrations, restrictive terms and conditions imposed on the use of telephone lines may make competition difficult or impossible. For example, Japan's Ministry of Education uses the TRON (Real Time Operation System Nucleus) system as a technical specification for personal computers, and the NTT (the company that provides basic telecommunications services) has announced that it will require TRON for the next generation of the digital communications network.

Restrictions are also imposed on legal and financial services and on construction, architectural, and engineering services. All of these restrictions are described in USTR (1989), which considers them important obstacles to U.S. exports of services.

There is no comparable compilation on U.S. barriers to imports of services except for the report by the European Community (EC 1989). That study notes that the United States has entered an exception to article 11(5) of the Patent Application Treaty, effectively postponing the date by which foreign patents become valid in the United States. It further observes that the application of the cabotage principle effectively denies foreign air carriers access to the internal U.S. market and that, with some limited exceptions, U.S.-flag air carriers must be used for international transport of government property and federal employees.

In waterborne transport, access to domestic trade (that is, trade that uses coastal, intercoastal, and inland waterways) is reserved for U.S.-flag vessels built in the United States and owned by U.S. citizens. U.S. law prohibits foreign vessels from carrying cargo or passengers from one U.S. port to another if the second U.S. port is the final destination. And at least 50 percent of all international cargoes generated by programs sponsored by the U.S. government is allocated to U.S.-flag vessels unless none are available.

Laws and regulations that affect foreign suppliers of services other than transport are far less significant deterrents. State governments, however, regulate banking, insurance, transport, and certain communications, and the wide variety of differing requirements complicates the operations of foreign businesses.

Developing the U.S. Position on Liberalization of Trade in Services

U.S. proposals for liberalizing trade in services conform to the general philosophy of deregulation in the United States, where, over the past decade, important steps have been taken to deregulate aviation, truck transport, and banking. Statements by U.S. authorities emphasize the potential gains from the liberalization of services trade for all participants, not just the United States. According to the official U.S. statement submitted to the General Agreement on Tariffs and Trade (GATT) in 1982 by William Brock, then the U.S. Special Trade Representative, "the basic goal of any future negotiations should be to expand opportunities for trade, making possible the economic gains that can be obtained from trade based on comparative advantage" (Brock 1982, p. 238). But the fact that U.S. political and business groups were in the vanguard in introducing services issues in the trade negotiations reflects the belief that liberalizing trade in services would benefit the United States. The extensive barriers against U.S. exports of services described in the previous section bear out this perception.

Trade liberalization in services was mandated by the Trade Act of 1974, which for the first time stated that "the term 'international trade' includes trade in both goods and services" (section 102). Section 121, which dealt with the reform of the GATT, directed the administration to seek "the extension of GATT articles to conditions of trade not presently covered in order to move toward more fair trade practices." Although the United States was not able to get more than a few references to services trade in the Tokyo Round agreements, it subsequently persuaded the other industrial countries of the Organisation for Economic Co-operation and Development (OECD) to undertake a study on services with a view to identifying areas for future negotiations. This led to the preparation of a paper entitled "Elements of a Conceptual Framework for Trade in Services."

In the meantime the United States pressed for further discussion of trade in services in the GATT framework and proposed that the work of the GATT include a study of the topic. After a prolonged debate between the developed countries, which came to support the U.S. position, and the developing countries, which opposed such a study, the trade ministers agreed in November 1982 that countries "that were so inclined could undertake national studies of trade in services."

The United States was the first to circulate a national study, in the spring of 1984. This study was part of a strategy for building support for the negotiations that became part of the Uruguay Round. The strategy has been successful; trade in services is on the Uruguay Round agenda.

The interrelationships between government and business have been important to the development of the U.S. position on trade in services. As Feketekuty (1988, pp. 5, 70) notes:

> International trade in services has become an important issue because international trade in services has become big business, and the enterprises that conduct trade are counted among the largest corporations of the world. . . . A model of the world economy that does not accommodate trade in services has become increasingly unacceptable to enterprises selling services. These enterprises do not see a fundamental distinction between the sale of services and the sale of manufactured goods to customers in other countries.

These statements are supported by a variety of business surveys. Mention may be made, in particular, of Price Waterhouse (1985), which reported on the results of a survey of Fortune's Directory of Service Companies (Price Waterhouse 1985). It should be added, however, that the interests of large business firms lie not only in their services exports but also in the production of services abroad. Thus, from the point of view of the balance of payments, there may be a divergence between the national interest in promoting exports and the interest of the firm in selling services, no matter where they are produced (Kravis and Lipsey 1988).

The United States Service Proposal

On October 23, 1989, the United States introduced a comprehensive proposal on services in the Uruguay

Round of multilateral trade negotiations. The U.S. proposal seeks to open work services markets. It is a flexible proposal, as it provides for countries to take limited reservations for those existing measures that do not conform to the agreement. Reservations could be entered for a finite period of time and would provide the starting point for future rounds of liberalization of trade in services.

The principal obligations that countries would assume under the U.S. proposal are divided into two parts. Several provisions concern various ways of providing market access (articles 4 to 7). Others are designed to protect market access (articles 8 to 15).

Market access includes the following items:

- *Establishment.* Extends the right to establish or expand a business in another country in order to provide a service in that country
- *Cross-border provision of services.* Extends the right to sell a service that is produced by one country in another country
- *Temporary entry for service providers.* States that countries should facilitate the temporary entry of service providers
- *Licensing and certification.* States that such measures should relate principally to competence or ability to provide services and should not discriminate against foreigners.

Other substantive obligations include the following items:

- *National treatment.* States that foreign service providers should receive treatment no less favorable than that accorded to domestic service providers
- *Nondiscrimination.* States that the benefits of the agreement should apply to all signatories, with agreed–on exceptions
- *Exclusive service providers and monopolies.* Requires countries to ensure that an exclusive or monopoly provider of services does not discriminate between domestic and foreign service users
- *Domestic regulation.* Recognizes the right of each country to regulate services and introduce new measures as long as they are consistent with the agreement and are administered in a reasonable manner. Countries must also provide for a prompt hearing and review of complaints.
- *Transparency.* Requires countries to make public all measures relating to services under the agreement. Except in urgent circumstances, countries should publish new measures before they become effective and allow time for prior notification and comment.
- *Government aid.* Prohibits government aid for services if such aid causes injury to another country
- *Payment and transfers relating to provision of a covered service.* States that, subject to IMF regulations, each country should permit free payments and transfers related to services that are provided across the border or by means of a commercial presence located in its territory
- *Short–term restrictions for balance of payment reasons.* Allows countries temporarily to apply restrictions, except for exchange controls or restrictions, in the event of a balance of payments crisis or under certain other conditions, to be reviewed annually in consultation with the IMF.

Under article 22 countries may enter reservations to articles 4–8 and article 13 with respect to specific services or specific aspects of existing legislation. Article 22 further calls on countries to withdraw these reservations as soon as circumstances permit and makes them subject to periodic negotiations.

This reservation approach, representing a negative list, is superior to the use of a positive list, under which countries indicate the obligations they are willing to assume with regard to various services. The latter alternative would be likely to encompass a limited number of items and cannot extrapolate into the future.

At the same time, the proposed agreement provides the possibility for countries that wish to undertake additional obligations to negotiate separate protocols that would apply only to their signatories. This would permit further deregulation in particular sectors for the participating countries.

One may object, however, to the introduction of special agreements in the U.S. proposal. These agreements would permit the exclusion of selected sectors by individual countries, which would go against the objective of trade liberalization in services.

Under article 18 it is further proposed to establish a Committee on Trade in Services, composed of representatives from each of the participating countries. The committee should have final decisionmaking authority with regard to the interpretation and application of the agreement.

All in all, the U.S. approach embodied in the proposed agreement represents an effort to develop a mechanism whereby countries commit themselves to liberalization in services. The United States specifically recognizes the right of countries to regulate services but wants to minimize the trade-distorting effects of regulations.

Conclusions

The liberalization of trade in services has been a long–standing objective of the United States. This objective conforms to the apparent comparative advantage of the United States in service industries, especially in modern services. It can be expected that freeing trade in services will improve the U.S. balance of payments. The existence of extensive barriers to exports of U.S. services supports this conclusion.

Although U.S. officials have stressed the gains that liberalization of trade in services would bring to the world economy, the benefits that the United States would obtain lie behind the single-minded determination on the part of U.S. authorities to pursue this goal. In fact, the idea of freeing trade in services originated in the United States, and U.S. authorities spearheaded the effort in the OECD as well as in the GATT.

In the United States, public authorities and business have collaborated to support liberalization of trade in services. This cooperation reflects a common view as to the advantages of freer trade for the United States. In the case of business, however, it also reflects the potential benefits from sales of services produced abroad, in addition to the gains to be obtained from exports of services.

The U.S. services proposal to the GATT concerns trade in services as well as investment in service industries. It seeks to open world services markets while allowing countries to take limited reservations for those existing measures that do not conform to the proposed agreement.

Note

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14

The European Community

Patrick A. Messerlin

Liberalization of services in the European Community (EC) sends three clear messages to the current and future multilateral negotiations on services.

1. As predicted by economic theory, unilateral liberalization pays. Three or four EC states undertook unilateral liberalization of services during the 1970s and 1980s, more than ten years before the EC initiated its 1992 program. Because these liberalizations were trade oriented (they opened national markets to foreign competition), they have yielded large gains to the consumers of these "liberal" EC states.

2. Unilateral liberalizations are fragile. A host of domestic and international factors have joined forces to close markets that had been liberalized. Monopolies that provided many services before liberalization have retained considerable influence in the small national markets. Nonliberal EC states have inhibited competition by keeping their own markets closed. As a result it has proved difficult to maintain a substantial level of competition in liberalized service markets in the long run.

3. Reinforcing and expanding unilateral liberalizations inside the EC has required a multilateral liberalization—the 1992 program, which was nurtured by the unilateral liberalizations and is consolidating them by diluting former dominant firms in larger markets. The program also makes liberalization attractive to EC states unable to undertake unilateral liberalizations in that it decreases the political costs of implementing liberal policies.

These three messages suggest that the Community's experience can be a driving force in the Uruguay Round negotiations on services. The 1992 program, however, is merely domestic liberalization. It does not contain an explicit foreign trade policy in services, and this missing aspect has nurtured fears of a "Fortress Europe." If the 1992 program is implemented behind high barriers, it will generate huge distortions that will be detrimental to the welfare of the Community and the world. The huge size of the EC service sectors has fueled these fears. Services account for roughly 60 percent of the gross national product (GNP) of the EC—the equivalent of the GNPs of all the developing economies together. In the mid-1980s EC banking and insurance represented one-third and one-fourth, respectively, of world business in those sectors. The EC fleet accounted for one-fourth of world shipping capacity, EC transport for one-fourth of the air traffic of the countries of the Organisation for Economic Co-operation and Development (OECD), and EC investment in telecommunications equipment for more than 40 percent of OECD investment.

Unilateral Liberalizations as a Driving Force

Only the United Kingdom and, more marginally, the Federal Republic of Germany, Ireland, and the Netherlands have been able to undertake unilateral liberalization in airlines, banking, securities, and telecommunications.[1] All of these moves share three features. They have followed common time sequences, and the resulting convergences have considerably eased the 1992 program. They offer alternative solutions to the delicate balance between competition and privatization that may be of some interest for developing countries. Last, and of the utmost importance, they all include a crucial trade component that qualifies them as genuine trade liberalizations.

Common Liberalization Sequences

Financial services provide the most complete illustration of common time sequences in unilateral liberalizations. During the 1970s and 1980s public policies and regulations have been a crucial engine of innovation in financial services. In banking, macroeconomic policies have been accompanied by an endless flow of new financial products—Eurobonds, fixed rate Euronotes, floating rate notes, note issuance facilities (NIFs), revolving underwriting facilities (RUFs), and swaps of all kinds.[2] In insurance, innovations have been fueled by domestic policies, in health care, for example, and by international policies such as freer trade in goods, which gives rise to larger risks. These innovations have required easier access to increasingly large capital markets. In such an environment some financial operators—such as the "universal" banks or insurers that provide most of the financial products—have exhibited comparative advantages.

All unilateral liberalizations in financial services have sought to favor the emergence of these new types of operators and their access to large and flexible stock markets by following a three-step pattern: removal of the barriers between the various parts of the banking industry to facilitate the move toward universal banks; abolition of foreign exchange controls to provide the large amounts of funds needed by financial operators; and the introduction of stiff competition in the stock market—the key market for an industry increasingly dominated by securitization.

Germany has long had universal banks and no exchange controls. By contrast, British financial services were heavily regulated at the end of the 1960s. Starting in 1971, however, the interest rate cartel operated by the principal British clearing banks was dismantled and the markets serviced by the banks and the building societies (the main savings and mortgage institutions in Britain) were integrated. In 1979 Britain abolished foreign exchange controls, finally catching up with Germany. In the mid-1980s the balance between the two countries changed. German financial services, although liberalized, remained protected from foreign competition, whereas Britain, starting in 1986, was the first to open the stock market to stiff foreign competition. The new regulations aimed at creating one market (by merging the Euromarket and the London Stock Exchange) and one type of operator (by merging brokers and jobbers into market makers); giving the Bank of England a decisive role in the crucial market of gilts (British government securities); and introducing a drastic trade component. The admission of corporate members to the stock exchange regardless of nationality and with no preset limit on the number of seats available has been at the core of the increasing importance of the London Stock Market since then.

Financial services elsewhere in the EC have followed the same pattern of evolution. Most EC states have taken the first step by now, and nearly half have reached the second step (the exceptions are Greece, Ireland, Portugal, and Spain). Only Britain has fully achieved the third step.

Competition and Privatization

A powerful force behind liberalization in services was the brake on the potential growth of many service sectors exerted by the existing public monopolies. Public firms were well adapted to provide standardized services with the use of traditional technology—transport of small numbers of air travelers between a few important towns, basic phone calls, and so on. But protected flag carriers and post and telecommunications operators (PTOs) have not been able to provide efficiently the "new" services made possible by modern technology. Examples of such services are "charter" air transport of large crowds of tourists to a host of exotic places and "electronic highways" that provide a wide range of services—from data transmissions to "chatlines" and telephone games—to individuals or firms who hook their computers to their telephones (Feketekuty 1989). Monopolies could not cope with such a rate of innovation. Market competition was necessary.

The capacity of public firms to discriminate and cross-subsidize between the markets of traditional services reinforced the complexity of the problems raised by diversity. The best illustration is provided by PTOs. More profitable than flag carriers (their average net income represented 10–20 percent of their revenue, as against 5–7 percent for flag carriers), PTOs were able to subsidize equipment manufacturers massively. For instance, direct subsidies from French Telecoms to French equipment producers have amounted to more than ECU 1 billion a year since 1983, and roughly 65 percent of the costs of the videotext Minitel are subsidized by French Telecoms (OECD 1988, p. 30; *Le Monde*, June 30, 1989 and July 17, 1989). Despite this strong grip on their sector, PTOs have been unable to forecast the demands with the highest growth (for instance, mobile phones in the French case) and to raise the financial and human resources necessary to match competition-driven markets in providing the "new" services.

Privatization of public monopolies was seen as the natural way to create the competitive markets required by the "new" services. Unilateral liberalizations, however, show that there can be a conflict between competition and privatization, especially as the latter is rarely a constraint-free choice. The privatization of British Telecoms was an unexpected consequence of British rules on the public budget,[3] and the German constitution has prevented privatization of the Bundespost. Governments that are obliged to privatize may want to make the step more attractive by selling firms with a flow of future potential rents—that is, by selling monopolies. Private buyers of such public monopolies are likely to oppose any future move toward competition that might erode the rents expected or paid.

A sound liberalization sequence can overcome the potential conflicts between competition and privatization. If new services—those that public monopolies are unable to provide—are opened up long enough before traditional ones, competitive markets can evolve that are large enough to reduce the potential anticompetitive impact of privatization. This is be illustrated by three examples.

In Britain, the liberalization of charter air transport (a "new" service) in the 1960s and 1970s gave birth to markets that by 1984 represented one-third of all British air transport. In that year Britain began to liberalize the traditional scheduled services by privatizing the flag carrier, British Airways, and by tacitly setting up a duopoly with a private carrier, British Caledonian (Vickers and Yarrow 1988).[4] In 1988 the duopoly collapsed with the takeover of British Caledonian by British Airways, but the negative effects of the collapse on competition were limited because the large charter carriers were powerful enough to buy half of the route licenses and of the 5,000 airport slots owned by British Caledonian and submitted to bids by the Civil Aviation Authority.

British telecommunications offers a different story. Britain began to liberalize traditional and new services almost simultaneously, in 1982, when Mercury was licensed to offer the traditional voice services and to operate a network of the new value added services. At that time value added services represented only 1 percent of telecommunications revenues in Britain. As a result, the prospects for competition did not look very encouraging, especially since the government explicitly established a duopoly consisting of British Telecom and Mercury (both privatized firms) for the first phase of liberalization, 1984–89. It was feared that the two firms would share a reason to oppose further liberalization—the need to undertake huge investments to modernize an old network, in the case of British Telecom, or to create a new one, in Mercury's case (Vickers and Yarrow, 1988; Beesley and Laidlaw 1989).[5] The new regulatory environment, however, was liberal enough to allow British consumers to take full advantage of a wave of technological progress and to generate an explosive growth of demand for private telecommunications networks, basic services (mobile phones), and value added services. In less than five years the size of the markets under competition has become so large that the British government can contemplate a huge injection of new competition: at least one firm, British Railways, with its huge and modern telecommunications network, can compete on equal terms with British Telecoms and with Mercury; three more licensees (in addition to the two initial ones) in mobile phones; and, possibly, authorization for firms to resell part of their private telecommunications networks to third parties.

The German experience in telecommunications suggests that when privatization is ruled out, a quicker and more massive introduction of competition is necessary to make liberalization credible.[6] In a single year (1989), several drastic measures were taken: the Bundespost was split into three corporations (post, bank, and telecommunications); its monopoly in customer equipment was ended; competition from private firms in data and mobile telecommunications was introduced; the Bundespost's ability to cross-subsidize was reduced by requiring that German Telecoms use flat-rate charges (easier than the former usage-sensitive tariff for competitors to match) in some data services; and the first network of mobile phones was licensed to a private group led by Mannesmann.[7] Large competitors have been convinced and have begun large-scale operations. Meganet (a subsidiary of German insurance firms) has started leasing lines in bulk from German Telecoms and selling capacity on them for data traffic. Volkswagen, IBM, and EDS (General Motors), among others, have begun to provide a wide spectrum of value added services. But in the absence of privatization, the competitive fringe of smaller operators that may be crucial for reaping all the potential gains from liberalization remains cautious.

Domestic Liberalizations as Trade Liberalizations

All the unilateral liberalizations undertaken by the EC states, although domestic in nature, rapidly incorporated a trade component and became authentic trade liberalizations.

First, liberal EC states felt it necessary to set up bilateral agreements among themselves and with the United States to strengthen their liberalizations. Air transport provides an illustration: multiple designation (licensing more than one domestic carrier for a given route), removal of restrictions on capacity and frequency, and the automatic approval of airline fares (except in case of disapproval by both countries) were introduced in bilateral air agreements between liberal EC states (Britain–Netherlands, Britain–Ireland, and so on) after 1984.

Second, unilateral liberalizations offered consumers new opportunities for substituting services produced in different EC states, including nonliberal states. Because of this larger set of potential "arbitrages," the prices charged in all EC states were driven by the prices emerging in the more competitive markets of the liberal states. Telecommunications is a good illustration of the power of arbitrage. In 1985–86 the tariff reductions that AT&T introduced on transatlantic calls made phone calls from France to the United States 30 percent more expensive in relative terms and obliged French Telecoms to lower its own tariff by 20 percent. Heavy additional pressure was imposed by the new tariffs of British Telecom, which made calls to the United States from eight of the EC states 15 percent cheaper (on average) if they were routed through Britain. Modern technology increased the role of arbitrage. Since British Telecoms and AT&T were able to offer large multinational clients a better service and to persuade them to locate their telecommunications hubs outside nonliberal countries, the PTOs concerned have been forced to take a more liberal attitude with their largest clients in order not to lose them.

Arbitrage seems to have played a more important role than bilateralism. For example, in banking EC states were concerned that their markets might lose business to more open financial markets in other EC members. Indeed, the failure of some EC states to liberalize their stock exchanges has benefited the stock markets of the most liberal EC states. The London Stock Market reform triggered a general movement away from the Continental stock exchanges, which obliged other EC states to begin to liberalize their own regulations, and the liberalization of some Continental stock exchanges in turn induced the London market to relax some of its stringent regulations.

The opening of domestic markets to foreign producers of services has been the most important feature of the unilateral liberalizations. Vested interests understood this point well and tried to stop arbitrage and bilateralism. In telecommunications the PTOs of the nonliberal EC states (France and Germany) have refused to conclude operating agreements with Mercury, which was obliged to enter into market-sharing agreements with British Telecom.[8] In airlines the International Air Transport Association (IATA) deliberately designed complex rules for air fares to ensure that travelers from nonliberal EC states could not take advantage of the proximity (by road or rail) of European airports to one another to benefit from the few existing liberal policies (Kasper 1988, p. 77).

The Gains from Unilateral Liberalizations

Britain's unilateral liberalizations of the early 1980s were profitable enough to induce a few other EC states (Germany, Ireland, and the Netherlands) to undertake similar policies. Gains from liberalizations come from three sources: lower prices for consumers, larger markets, and new comparative advantages revealed by more competitive firms.

Lower Prices

Liberalized airlines, banking, and telecommunications have all experienced price decreases. A few months after the introduction of the 1986 regulations, commission rates on the London Stock Market had decreased by 20 percent on average. In 1986 average British air charter fares were lower by 10 to 30 percent than the comparable scheduled fares and were similar to those in the deregulated U.S. markets (McGowan and Trengrove 1986, p. 78). In 1987 scheduled fares on European routes with a significant charter presence were estimated to be 40 percent lower than fares on routes with little or no charter competition (*Financial Times*, December 24, 1987). In 1985 Mercury's phone tariffs were, on average, 15 percent lower than those of British Telecom; in 1989 they were 30 percent lower (Beesley and Laidlaw 1989, p. 29).

The impact on tariff structures has been even greater. Average price changes underestimate the impact from competition because liberalizations tend to increase the prices of costly services and to compensate by huge decreases in less costly services. For instance, commission rates on the London Stock Market increased by 5–25 percent for transactions of less than 50,000, decreased by 20–35 percent for bargains of 50,000–500,000 (the largest part of the market), and remained stable for larger purchases (Price Waterhouse 1988, p. 133). Tariffs on the London-Amsterdam route increased by 5–15 percent for the most expensive seats, whereas inexpensive fares (late bookings in economy class) were offered at a 60 percent discount.

These new tariff structures reflect the reduction or elimination of the cross-subsidization policies of domestic monopolies. Following liberalization in Britain, price structures in telecommunications have diverged from those in Continental Europe. In 1987 local calls were twice as expensive in Britain as in France or Germany, whereas long-distance trunk calls were 50 to 70 percent more expensive in France and Germany than in Britain. In the few niches that have seen stiffer competition, price changes have been larger. In 1987 international leased lines were 30 to 100 percent more expensive in France and Germany than in Britain (Muller 1988, p. 139). The most recent prices for private lines are considered roughly in line with costs in Britain (although long-distance traffic is still subsidizing short-distance circuits) whereas in Continental Europe they are, on average, four times costs (*Financial Times*, May 10, 1989).[9]

Larger Markets

Lower prices brought about by domestic liberalization are a sure way of increasing the size of domestic markets and thus the probability that domestic exports will become internationally competitive—a goal that industrial policies often fail to achieve at a reasonable cost.

The number of stocks traded in the London Stock Market grew by 20 percent in the first six months after the introduction of the new 1986 regulations. This growth was mainly attributable to the competitive "betatype" stock markets, defined as those with six or more market makers (or four quoting firm prices).

Air charter markets—now more or less liberalized in most EC states—represented more than 60 percent of total European air markets in 1987. The British liberalization was the first and has been the most far-reaching up to now, as can be seen in the fact that in 1987 British charter services represented 60 percent of independent intra-European charter air traffic and more than twice the share of Germany (the second largest in the EC).

In telecommunications the ratio of calls as a share of British gross domestic product (GDP) or to exports increased in relation to the corresponding ratios for Germany and France by 15 percent and 25 percent, respectively, between 1980 and 1986. During the same period calls from Britain to the United States as a share of total calls between the two countries increased by 8 percent, reflecting decreased relative prices. Meanwhile, the corresponding proportion decreased by 7 percent for Germany and by 13 percent for France. In some niches changes were more dramatic. The British market for value added network services is estimated to represent 80 percent of the total European value in the late 1980s. The British mobile phone market—operated by two (soon, five) firms under competition—had five times more subscribers than the German or French markets, which are run or dominated by PTOs.

Revealing New Comparative Advantages

New comparative advantages are revealed by firms working under the strict discipline of high competition and minimal rents. It is currently estimated that at least one-fourth of the existing market makers in the London Stock Market will leave in the near future. In the gilts market alone ten market makers of the initial twenty-eight have retreated since 1986, and the current leading four account for roughly 50 percent of the market. (Prior to liberalization, however, the two leaders in a field of only eight firms accounted for 75 percent of the market.) Over the past ten years the number of tour operators licensed in Britain increased from 473 to 703, and the profit margins of the top thirty slumped from 4 percent in 1983 to roughly zero in 1987–88, leading to difficulties for the charter airlines (such as British Island Airways) that depend on them.

Benefits from such disciplines are most visible in the sectors that have been liberalized for the longest time, such as charter air transport. Massive entry in air charter markets has selected the most successful tour operators to build large low-cost charter carriers able to compete with and become credible alternatives to foreign-flag carriers. Since the mid-1980s the largest British (and EC) charter company, Britannia, has been responsible for roughly as many passenger–kilometers as Air France on the intra-European routes, the second largest EC flag carrier after British Airways. In the second half of the 1980s two charter airlines, Britannia and Dan-Air, accounted for more passenger–kilometers than Swissair. In telecommunications the experience acquired in the liberalized cellular phone market in Britain has allowed British Telecom to buy 20 percent of McCaw Cellular, one of the largest U.S. firms in this booming niche and the first truly national cellular network in the United States.

The Limits of Unilateral Liberalizations: Toward a Multilateral Effort

Despite these large gains, unilateral trade liberalizations have proved fragile, and their political costs can be high. Voters may find it easy to accept that cheaper air tickets for holidays improve their welfare, but—as users of subsidized short-distance phone calls—they are harder to convince that loss of these subsidies might be offset by the increased efficiency in the economy brought about by cheaper long-distance calls. Firms—the direct beneficiaries of telecommunications liberalizations—have little incentive to lobby for liberalization if they are able to pass through their telephone bills to consumers, as most European firms did during the 1970s and early 1980s, when telecommunications still accounted for less than 10 percent of their costs. As a result, the late 1980s saw some erosion of the unilateral liberalizations in two ways.

First, unilateral liberalizations have been under strong pressures in the liberal EC states. The competitive forces introduced in domestic markets have been eroded by former, but still powerful, monopolies. Flag carriers have reacted to lower profits brought about by increased competition by buying substantial shares in the emerging competitors, as KLM did on the London–Amsterdam route. This vulnerability to old vested interests has also been observed in the United States; in the early 1980s the U.S. government renounced a more comprehensive competition policy in air transport under the double pressure of foreign governments and of European and U.S. carriers (Kasper 1988, p. 80). In telecommunications duopolies complain bitterly about being excluded from new licenses—an example is British Telecom in mobile phones—and lobby heavily for them.

Second, gains from unilateral liberalizations have led the nonliberal EC states, initially hostile to liberalization, to introduce quasi-liberalizations—"quasi" because the sectors concerned are still sheltered from foreign competition. Air transport offers good examples of quasi-liberalizations. Flag carriers have created their own charter carriers behind high barriers, as Lufthansa did with Condor and Air France with Air Charter. "Flag charters" were conceived by their owners largely as a deterrent to the entry of domestic independent air carriers, which as a result have had a difficult time growing. In 1987 the average size of the French and German independent carriers was 7 percent and 40 percent that of the British ones. The 35 percent stake that Air France was able to buy in TAT (the fourth largest French air carrier) in 1989 led to increased dominance by the flag carrier. In such closed markets, domestic competition is easily inhibited. For instance, a recent attempt by Aero-Lloyd, the fourth biggest German charter airline, to compete on domestic scheduled routes with Lufthansa failed because a large proportion of Lufthansa's passengers use internal flights only to connect with international flights and enjoy almost free internal flights. Finally, quasi-liberalized markets remained under political control. In 1988 a proposal to merge two small (by British standards) French and Belgian charter carriers, Point Air and Trans European, was blocked by the French government (this was in sharp contrast with the government's blessing of the takeover of UTA—the only large independent French carrier—by Air France). Similar experiences can be observed in telecommunications and posts (express freight); most European PTOs have created private subsidiaries—for instance, French Telecom created Chronopost (express mail) and Transpac (data traffic).

Having kept foreign competition at bay can be a source of future difficulties, as French banking illustrates. In the 1980s the French government actively pursued a policy of "universal" banks, and France has some of the largest world conglomerates of banks-insurers-brokerage houses. But because these giant "universal" banks were consolidated through state ownership and regulations in noncompetitive markets, it is difficult for them to attain the Cooke Committee standard for capital adequacy (a minimum ratio of capital to assets of 8 percent), which will become the standard in the post–1992 Community. To improve their competitive situation in post–1992 Europe, French banks might have to acquire foreign firms. But that would require capital and would increase assets, causing further deterioration of the Cooke ratios. In air transport the increasing dominance of Air France has inhibited a necessary decrease in wage costs; pilots' wages have absorbed 70 percent of the decrease in labor costs allowed by the new 747-400 aircraft bought by the flag carrier (*Le Monde*, September 3, 1989). Under these circumstances, European liberalization is an attractive solution.

The 1992 Program

This section reviews the part of the 1992 program devoted to internal trade liberalization in services and the corresponding economic gains that can be expected. It then examines the competition rules embodied in the Treaty of Rome, which have been the engine of the intra-EC liberalization and have made the Court of Justice the cornerstone of that liberalization, and the elements of an EC foreign trade policy on services that might emerge in the wake of the 1992 program.

The 1992 "Single Market" in Services

The part of the 1992 program that deals with services consists of fifty-one directives to be drafted and adopted between 1986 and 1992.[10] As of January 1990 more than half have been adopted and the rest tabled. The program has adopted the broadest definition of services: it deals with trade in services related to factor movements—including labor movement—and to cross-border movements of consumers as well as of services. Its sectoral scope is wide, covering previously untouched services such as insurance, shipping, road transport, and professional services. Finally, the 1992 program interprets progressive liberalization essentially as meaning that the less developed EC states will be granted longer time periods for adopting common rules. Appendix 14–A focuses on the most important directives in each service sector.

The Gains to Be Expected

The 1992 program aims at dismantling intra-EC barriers. Despite previous unilateral liberalizations, these barriers remain substantial, as indicated by the low ratio of intra-EC to extra-EC trade in services, which is 25 to 30 percent, or half of the corresponding ratio for goods. As a result, price reductions and welfare gains can be expected to be large. Studies done under the auspices of the Commission (the Cecchini report) estimate that price reductions will be 21 percent (in Spain) to 4 percent (in the Netherlands) in financial services, about 10 percent in air transport, 5 percent in road transport, and 3 percent in professional services, for total estimated savings to consumers of roughly 2 percent of the GDP of the EC (Emerson and others 1988).

These studies give to scale economies a large role that some have found excessive. In a substantial range of services, such as retail banking and insurance, economies of scale are likely to be small (Neven 1989), and the "single" European market could offer more opportunities for differentiating products in diversified markets than for homogenizing them to make possible massive economies of scale (Centre for Business Strategy 1989). Others, however, have argued that adding dynamic effects to the static effects measured by Emerson greatly increase the gains to be expected (Baldwin 1989). Despite these controversies on the extent of the gains, there is a consensus that the 1992 program will bring substantial benefits to the Community.

The Engine of the 1992 Program: Competition Rules

EC competition rules are embodied in three articles of the Treaty of Rome: article 85, on collusive practices; article 86, on abuses of dominant power; and article 90, which states that public firms are not exempt from competition rules embodied in articles 85 and 86 except as necessary for their "general interest" tasks. Until the mid-1980s these rules were barely used in services because existing service providers, benefiting from noncompetitive markets, had no motive for invoking them. Competition-oriented markets shaped by unilateral liberalizations since then have generated firms and people that are eager to see their rights to competition enforced and to take cases to the European Court of Justice.

AIR TRANSPORT. In a 1986 ruling on a case examining Air France's allegations of price undercutting by the French tour operator Nouvelles Frontières, the Court stated that EC competition rules apply to scheduled air transport. That ruling has definitively brought the sector—which since 1962 was exempted from the enforcement of articles 85 and 86—back under competition rules (van Bael and Bellis 1987).

In April 1989 a second ruling extended, de facto, the scope of competition rules to routes between the EC and the rest of the world. The case concerned the Frankfurt–Tokyo route. Two German travel agents discovered that, because of the difference between the market exchange rates and the exchange rates used by the IATA when setting the global network of European fares, the Lisbon–Frankfurt–Tokyo fare was much less expensive than the simple Frankfurt–Tokyo fare. An association "for the campaign against unfair competition," backed by flag airlines, lodged a complaint of unfair competition and price undercutting against the two travel agents. The Court stated that price-fixing agreements for flights between EC and non-EC airports were under the scrutiny of article 86 if they induced competitors to charge excessively high or low prices fares on a single route—that is, if they abused a dominant position. Moreover, airlines carrying out a task of "general interest" (flag carriers) were also subject to competition rules insofar as the application of such rules did not obstruct the performance of these particular tasks—a reminder of the article 90 philosophy.

FINANCIAL SERVICES. Through a growing number of cases looking at national banking associations and commission rates in commodity markets, the Court is exerting increasing pressures for a strict enforcement of competition rules in banking (Commission of the European Community, *Reports on Competition Policy*, various years). The main contribution of the Court, however, has concerned the definition of the *mutual recognition* principle governing cross-border trade in insurance according to which each EC state will recognize the licensing rules of the others and will apply its own operating rules on a nondiscriminatory basis to EC firm affiliates (see appendix 14–A, "Banking"). In four recent rulings the Court extended to this trade two basic concepts elaborated for trade in goods in the Cassis de Dijon case: the obligation that EC states not erect trade barriers between themselves and the relevance of the public interest test as a restriction on freedom to provide services. According to the Court, existing Community law does not provide sufficient harmonization to justify a claim that the public interest is already protected by the home state of the exporters of insurance services. Small policyholders ("mass" risks, in Community jargon) could thus be confused about the real coverage offered by insurance products imported from other EC states. In other words, "imperative reasons relating to the public interest" may justify restrictions on the freedom to provide cross-border insurance services for small policyholders.

This ruling on insurance has been criticized as a setback to intra-EC liberalization (Hindley 1988). If greater harmonization in "mass" risks is difficult to achieve in the near future, the Court's ruling would de facto limit the 1992 program to large policyholders ("large risks")—the only ones supposed to be capable of mastering the problems arising from "imported" insurance contracts.

The "general interest" principle, however, is sufficiently complex to have a positive impact on liberalization. First, it has obliged the Commission to definitively abandon the harmonization route in insurance and to adopt the much less heavily regulatory approach of mutual recognition through branching. This is the meaning of the proposal by the vice-president of the EC Commission, Leon Brittan, to allow insurers to sell the full range of their products on the basis of a single license (see appendix 14–A, "Insurance"). Second, the principle will be useful for solving the disputes likely to emerge when enforcement of mutual recognition requires a precise border between licensing and operating rules. Finally, the principle can be a powerful argument against monopoly power. For instance, if the basic telecommunications network is of "general interest" and could, under the Rome Treaty, be entrusted by EC states to a single operator (*Financial Times*, June 29,1989), the result may be a stronger enforcement of article 90 than under the present circumstances.

TELECOMMUNICATIONS. In telecommunications the Court launched the 1992 program by reaffirming that article 90 of the Treaty of Rome subordinates public firms to competition. A first ruling (on telex forwarding, in 1985) stated that government-sanctioned monopoly practices could conflict with article 86 of the treaty. In 1987 the Commission used the procedure for the first time under article 90 in the 1992 program as the legal basis for the directive liberalizing telecommunications terminal equipment. Such a procedure (which can be applied only if public firms that enjoy exclusive rights use them in a way that restrains competition) authorizes the Commission to act without a vote by the EC states. Because of this procedure, the directive on terminals has been enforced and continues to be valid, although four EC states (Belgium, France, Germany, and Italy) have asked the Court to examine the legitimacy of the Commission's use of article 90. Since then, the Commission has used the article 90 procedure twice: as a basis for liberalizing the Community's ECU 65 billion market of value added services and to request regulatory changes in the Dutch express mail regulations (*Financial Times*, January 9, 1990).

The Emerging EC Foreign Trade Policy in Services

The 1992 program deals exclusively with intra-EC matters. The number and force of the trade barriers to be dismantled if the EC opens its borders to foreign services indicate how deeply entrenched is protection of some sectors (table 14–1). Whatever the borderline between the Commission's and the EC states' powers in trade policy in services turns out to be, the EC states will retain many ways of influencing trade in services in the near future. (For instance, airports and air control are still under the jurisdiction of the EC states, and restrictive practices in this domain may create substantial barriers to freer air transport.) The figures confirm the leading role of Britain and the foot-dragging of France, Italy, Spain (and, at this time, Germany). It also suggests that the smaller EC states may be more open than the larger ones.

The 1992 program has indirectly led to the emergence of the first elements of the EC foreign trade policy in services, as illustrated by the debate on reciprocity in banking and the Commission's desire that it (instead of the EC states) negotiate bilateral air agreements after 1992.

The most elaborate elements concern the shipping sector. Two directives of the four on shipping in the 1992 program specify rules involving non-EC states. The first directive deals with "noncommercial" advantages enjoyed by foreign fleets in markets in which EC fleets are operating. The directive introduces regulations and procedures that, except for a few points related to the respective roles of the Council and the Commission in trade policy in services, are similar to those of the EC antidumping law, which is an instrument with a well-established protectionist and anticompetitive impact. This first directive has already been enforced, in 1988. A Korean shipping firm, Hyundai, was accused of noncommercial advantages by European liners operating in the European–Australian Conference and was subjected to a "redressive" duty of approximately 25 percent. As a result, Hyundai has stopped its operations on the route.

The second directive provides for coordinated Community action with diplomatic initiatives or countermeasures in cases in which third countries restrict access of EC shipping companies to ocean trade. The threat of Community action—which makes this directive similar to a U.S. Section 301 case, but limited to shipping—covers bulk and liner cargoes, tramp services, passenger transport, and movement of people or goods to or between offshore installations. The first case under this directive, which concerned the routes between Europe and the United States, was lodged in 1987 and was renewed in September 1989.

The concept of "fair" trade is not ignored in other services, even if it has not been embodied in directives so far. As shown below, it has surfaced in the banking dispute between the EC and United States. In air transport the unfair advantages allegedly enjoyed by "low-wage" air carriers have been cited. In telecommunications the first liberalizations in services are not, at this stage, giving rise to actions such as those against Hyundai in shipping, but they have triggered increased imports of telecommunications equipment, which have already been under antidumping actions. In July 1987 and March 1988 the ad hoc office of the EC Commission initiated an antidumping case against exports of mobile cellular phones from Canada, Hong Kong, and Japan. This action was echoed in the warning by Oftel, the British watchdog in telecommunications, against service providers that lure users with cheap, low-quality mobile phones but impose high call charges.

Table 14–1. ***Main EC Barriers, as Reported by U.S. Firms, 1985***

Service	*Belgium*	*Denmark*	*France*	*Germany*	*Greece*	*Ireland*	*Italy*	*Netherland*	*Portugal*
Air transport	2	1	3	2	1	1	2		1
Banking									
Construction							1		
Insurance	1	1	1	4	2	2	3	1	1
Films and broadcasting	2	2	2	2	2	2	2	2	2
Professional services	2		4	1			2	1	
Telecommunications	2	2	2	5	2	2	2	2	2
Tourism	1		2		2		3		4
Total, excluding shipping	10	6	14	14	9	7	15	6	10
Percentage	8.3	5.0	11.6	11.6	7.4	5.8	12.4	5.0	8.3
Shipping	2	5	4	4	4	5	3	5	1
Total, including shipping	12	11	18	18	13	12	18	11	11
Percentage	7.3	6.7	10.9	10.9	7.9	7.3	10.9	6.7	6.7

Note: The U.S. Trade Representative study is based on reports by U.S. exporters of services about "selected problems" they encounter. As a result, it tends to mirror the capacities of the United States to export—that is, it overestimates barriers in relatively open states or sectors and underestimates the others. This is why another source has been considered for shipping (White 1988).

Sources: For all services except shipping; USTR (1985). For shipping; White (1988).

The EC 1992 Program and the Uruguay Round on Services

What implications and lessons does a successful 1992 program have for the Uruguay Round negotiations? The implications concern the impact on the EC's negotiating position of the crucial choice made by the 1992 program—to adopt the widest scope of trade in services. Lessons follow from the fact that the 1992 program has already begun to test many of the main concepts to be embodied in the Uruguay Round, as best illustrated by the rules on market access and competition.[11]

Scope

The 1992 program embraces the widest scope the Uruguay Round agreement on services could consider: it covers movement of consumers and of the factors of production required for producing and selling services as well as cross-border trade in services, and it includes future as well as existing services. The scope of the program has influenced the Community's response to the invitation in the Montreal ministerial declaration to submit an indicative list of service sectors of interest; the EC was one of only three Contracting Parties to table such a list, and its list covers all internationally tradable service sectors. There is, however, a significant difference between the 1992 program and the EC approach in the Uruguay Round: the EC opposes coverage by the Round agreement of trade in services that requires labor movement other than that of "skilled and key personnel and for a limited duration." This limit will not harm all workers from developing countries; some will be recruited by EC firms, as in the case of the flagging-out shipping policies examined above. But it will undoubtedly hamper many firms from developing countries in exploiting their comparative advantages.[12]

The Impact on the EC Negotiating Attitude

That no service sector is a priori excluded from the agreement has allowed the EC to balance as much as possible the interests of its potential exporters and importers in the Uruguay Round negotiations. To this extent, the 1992 program has decreased the likelihood of a "Fortress Europe"—a combination of intra-EC liberalization with high external protection.

Trade balances are an indicator of the likely reactions of EC service industries to a world liberalization under Uruguay Round auspices. Negative or deteriorating balances are likely to be used as an argument for protection; increasingly positive balances could support protrade arguments. Table 14–2 shows the trade balances between the EC and the rest of the world for fourteen service sectors. There may be active lobbies for protection against the rest of the world in four industries: telecommunications, advertising, films and broadcasting, and sea freight. Three industries—banking, insurance, and travel—might favor a freer EC trade policy. The attitude of the other sectors is more difficult to predict, either because trade balances are positive but deteriorating or because no clear trend has emerged. Table 14–2 is confirmed by table 14–1, which also suggests that telecommunications, films and broadcasting, shipping, and air

Spain	United Kingdom	EC Total	EC (percentage)
2	3	18	10.9
3		3	1.8
	1	2	1.2
1	1	18	10.9
2	2	22	13.3
3	2	15	9.1
2	2	25	15.2
4	2	18	10.9
17	13	121	
14.0	10.7	100.0	
8	3	44	26.7
25	16	165	
15.2	9.7	100.0	

transport are good candidates for supporting protectionist policies, whereas banking should be more supportive of freer trade because it is more open.

The sectors in which protectionist pressures are likely to be the highest (telecommunications and air and sea transport) are also likely to be the most difficult to liberalize within a multilateral framework. That raises a question: will the 1992 program, which aims at creating a customs union in services (or, to use the current wording of the Uruguay Round, a regional integration arrangement) increase trade distortions by facilitating trade between the constituent territories and raising barriers to the trade of other contracting parties with such territories—as most of the custom unions in goods did? Or might regional agreements in services differ from custom unions in goods in that they generate more forces able to inhibit trade distortions than do customs unions?

The second alternative seems the more plausible because prior to regional agreement services are regulated by a host of international agreements that make it difficult to increase the barriers between the members of the regional integration agreement and the rest of the world. These agreements were necessary because service producers put much more emphasis on establishment for market access than did producers of goods. The following list gives a flavor of this extensive pre-1992 network of agreements and their impact on the EC.

In banking the rules adopted under the aegis of the Bank for International Settlements have been incorporated in the EC directives, and bilateral agreements on cooperation between agencies in charge of monitoring securities markets have been signed between non-EC and EC countries. In insurance the directive on motor insurance must

Table 14–2. *EC Trade Balances in Services, 1980–86*
(billions of ECUs)

Service	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
Banking	0.89	0.95	0.80	1.77	2.32	2.88	3.12
Insurance	0.31	1.26	1.05	1.22	1.08	2.65	4.08
Telecommunications	-0.11	-0.31	-0.47	-0.58	-0.47	-0.36	-0.33
Air freight	0.51	0.50	0.48	0.53	0.69	0.92	1.08
Air passenger	2.14	2.12	2.38	2.82	3.33	3.20	1.60
Sea freight	1.15	0.15	0.07	-1.14	-2.08	-2.32	-1.61
Sea passenger	0.25	0.28	0.42	0.41	0.41	0.54	0.53
Other transport	0.04	-0.28	-0.72	-1.37	-0.73	0.46	-0.47
Advertising	-0.36	-0.37	-0.57	-0.83	-0.87	-1.02	-1.16
Films and broadcasting	-0.12	-0.21	-0.21	-0.24	-0.30	-0.28	-0.46
Trade	0.05	-0.39	-0.20	0.39	0.08	-1.27	0.19
Other business services	1.92	2.53	2.56	2.82	2.76	2.79	2.70
Construction	2.61	3.50	3.57	3.00	3.58	3.15	2.62
Travel	-0.58	0.23	2.38	6.49	10.47	11.86	5.76
Property incomes	-1.53	-1.56	-1.89	-1.81	-2.31	-2.42	-2.60
Other services	2.14	3.48	3.56	3.88	2.61	5.28	6.33
Unallocated	3.07	3.31	3.38	3.52	4.25	4.39	4.30
Total	12.35	15.18	16.61	20.87	24.82	30.46	25.67

Note: There are no doubt many problems with these data. The main one is that they capture cross-border trade flows and not sales of services related to foreign presence—a crucial point for such sectors as banking.

Source: Mathisse (1989).

remain compatible with the green card system that covers non-EC countries. A U.S. life insurer can do business in Britain under the 1986 Financial Services Act if its home state is considered a "designated territory" under the act—like, for example, Pennsylvania is. In airlines the 66 air agreements between EC states are intertwined with the 218 agreements involving the 22 European members of the European Civil Aviation Conference (ECAC). That Norway and Sweden are part of the SAS airline network with Denmark has necessitated special adjustments to EC rules to grant the Community's passport to SAS. In telecommunications the technical rules adopted by the International Telecommunication Union (ITU) are enforced by the European PTOs. EC rules are compatible with regional agreements involving non-EC countries, such as the future MDNS (Managed Data Network Services) elaborated by Europe's twenty-two PTOs.

Market Access Rules

Market access clauses, which are harder to define in the context of services than of goods, have already been tested in actual situations in the EC. The 1992 program has had to find operational ways of using such concepts as national treatment, reciprocity, and progressive liberalization.

NATIONAL TREATMENT, AND MORE. The Montreal declaration defines national treatment by the "no less favorable" provision. For cross-border services, the concept of treatment "no less favorable" in respect of all regulations than that accorded domestic services in the same market has a clear meaning, similar to the accepted one for trade in goods. But this definition is plagued by many problems when services are "traded" through the establishment of suppliers in "importing" countries. For instance, it may exclude situations in which the domestic provider in the importing country is a monopoly, as in air transport or telecommunications in many developing countries.

This first source of problems is modest compared with the second: what does the Montreal definition mean when one trade partner imposes stricter regulations on its domestic firms than another partner—a situation that is likely to be very frequent, if not the rule? The EC faced this problem in the specific context of the banking sector in a (sometimes acrimonious) debate with the United States and Japan.[13] Similar cases are likely to emerge in other service sectors if the 1992 program succeeds. For instance, in air transport the fifth freedom between two EC states will become close to a cabotage right after 1993.

Such situations have led the EC to expand the definition of national treatment (the "no less favorable" clause) by a provision that takes into account the mode of delivery of services in foreign markets. The EC forged the concept of "effective market access," defined as the situation in which service providers of the two countries enjoy "comparable competitive opportunities" (to use the wording of the Second Banking Directive) in the two markets. This concept sheds some light on reciprocity and progressive liberalization.

RECIPROCITY. Reciprocity is the threshold of mutual concessions that trade partners consider satisfactory enough to sign a trade agreement. It is a concept used in negotiations, not in economics. In cross-border services, national treatment links reciprocity to host country rules, as it does in trade in goods. That financial services exported by EC banks are subject to U.S. regulations in the United States and the other way around seems to be an acceptable bargain for the two partners and is generally the equilibrium point of the negotiation. By contrast, that suppliers of services are subject to host country rules does not lead to such an acceptable bargain: producers in the most liberal country are seen as disadvantaged in comparison with producers in the less liberal country. Although there is no economic rationale for this proposition consumers may prefer the more stringent rules.

The "comparable competitive opportunities" concept makes assessing reciprocity more complex because it compares host and home country rules. The rule of the most regulated home country could be chosen as the internationally agreed standard for reciprocity. In this restrictive option U.S. banks would operate in the EC under U.S. rules—that is, they would not be able to engage in securities activities in the EC or to enter simultaneously into all the EC states. (Such an option is close to the 1988 position of former EC Commissioner de Clercq.) Conversely, the rule of the most liberal home country could be chosen as the international standard. Then EC banks would operate in the United States under rules similar to those of the EC; that is, they would be able to conduct securities business in the United States, to branch freely, and to provide cross-border services throughout the country (which U.S. banks are not allowed to do). This option is close to mutual recognition and to the principle adopted in July 1989 by the EC and Switzerland in an agreement on nonlife insurance that opens EC markets to Swiss firms on condition that Switzerland adapt its insurance laws to those of the EC.

In the mercantilist approach to trade negotiations, this wide range of options leaves no equilibrium point that is easily acceptable by both partners. As a result, the EC has chosen to leave the task of finding such an equilibrium point to procedures (internal consultations and negotiations with the trade partner) that are applied case by case. Such an approach seems to be plagued by an opportunistic attitude and could endanger the multilateral trading system, as illustrated by the acrimonious banking debate between the EC, Japan, and the United States, which has been summarized as follows: "Reciprocity is a missile aimed at Tokyo which will land in New York and explode on Capitol Hill" (*Financial Times* October 28, 1988). Although there may be some basis for this fear, two points are worth noting.

First, countries that take the mercantilist approach to multilateral negotiations tend "involuntarily" to favor solutions that are the most economically sound for the trading partners. Country A tries to get country B's markets as open as possible—a policy beneficial to the consumers of country B—and the other way around. Second, reciprocity is not only a conflict between trading partners but it is also a conflict of interests within each domestic industry of the two trading partners. For instance, the restrictive option described above would favor U.S. banks that already have a subsidiary in one EC state (and are thus able to branch through the Community and reap all the benefits from the 1992 program) over U.S. banks that are not already established in the EC. By contrast, the large influx of foreign securities firms into the EC brought about by the liberal option could be beneficial to Continental stock exchanges—in which there are a lot of niches to be exploited—in relation to London.

PROGRESSIVE LIBERALIZATION. The concept of progressive liberalization is essential in the context of the participation of the developing countries in the Uruguay Round. The concept of "comparable competitive opportunities" can take progressive liberalization into account in two ways. First, it suggests that developing countries need to create competitive structures in their own services sectors in order to open them. It thus recognizes that developing countries may face the heavy task of building new, competition-oriented, domestic regulations—a point often emphasized by developing country negotiators. Such a perspective is present in the 1992 program: the Community's less developed countries have often been granted a longer time period for opening their sectors so as not to put them at risk.

Second, industrial countries may agree to give firms from developing countries advantages greater than those granted by these countries to firms from industrial countries. They can do so by defining what they judge as "comparable" to the competitive opportunities they offer. Industrial countries may be eager to graduate their reciprocity threshold to the level of development of their trade partners, especially if they do not feel trapped by a rigid rule of "special and differentiated" treatment.

Competition Rules

Competition rules have been crucial to the EC internal liberalization. Lessons to be drawn for the Uruguay Round can be grouped around the three types of competition rules: "antimerger" (antitrust) rules, rules against the "abuse of a dominant position," and rules against "collusive practices."

There is one crucial motive—in addition to the usual one of promoting competition—for including competition rules in the Uruguay Round: such rules are an extremely economical way of regulating an economy. There are three reasons for this. First, competition rules do not require lengthy provisions: the Treaty of Rome devotes 3 articles (out of 246) and fewer than 60 lines to these rules. Second, since they concern only real problems revealed by the functioning of the markets, they minimize the need for reregulation and thus the risk of premature or excessive reregulation—a danger in multilateral negotiations, which are always quick to consider all possible problems. Third, they maximize the efficiency of the minimal set of reregulations really necessary by offering a sure way of enforcing these regulations if they are consistent with the interests of consumers.

ANTIMERGER RULES. Antimerger rules are unlikely to be part of the Uruguay Round agreement because in many countries many services are provided by public or private monopolies or duopolies, as in telecommunications. The experience of the Community suggests, however, that the absence of antimerger rules will not impede the world liberalization; such rules at the EC level have played no role in the intra-EC liberalization, since they were adopted only in December 1989.

More interestingly, the EC experience even suggests that mergers—apart from their economic pros and cons—can be a positive force for adopting a trade liberalization program. Mergers offer to each member firm a share in the comparative advantages of the other suppliers and in other national markets that may have larger or more dynamic demands. National monopolies or dominant firms can thus reduce the risks associated with trade liberalization through mergers, which become a crucial instrument for dissolving the "national champions" inherited from the 1970s. For instance, the emerging European "megacarrier" consisting of British Airways, KLM, and Sabena offers an unique opportunity for improving the efficiency of Sabena by linking it to two efficient and wealthy firms and for achieving a partial privatization of Sabena at the same time. (British Airways and KLM will each own 20 percent of the shares of the new Sabena World Airlines.) Both effects can only make Belgium's air transport policy more liberal.

There are similar recent examples involving firms from developing countries. For instance, Singapore Airlines and Swissair have signed a cooperation agreement with exchanges of equity. This agreement indirectly reinforces the links between Singapore Airlines and Delta Airlines (a U.S. company), and opens the way for similar deals with SAS, Finnair, and a few other airlines. It generates a "global aviation system" that reduces the risks of changes associated with world liberalization for each member firm and thus lessens the fears of the governments concerned.

This role of mergers can also be observed in the equipment industries linked to service sectors. This is best illustrated by the telecommunications equipment producers, which have constituted consortia for definite tasks.[14] For instance, the recent German bid for a mobile phone license was granted to a Mannesmann-led consortium that included British, French, and U.S. firms. Four of the other offers also involved British firms, including British Telecom itself. In the short run, such mergers, which are now frequent in telecommunications and construction, are a partial substitute for liberalization of the public procurement procedures. They lay the ground for the still rare successes of individual firms (Ericsson in the United States, AT&T in Italy, Sony in Britain, and Fujitsu in Britain and Germany). In the long run, they ease the introduction of more competition-oriented rules in public tenders.

There is a point, however, at which the costs of such mergers or consortia become higher than the gains. Mergers may reach sizes that will hinder the emergence and survival of otherwise efficient mavericks and will thus make competitive markets impossible. In airlines, for instance, the coalition between British Airways, KLM, and Sabena and the one between Air France, Lufthansa, and Iberia would in 1985 have represented 50 to 55 percent of the air services operated by all the EC airlines. In sum, the absence of antimerger rules is an easily acceptable risk only if there are competition rules against abuse of a dominant position.

RULES AGAINST ABUSE OF A DOMINANT POSITION. Dominant positions are likely to be frequent in many service sectors because a successful Uruguay Round will merely open the legal possibility for obtaining better access to networks run by dominant firms (monopolies). These networks include telephone lines run by PTOs, computerized reservation systems, or CRSs—the electronic networks that allow travel agents to book flights and facilities—run by airlines; slots run by airport authorities; roads controlled by governments; and so on. In sum, services will be liberalized, but networks will not, leading to the risk that the network owners will abuse their dominant position if they provide services and compete with mere suppliers of services.

Rules against abuses of a dominant position allow the solution to potential competition to be shifted from *ex ante* general regulations to *ex post* specific cases, as shown by telecommunications value added services. Under the 1992 program PTOs will keep their monopoly on networks but will make them accessible to competitors in value added services. Preventing network-owner PTOs from abusing their privileged position to eliminate competitors has led to special rules of conduct (see appendix 14–A, "Telecommunications"). In other words, liberalizing cross-border services—such as value added services—has led to the reregulation of the providers (the PTOs) of equipment (networks) and services (basic services) that are not yet liberalized. Such a situation generates complex questions. Should reregulation be applied to the PTOs alone, or should the regulatory activities cover newcomers as well? A satisfactory solution is unlikely to reside in static and detailed regulations; it is more likely to emerge from the analysis of a concrete situation in which a given service provider perceives that it faces abuse of a dominant position, in the light of the economically sound criterion of competition rules: the interests of the consumers.

Rules against abuses of a dominant position are necessary for effective enforcement of codes of conduct and similar regulations, as illustrated by the computerized reservation systems. The two emerging EC megacarriers are organized around two CRSs, with, so far, no future competitors in the EC, and with international connections.[15] As CRSs are extremely expensive (both in physical and human capital), they are operated by joint ventures of airlines that have been exempted from competition rules (another example of limited use of antimerger rules). The Commission is well aware of the risks of such an exemption, and the exemption has been subject to conditions that ensure free access to the systems, elimination of biases between air carriers, and more flexibility for the contracts offered to travel agents. It has also been complemented by the adoption of a mandatory code of conduct insisting on nondiscriminatory and transparent use of the CRS. But the credibility of the exemption and of the code relies on the threat imposed by the existence of rules against abuses of a dominant position and on the ability of firms to complain on a case-by-case basis.

All these considerations are of special interest for the Uruguay Round. Many believe that "sectoral annotations"—that is, additional provisions interpreting and clarifying framework provisions for each individual sector—will be necessary. That could represent a great danger for the Round: interminable negotiations and increasingly ambiguous, inconsistent or useless clauses, offering a back door for protection. One can argue that many "sectoral annotations" could be avoided by competition rules.

Two final remarks are necessary. First, competition is often stiffer than initially expected. In telecommunications, private networks are only starting up. Public firms in similar services can generate competition pressures; for example, SNCF, the French railways company, has decided to create its own worldwide reservation system based on the technology of Sabre, the CRS developed by American Airlines (*Le Monde*, November 30, 1989). Second, a balance between the regulations to be applied to dominant private or public firms should be maintained. These two types of firms have different ways of abusing a dominant position, and the Uruguay Round framework should take this difference into account, as the Treaty of Rome did by supplementing article 86 (focusing on private firms) with article 90 dealing with public firms.

RULES AGAINST COLLUSIVE PRACTICES. The EC experience shows that competition rules against collusive practices are a crucial ingredient in the initiation of liberalization in services. Including such rules in the Uruguay Round framework would be useful for three main reasons.

First, Uruguay Round provisions are unlikely to lead to an immediate application of essential provisions to some service sectors. For instance, the most favored nation clause is unlikely to be applied in air transport because this sector relies on a host of bilateral arrangements. As a result, it is likely that there will be a "freeze" in this sector. The danger is that the freeze in liberalization of some sectors will continue forever and become a de facto permanent exception, as in the case of textiles in goods. Accepting a freeze is a risk that can be taken only if there are provisions that permit market forces to reveal a desire to move toward more competition. In the EC experience the enforcement of rules against collusive practices has started the liberalizations in air transport and telecommunications equipment, in particular.

Second, many industrial and developing countries already have active competition rules. When applied to service sectors, these national rules can easily lead to problems of extraterritoriality, which are political and legal nightmares. In such circumstances, actions can take decades or be abandoned, to the detriment of an economically sound procompetitive solution. For instance, the EC code on CRSs applies not just to Amadeus and Galileo but to all CRSs operating in the Community, whether based inside or outside the EC states. The implied risk in terms of extraterritoriality may inhibit enforcement of the code. The adoption of rules against collusive actions in the Uruguay Round would offer a way of solving this type of problem.

Third, the Uruguay Round will adopt safeguards and provisions that have a similar economic impact, such as antidumping and antisubsidy regulations (Hoekman and Leidy 1990). The GATT experience in such matters is crystal clear: either provisions are designed with economically sound constraints (nondiscriminatory measure, compensation, and so on) and are rarely used, as illustrated by the GATT article XIX, or they rely on ambiguous concepts ("unfair" competition, domestic industry, and injury that are rapidly captured by domestic firms looking for protection and are used as devices for enforcing collusive practices with public sponsorship (Messerlin 1990a). The concepts embodied in competition rules against collusive practices offer a way of limiting this phenomenon of capture.

A Brave New World: Competition in Regulations

Services are regulation-intensive. As a result, comparative advantages in services are determined by the ability of states to generate the best rules: states that open their service sectors will compete in regulations. The more market access is granted, the stiffer is the competition. This is best illustrated by the mutual recognition principle, which can mean better treatment of foreign firms than does national treatment. For example, if British licensing or operating rules are better designed than French rules, French branches of the British banks will enjoy better treatment than French banks.

Developing countries may be afraid to compete on these terms because they may feel "disadvantaged" and "unprepared." But there are good reasons for them to accept the challenge and to participate in the "uneasy" free market revival (Henderson 1988).

First, competition in regulations will induce developing countries to elaborate their own regulations. Far from inhibiting their capacity to regulate—a fear often expressed by developing countries—an economically sound Uruguay Round will be a stimulus for them to adopt better regulations. The EC experience in the past decade can be best described as a continuous effort to move from a set of inefficient regulations to a new set of rules that are more efficient because they support a higher level of competition. There is no better illustration than the ongoing competition between the London and Continental stock exchanges. The 1987 crash revealed the weaknesses of some of the new regulations in the liberalized London International Stock Exchange, from too stringent rules on shareholders' preemption rights to medieval methods of transfer. Continental stock exchanges took these weaknesses as an opportunity to step up the removal of old regulations and the introduction of new ones, and the past two years have seen a constant emulation among the regulatory bodies of the national stock exchanges.

Second, competition in regulations will be as dynamic as in goods. Comparative advantages will shift, as they do in goods. By liberalizing long-regulated national markets, the 1992 program has imposed adjustment efforts on the "free" markets that prospered during the nonliberal period, such as the Eurobond market, the reinsurance market, and the insurance markets of the Isle of Man and the Channel Islands. And the EC financial integration is accelerating the pace of U.S. and Japanese reforms of regulations that have imposed tight constraints on U.S. and Japanese banks and insurance firms in their domestic markets. Similarly, the expected liberalization in EC telecommunications has attracted the "Baby Bells"—the regional U.S. phone monopolies born of the breakup of the Bell System. The restrictions on their U.S. operations have induced them to invest in mobile phones, cable television, computer services, and fiber optic cables all over the EC: six "Baby Bells" (out of seven) have invested in such liberal EC states as Britain and Germany, and, even more remarkably, three have invested in France and two in Spain and Italy.

Finally, the gains to be expected by developing countries from liberalizing services are enormous. Liberalization of services opens competition in equipment, as shown by the EC experience in telecommunications. Competition in services has induced European PTOs to abandon their traditional domestic suppliers for cheaper sources, and new services have induced European consumers to buy new equipment. Developing countries have largely benefited from these evolutions: the market shares of their exports of telecommunications equipment to EC countries increased, on average, by 20 percent in the first two years after the beginning of liberalization, and in only a few years some developing countries have upgraded their products from phone sets to small terminals (Messerlin 1990b). These increased exports will give developing countries the means to pay for increased imports in services, which in turn will allow them to improve the efficiency of their economies by decreasing the costs of services used as inputs. The estimated gains from the 1992 program to the EC countries—2 percent of their total GNP—look impressive. It is likely, however, that they greatly understate the gains to be expected in developing countries, where the lack of adequate telecommunications or finance often has an infinite cost, since it inhibits potential exports.

Appendix 14–A. The 1992 Program, by Service Sector

BANKING. The main new directive, the Second Banking Directive, deals with the creation and implementation of a single EC banking license. After 1992 (and as in the past), bank subsidiaries, which are classified as factor-related trade in services in the EC framework, will be governed by the *national treatment* clause—that is, they will be treated by the host EC state as domestic banks in terms of licensing and operating requirements. For instance, a French subsidiary of a British bank will be treated as a French bank. The crucial innovation of the directive concerns the provision of cross-border banking services (for instance, money transfers) and bank branches, which are classified by the EC as cross-border services. After 1992 these services will be ruled by the principle of *mutual recognition;* each EC state will recognize the licensing rules of the others and will apply its own operating rules on a nondiscriminatory basis to branches of banks licensed in other EC states. For instance, a French branch of a British bank will be under British, not French, licensing rules and will operate under French operating rules concerning monetary regulations, liquidity, and the like.

In fact, banks operating throughout the Community would be largely regulated by their home countries. The exact coverage of mutual recognition is still uncertain because the borderline between licensing rules and operating rules is difficult to draw with precision at this stage. For instance, will a firm operating under a British building society license be able to offer variable mortgages or money market funds in the whole EC, including in EC states that prohibit such mortgages and funds? If so, the French ban on such mortgages will "disadvantage" French banks in relation to British banks or to banks from EC states that allow this service. Similarly, the German ban on money market funds will work to the "disadvantage" of German banks.

The main benefit of the mutual recognition approach is to require the minimal effort in regulatory harmonization—a huge gain in efficiency when twelve countries are involved. Because of its enormous potential impact, the mutual recognition principle is likely to trigger creeping resistance to liberalization, as indeed has been seen in the efforts of some EC states (led by France) to impose withholding taxes on capital to prevent capital movements and limit competition. The ambiguity of the principle is also likely to generate cases for the Court of Justice.

The Second Banking Directive is flanked by two directives—on mutual funds (the "undertakings for collective investment in transferable securities," or UCITS, in EC jargon) and on "investment services" (brokers, dealers, and so on). The directives apply to these two types of securities firms the same mix of national treatment and mutual recognition principles. The three directives constitute the backbone of the 1992 program as it applies to banking and securities. The minimal harmonization in prudential matters is covered by eight directives on banking, five on securities, and three on capital movements.[16]

INSURANCE. The 1992 program inherited the free establishment principle that was adopted in 1973 for nonlife insurance and in 1979 for life insurance. The huge effort to harmonize the regulations of the EC states necessary to transform this principle into actions failed. Insurance markets remained closed, except for reinsurance. As a result, the 1992 program initially focused on the right of firms to provide services across the borders of the EC states. Its main success concerns the nonlife "large risks"—property and damage risks that involve firms of a minimum size, as measured by number of employees, turnover, and assets, and that are estimated to represent 50–65 percent of the nonlife market. After 1991 such risks will be offered by insurance firms operating under home country rules, which implies mutual recognition of insurance regulations among EC states.

In the remaining areas of nonlife insurance ("small" policyholders) and in life insurance, progress has been limited. As a result of rulings by the Court of Justice (discussed above), the current 1992 program allows EC insurers to compete in all EC states only under host country rules. The expected impact of such measures is not high: insurers will not be keen to undertake the huge costs of penetrating markets in a alien legal environment, except through mergers—an ambiguous move from the point of view of competition. As a result, the vice-president of the Commission, Leon Brittan, recently proposed that the same approach as in banking and securities be followed: insurers would be free to set up branches in other EC states and to sell their products on the basis of a single license and supervision from the home country (*Financial Times*, November 28, 1989).

AIR TRANSPORT. The December 1989 package expands the decisions made in the December 1987 package. Quota (capacity-sharing) arrangements are dismantled, the initiative of basing prices on costs is given back to airlines by generalizing the "double disapproval" procedure, and discounts are authorized.[17] These provisions, however, are not likely to introduce significant changes in competition and fares unless new rights regarding market access are adopted: "multiple designation" (that is, the capacity to designate more than one carrier to operate the same route) and the fifth freedom (the capacity to set down and pick up passengers at an intermediary airport en route to the final destination). Without these two conditions—particularly the first one, which represents a shift from bilateral to multilateral liberalization—airlines have no strong incentives to enter new routes.

The ambiguity of the December 1989 package is that it includes these provisions, but only as nonbinding agreements. The 1987 package has not allowed a major breakthrough in these matters. The coverage of multiple designation increased from 5 percent of the scheduled air routes in June 1987 to 7 percent in June 1989, mainly because of Britain's policy. The coverage of the fifth freedom is even lower: one fifth-freedom service was operated by a Community airline before 1988 and only 14 in 1989 (Commission 1989).

TELECOMMUNICATIONS. The content of the 1992 program concerning telecommunications has been confirmed and refined by the December 1989 agreement. The program relies on two main directives that strike a delicate balance between forces in favor of and against liberalization.

The directive on telecommunications services states that value added network services will be liberalized but that the PTOs will keep their monopoly in basic services. The crucial point—the borderline between the two types of services—is defined by the December 1989 agreement: by mid-1991 value added services will cover advanced services, such as electronic mail and access to computer data bases, and in early 1993 they will be extended to cover basic data communications—at 25 to 30 percent a year, the fastest growing part of the market—leaving only telex and voice telephony to basic services.[18]

The directive on open network provisions (ONP) aims at harmonizing the conditions under which the liberalized telecommunication services industry would gain access to the networks. It states three basic rules: technical harmonization that allows full connectivity among the EC networks; minimal standards required for private firms under competition; and harmonization of the principles for setting tariffs, preferably on the basis of cost. More detailed regulations are to follow the directive. The fact that they will be drafted by a body emanating from the twelve PTOs has raised fears of collusion or abuse of dominant positions by PTOs.

SHIPPING. During the 1980s shipping suffered from a decline of activity coupled with the emergence of new competitors—an unusual feature among services, and one unfriendly to liberalization. During these years EC state shipping policies were limited to waivers to cabotage rules and to more liberal grants of cargo reservations. The progressive implementation of "flagging-out" policies (opening ship registers, with fewer constraints on hiring, meaning lower taxes and wages) is introducing a subsidy policy through a "fiscal" delocalization of the industry. The flagging-out policies have only a modest liberalization component in that the protectionist bias against crews from developing countries is reduced, facilitating movement of semiskilled labor. Finally, the drift of liner conferences into cartels backed by international agreement (the UNCTAD Liner Code) has made virtually impossible the adoption of more competitive rules within the EC.

The 1992 program in shipping mirrors these problems. Liberalization is slow: freedom to provide services between EC states has been adopted, but freedom to provide services within EC states has not. (So far, this is the only 1992 directive to be rejected). Competition has difficulty in emerging: liner conferences have been granted a "block exemption" from the competition rules of the Rome Treaty.

ROAD TRANSPORT. In road transport the 1992 program is starting from scratch with the issuance of 15,000 special permits, to be distributed by EC states, that will be valid for limited periods and will enable haulers to do business across the Community.

BUSINESS SERVICES AND LABOR MOVEMENT. The main business services dealt with in the 1991 program are accounting, television programming, and the legal and medical professions. Nine directives deal with the progressive introduction of the mutual recognition principle in professional services to ensure free movement of skilled labor. Enforcement of this principle is likely to be a long, contentious process. Semiskilled or unskilled labor (for instance, in the construction sector) is partly covered by EC provisions dealing with public procurement, as illustrated by the recent contract for the construction of the Great Belt Bridge in Denmark; the initial clause calling for use of Danish labor was dropped after the Commission intervened.

Notes

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1. In a very few instances the absence of national firms has allowed EC states to be liberal for a long time—Denmark in telecommunications and Luxembourg in airlines are examples.

2. NIFs are note issuance facilities (revolving facilities that enable borrowers to issue a stream of short-term notes). RUFs are revolving underwriting facilities, a kind of guaranteed NIF.

3. The "Ryrie rules" stated that private financing of public firms should be allowed only if this would result in improved efficiency—a condition close to a veto with the British Treasury as umpire (Ryrie 1989). The privatization of British Telecoms required the raising of 2.5 times more funds than the five privatizations undertaken between 1981 and 1984.

4. Liberalization of scheduled services took off in 1984 with relaxations of the licensing rules (licenses were given to fly any route, except some specified ones) and the domestic fare approval system (Barnes 1988).

5. To license new competitors (such as British Railways) or to authorize the resale of leased lines from British Telecom might have been alternatives to the duopoly, if one ignores potential entry by large foreign firms. Interestingly, Mercury relies on Hong Kong Telecoms for most of its profits (*Financial Times*, June 10, 1989).

6. Until 1987 Germany was considered the most protectionist EC state in telecommunications by any standard: a 100 percent state-owned monopoly dominated public procurements in telecommunications, and there was no separate regulatory agency, no other network operator, no separate subsidiaries in competitive markets, and no unrestricted use of leased lines for value added services (Muller 1988, p. 172).

7. This decision has applied to low-speed data services since April 1989 and to the much more important high-speed data services (64K bit per second and 2 megabit per second lines) since June 1989.

8. Mercury's ability to survive as an independent firm was attributable to the fact that it was owned by Cable & Wireless, a firm that had a long tradition of world-wide telecommunication systems (Ergas and Paterson 1989) and was well established in other key areas, such as Hong Kong; to the most recent technology, which makes possible considerable flexibility for locating telecommunications hubs in other countries; and to the competitive pressures from the other side of the Atlantic (although U.S. Judge Harold Greene did bar a joint project of Nynex and Cable & Wireless for a transatlantic fiber optic telephone cable *Financial Times*, February 15, 1989).

9. This is confirmed by recent estimates from a National Utility Services study according to which a standard 3-minute long-distance call is three times more expensive in Germany than in Britain and a local call is 25 percent less expensive in Germany than in Britain (*Financial Times*, June 30, 1989).

10. Directives are Community laws that have to be introduced as national laws. The complete 1992 program deals with many other topics in addition to trade in services and rests on 279 directives. The Commission is increasingly worried about delays in transforming directives into national laws.

11. For a view about the EC 1992 program and the Uruguay Round embracing manufacturing and services, see Sapir (1989). For a view focusing on 1992 and developing countries in services, see Nicolaides (1989).

12. Policies such as flagging out cast some doubt on the value of the immigration argument raised by all industrial countries for limiting labor movement. Would foreign crews recruited by EC firms be "less foreign" than foreign crews employed by foreign firms?

13. For a detailed and comprehensive analysis, see Key (1989). Under article 58 of the Treaty of Rome, subsidiaries of non-EC banks benefit from all the rights accorded by Community law. There were roughly 530 foreign bank branches in the EC as of February 1989 (Fitchew 1989).

14. Some mergers or consortia cover equipment and services, as, for example, the recent "pact" between British Telecom, STET of Italy, and Telefonica of Spain on network modernization, mobile communications, value added services and international communications (*Financial Times*, December 19, 1988).

15. Galileo is built by British Airways, KLM, and Sabena (with Alitalia and Swissair) and Amadeus by Air France, Lufthansa, and Iberia (with SAS). Galileo is connected with United Airlines (a U.S. airline) and Amadeus with Texas Air (a U.S. airline) and with several Asian–Pacific airlines through Abacus, the common CRS of Cathay Pacific, China Airlines, Malaysian Airlines, Philippine Airlines, and Singapore Airlines, which was developed with the technical support of Cable & Wireless.

16. In banking the main harmonizations concern solvency standards, own funds, accounts of banks and of foreign branches of banks,

cross-border provision of house mortgages, and principles to be adopted by supervisory authorities in dealing with institutions in difficulties. In securities harmonization provisions deal with information to be provided in case of sales to the public or of acquisitions of major holdings and with insider trading, with derogations for Greece and Portugal. Capital adequacy directives covering credit risk and risks related to interest rate, exchange rate, position, and settlement are being drafted. Capital movements provisions spell out harmonizations with a longer period of transition for Greece, Ireland, Portugal, and Spain and a safeguard clause in case of major macroeconomic problems.

17. The 1987 directive on capacities replaced the traditional capacity sharing rule (50–50 percent) with a lower quota (45–55 percent and, in October 1989, 40–60 percent). The 1989 agreement targets a 25–75 percent quota by the end of 1992. Fares that "reasonably reflect the costs of an individual airline" should be approved by the EC states. Discount and deep discount fares are available for off-peak periods and specific passenger categories. Fare measures are accompanied by safeguards if fares drop by more than 20 percent.

18. But EC states that wish to issue license conditions for data communications will be able to do so if the conditions are nondiscriminatory and are vetted by the Commission. Greece and Portugal have received a potential derogation up to 1996 if their public services are at risk.

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15

Lessons from the Experience of the OECD

Rainer Geiger

Looking at the experience of the OECD with trade in services can be useful for those involved in international service transactions and in the Uruguay Round of negotiations. There are several reasons for this.

- The OECD framework is multidisciplinary and multilateral. Its approach combines basic policy principles and specific sectoral rules and includes both commitments by governments and standards of behavior for market operators.
- Many of the key concepts put forward in the international negotiations on services have already been tested through OECD experience.
- The OECD brings together a representative sample of countries that account for the bulk of international transactions in services.

Of course, caution is needed in drawing conclusions from OECD experience. The diversity of actors at a broader international level and the complexity of the issues under negotiation defy easy generalization. One should not forget, however, that although OECD member countries share broad economic goals, they do not necessarily have the same interests where trade in services is concerned: their competitive positions in various service sectors may be different, and their regulatory regimes are far from being harmonized. Consensus on common principles has sometimes been difficult to achieve, and where progress has been made, it has been through relentless persuasion and peer pressure rather than through legal rulings. Yet since the inception of the OECD in 1961, and even under its predecessor, the Organisation for European Economic Co-operation (OEEC), there has been a continuous process of liberalization in capital movements and services among members and in most, if not all, cases with respect to nonmembers. All of the instruments discussed in this chapter predate the international negotiations on services now being pursued in the Uruguay Round, and efforts to strengthen and update these instruments parallel the negotiations.

The OECD approach to services is not monolithic; instruments that have evolved separately in various institutional settings coexist and interact. But all of these instruments are based on the same underlying philosophy: an open international environment for transactions in goods, capital, and services is not only beneficial to the expansion of trade and to international welfare but also serves the enlightened self-interest of each participant. Although the rate of progress toward liberalization may vary from country to country according to the level of economic development, all members adhere to the same principles and rules of the game and benefit from nondiscriminatory treatment. Many of the concepts that are implicitly or explicitly included in the OECD instruments coincide with the key principles stated in the part of the Uruguay Round midterm review that deals with services.

Throughout, the term international transactions in services is defined to include all modes of delivery: cross-border movements of services, cross-border movements of producers or consumers of services, and provision of services through establishment or commercial presence in the recipient country.

A Policy Framework for International Transactions in Services

The OECD framework consists of two main types of instruments. The Code of Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations (hereafter, the Capital Movements Code and the Invisibles Code) were adopted in 1961 by decision of the OECD council and are legally binding for member countries. The Declaration and Decisions on International Investment and Multinational Enterprises (hereafter, the 1976 Declaration), adopted by OECD member governments in 1976, has no legal force but is supplemented by implementation procedures set forth in council decisions. Taken together, these instruments cover the main features of international transactions in services. Other policy principles and recommendations adopted by the council and dealing, for instance, with competition and specific sectoral aspects are also relevant.

Cross-border transactions in services and related transfers between residents and nonresidents are covered by the Invisibles Code to the extent that the activities fall within one of the categories listed in the code's annex A. The annex includes all service sectors (with the notable exception of informatics and data services, which were hardly developed when the code was adopted). For each sector the annex defines in more detail the commitment to eliminate restrictions that is stipulated in general terms in article 1 of the code.

Provision of services through investment and establishment in the recipient country comes within the purview of the Capital Movements Code, annex A of which lists the activities to be liberalized. One of these activities is direct investment.[1] The obligation to liberalize covers all forms of direct investment, whether through subsidiaries, branches, or acquisition of other types of controlling interests; the choice as to which form an investment may take rests with the investor.

For foreign direct investment to be liberalized, it is not sufficient that transactions and transfers be authorized in a formal sense; nonresidents must be given effective access to business operations within the general framework of the host country's laws and regulations. This understanding was made explicit in a 1983 amendment to the code.[2]

Cross-border movements of suppliers of services are not covered by the codes, which do not explicitly require liberalization of establishment by physical persons. Some services, however—such as construction, engineering, and professional services—are frequently provided through temporary movement of suppliers and cannot be considered to be effectively liberalized when this important mode of delivery is excluded. To become effective, an understanding would have to include movement of persons. Further efforts toward liberalization through amendment of the code are especially needed in the area of professional services. A 1985 report by the OECD Committee on Competition Law and Policy recommends the removal of entry barriers to professional services that discriminate against foreign service providers on the sole basis of their nationality.

Liberalization of direct investment and establishment is not in itself a sufficient guarantee of effective market access if foreign suppliers, once established in the host country, are subject to discriminatory treatment that creates significant competitive disadvantages in relation to domestic suppliers. National treatment for foreign-controlled enterprises operating in host countries is dealt with in the 1976 Declaration, which is complemented by the Guidelines on Multinational Enterprises. "Operating" has been interpreted to require some form of commercial presence in the country concerned—that is, a subsidiary, branch, or sales office. If such a commercial presence is established, the foreign-controlled enterprise has to be given treatment no less favorable than that accorded to domestic enterprises in like situations. The qualification "in like situations" means that in certain circumstances, and for legitimate reasons other than nationality, foreign suppliers of services may be treated differently, provided that such treatment does not affect the competitive situation of the enterprise concerned. Thus, for reasons unrelated to nationality (such as prudential supervision or to prevent tax evasion), foreign branches may be given different, but equivalent, treatment as compared with subsidiaries or branches of domestic enterprises.

The national treatment instrument provides the necessary complement to the freedom of entry and establishment granted by the Capital Movements Code. Although both the code and the declaration interact closely, only the code is legally binding. In the context of an overall review of the 1976 Declaration scheduled for 1990, efforts are being made to strengthen members' obligations under national treatment by making that part of the declaration a binding instrument.

The Guidelines for Multinational Enterprises, which apply to the behavior of international market operators in the fields of both goods and services, directly address multinational enterprises. Although they are not legally binding, they carry the weight of joint recommendations by all OECD governments, and follow-up procedures have been set up at both national and international levels to ensure their effectiveness.

Key Concepts of the OECD Instruments

Although the legal nature of the OECD instruments and their modes of implementation differ, they are based on a common set of concepts and principles, including progressive liberalization, nondiscrimination, national treatment, competition, and standards of behavior for multinational enterprises.

Progressive Liberalization

The concept of progressive liberalization is common to the Declaration of Punta del Este and the OECD instruments. For the OECD, it is based on the following elements.

- All members undertake a firm commitment to the objective of liberalization and submit to a regular examination procedure that encourages steady progress toward that goal.
- The pace of implementing this objective depends on each member's particular situation, especially its level of economic development.
- All members subscribe to common rules of the game and submit to international surveillance of the way in which they carry out their obligations.
- Liberalization, once attained, is irreversible (standstill), and remaining restrictions are subject to examination with a view toward their gradual elimination (rollback).

Under the two codes, members have several possibilities for obtaining dispensation in accordance with their economic and financial situation. The most far-reaching exemption, which is now largely irrelevant, is provided in article 7(a) of the Capital Movements Code. Under it, a member, for reasons related to its economic development, can invoke a derogation from the totality of the liberalization obligations. A few members initially availed themselves of special status under the code, but Spain, Greece, and Turkey have dropped this derogation and are now assuming full responsibility under the code, leaving Iceland as the only country still invoking the clause. Since the derogation cannot be re-established once it is withdrawn, article 7(a) has become obsolete for all countries but one.

Under the remaining clauses of article 7, if a liberalization measure leads to serious economic and financial difficulties in the country concerned, it can be withdrawn, and if there are serious balance of payments difficulties, the measure can be temporarily suspended. In both cases derogations must be confined to the minimum necessary to remedy the difficulty, and the validity of the derogation is judged by the OECD council. The continuing justification for a derogation is closely monitored until the derogation is ended.

The most common way of obtaining a dispensation is to lodge reservations under specific items of the codes, as provided in article 2(b) of both codes. These reservations are recorded in separate annexes, which are integral parts of the instruments. Reservations can be entered only if:

- A new obligation is created
- An existing obligation is extended
- An obligation has just begun to apply to a member.

Thus, under the most important items of the Capital Movements Code, the inequality of rights and obligations among members that is created by the maintenance of reservations is mitigated by a standstill provision. That is, new restrictions not covered by an existing reservation cannot be introduced, and new reservations on items listed in annex A (which includes, among other things, direct investment) cannot be lodged except under the limited circumstances mentioned above. Under the national treatment instrument, members may maintain exceptions that have to be notified to the OECD. In May 1988 members agreed on a standstill commitment under which new exceptions will no longer be admitted.

Rollback is an essential feature of progressive liberalization. Any restrictive measure maintained under the codes, whether by reservation or derogation, as well as any exception to national treatment, is subject to periodic examination aimed at the removal of the measure. The prohibition of new restrictions is intended to ensure the maintenance of the liberalization that has been attained.

Nondiscrimination

This principle is fundamental to relations among members under the codes and the national treatment instrument. It has two important elements. First, liberalization measures and remaining restrictions should not discriminate among members. (This obligation also applies to members having recourse to reservations or derogations under the codes.) Second, most favored nation treatment applies to all members who adhere to the codes and comply with the rules, regardless of the state of liberalization they have attained.[3] Thus the codes, in accordance with their multilateral character, take a firm position against reciprocity provisions; these and other forms of discrimination are, as a matter of principle, not permitted. In the area of direct investment and establishment, however, and in particular in the financial services sector, a number of members did maintain reciprocity provisions—some of them rarely activated—which they were not ready to remove. It was felt that such provisions should be distinguished from other types of restrictions that are covered by reservations. Accordingly, they are dealt with in a separate council decision (annex E of the Capital Movements Code) which enumerates all existing reciprocity measures, and they are subject to the same procedures as ordinary reservations concerning their review and progressive elimination.

The council decision refers only to existing reciprocity measures and does not mention the treatment of new ones. But since reciprocity is a deviation from the nondiscrimination principle, which is essential to the multilateral nature of the OECD instruments, any exception in its favor should be narrowly construed. Reciprocity provisions that are not explicitly allowed should be considered prohibited. In other words, the standstill obligations concerning reservations also apply to restrictions based on reciprocity. The same reasoning would also apply to the national treatment instrument, under which new exceptions based on reciprocity should not be introduced.

Article 10 of the Capital Movements Code and the Invisibles Code provides that "members forming part of a special customs or monetary system may apply to one another . . . other measures of liberalization without extending them to other members." This article, which undoubtedly applies to the European Economic Community, allows members of the system to liberalize among themselves without extending the liberalization measures to other OECD countries. It does not justify the introduction of new discriminatory restrictive measures. Liberalization of services within the European Economic Community must be judged against these standards, in particular if they involve any new reciprocity clauses with respect to other OECD countries.

The question of whether bilateral free trade agreements such as the Canada-U.S. Free Trade Agreement qualify as customs unions under article 10 has not yet been resolved within the OECD. The notion of a "special system" implies the establishment of permanent and institutionalized arrangements between the contracting parties with the goal of removing customs and other trade barriers, but the required degree of economic cooperation and integration of the partners has not been defined. Although the legislative history of the codes seems to indicate that free trade agreements were thought to come within the purview of article 10, it is for the competent OECD committee and, ultimately, the council to determine the applicability of article 10. Any interpretation will have to take into account the importance of maintaining the multilateral nature of the code, which should not be undermined by the proliferation of special arrangements among members. The national treatment instrument does not now contain any clause similar to article 10 of the codes, and it is doubtful whether a clause that would justify discrimination between foreign-controlled enterprises already operating in the territory of the member country concerned would be acceptable.

National Treatment

Whereas nondiscrimination applies to relations among members, the principle of national treatment pertains to measures taken by governments with respect to market operators. Under the codes nonresidents must be able to carry out service transactions and related transfers on the same basis as residents. National treatment, as defined in the 1976 Declaration, means "treatment under [the member countries'] laws, regulations, and administrative practice consistent with international law and no less favorable than that accorded in like situations to domestic enterprises."

It is clear from the language of these instruments that they do not intend to place nonresident operators and locally established foreign-controlled enterprises in a better position than domestic enterprises. As stated in an interpretation of the code by the competent committee, the liberalization provisions "do not entitle a nonresident to engage in an economic activity without compliance with the general regulations of the member concerned," and the same consideration applies to national treatment.

National treatment does not necessarily provide foreign operators with effective access to markets for services in countries in which services are heavily regulated. Many countries have general economic regulations concerning entry and operating conditions in service industries that affect both domestic and foreign suppliers. The main types of government intervention in service sectors include:

- Public monopolies, whereby entire sectors are closed to private involvement, whether by foreign or domestic enterprises
- Government-sanctioned private monopolies that have the same effect
- Mixed public-private monopolies or sectors dominated by government-owned enterprises that enjoy preferential operating conditions
- Concession or license requirements that limit the total number of firms operating in the sector, regulations on rates and prices, and other restrictive operating conditions.

The situation is further complicated because certain regulations are implemented at the regional or municipal rather than the national level or have been delegated to nongovernmental bodies, as in the case of professional services.

Laws, regulations, and other measures that establish public monopolies, government-sanctioned private monopolies, or a combination of the two, like nondiscriminatory economic regulations in general, do not fall under the liberalization commitment stipulated by the codes, nor are they contrary to the national treatment instrument. They are considered part of the economic framework in member countries. Yet they may severely limit or frustrate competition by foreign providers of services.

The asymmetry of regulations, particularly in banking and financial services, is another cause for concern, as liberalization based on national treatment simply may not lead to a comparable level of market access for all trading partners. (Universal banking versus separation between banking and securities operations is the most striking case in point.)

Should national service regulations, even if nondiscriminatory in a formal sense, be subject to international scrutiny and negotiation? Where is the line between "appropriate" and "inappropriate" regulations? Is it permissible to define the scope of "natural monopolies—for example, in telecommunications—in an extensive manner, to include equipment and value added services areas, where competition is clearly possible? Is it acceptable to maintain strict entry rules in sectors, such as transport, where economic evidence shows that markets are "contestable"?

These questions are under discussion within the OECD, but the issues have not yet been resolved. Public monopolies and other formally nondiscriminatory measures are now subject to transparency commitments and critical review. The OECD Committee on Competition Law and Policy, among others, is reviewing regulatory reforms in member countries' service industries, the effects of such reforms, and actions taken to fight anticompetitive practices by operators. This review is expected to lead to policy recommendations that may contribute to trade liberalization in these areas.

Competition and Corporate Behavior

Trade liberalization in goods in the post-World War II period has been accompanied in many member countries by the development of competition legislation designed to prevent the replacement of trade barriers with private restrictive practices among market operators, such as price-fixing and market allocation agreements. It is not surprising that similar concerns are raised with respect to the liberalization of services. Many countries have heavily regulated service sectors that have not been subject to the full force of competition laws or have even been totally exempt from such legislation. One aim of the regulatory reforms now under way in many countries is to create more competitive markets for services and to apply competition law more vigorously. In addition, competition policy criteria should apply to trade restrictions enforced by nongovernmental organizations (for example, shipping conferences) and by professional bodies.

At the international level, competition policy principles are set out in the Set of Principles negotiated within the United Nations Conference on Trade and Development (UNCTAD) and adopted by the United Nations General Assembly in 1980. These principles apply to goods and services alike, with no sectoral exemptions, and cover both collusive practices among competitors and abuses of market power by dominant enterprises. Similar but less detailed principles are contained in a special chapter on competition of the 1976 OECD Guidelines for Multinational Enterprises.

In international discussions on restrictive business practices, reference is often made to intragroup arrangements within multinational enterprises that may involve, among other things, market allocation and production transfer pricing and cross-subsidization. Under the competition laws of most countries, such intragroup practices are not considered harmful unless they constitute an abuse of a dominant position and adversely affect competition outside the affiliated enterprises. The United Nations Code and the OECD guidelines follow the same approach. Examples of abuses of dominant positions given in the guidelines include:

- Anticompetitive acquisitions
- Predatory behavior toward competitors
- Unreasonable refusal to deal
- Anticompetitive abuse of industrial property rights
- Discriminatory (that is, unreasonably differential) pricing and the use of pricing transactions between affiliated enterprises to adversely affect competition outside these enterprises.

Abuse of dominant positions under these provisions presupposes the existence of market power. Determining whether market power does exist requires careful examination of relevant product and geographic markets taking into account, among other things, the characteristics of the products or services concerned, the availability of substitutable products or services, the degree of concentration in these markets, entry barriers, and the existence of foreign competition.

It should not be concluded that in the absence of anticompetitive practices the OECD guidelines are irrelevant to intragroup arrangements. According to the guidelines, multinational enterprises should "take fully into account established general policy objectives of the member countries in which they operate" and "allow their component entities freedom to develop their activities and to exploit their competitive advantage in domestic and foreign markets, consistent with the need for specialization and sound commercial practice." Although the OECD guidelines do not create any legal obligation, governments that have adopted them expect them to be observed by multinational enterprises, and follow-up procedures at the national and international levels provide an opportunity for raising any issues encountered in their application. Thus, the guidelines constitute an important balancing element to the commitments undertaken by governments under the codes and the national treatment instrument.

Implementation

Two OECD committees are primarily responsible for implementation and surveillance: the Committee on Capital Movements and Invisible Transactions (CMIT) and the Committee on International Investment and Multinational Enterprises (CIME). The CMIT's mandate is determined by the two OECD codes. The CIME has an overall mandate for all investment policy issues arising in OECD and specific responsibilities for the implementation of the 1976 Declaration. In addition, several other OECD committees deal with questions relating services: the Insurance Committee, the Committee on Financial Markets, the Maritime Transport Committee, the Tourism Committee, and the Committee for Information, Computer and Communications Policy. The Trade Committee is carrying out a comprehensive analysis of trade in services in connection with the Uruguay Round; both sectoral and conceptual issues relevant to the negotiations are being discussed.

The institutional framework set up under the codes is somewhat different from other working arrangements within the OECD. Whereas all other committees are composed of representatives of member governments acting by consensus, the CMIT, which is in charge of implementation of the codes, is a body of experts named by governments in their individual capacities. It can decide by simple majority, and it reports directly to the OECD council. Although the CMIT experts are understandably sensitive to the interests of the governments that nominate them, and although a formal vote is rarely taken, these special rules have contributed to the committee's operational effectiveness.

Transparency and Notification

Transparency is achieved through formal notifications by members, through surveys undertaken by the OECD secretariat, and through informal question-and-answer sessions. Under the codes and the national treatment instrument, members are required to notify the OECD of all restrictive measures requiring a reservation or derogation to the codes or constituting an exception to national treatment. They also report any relaxation or removal of restrictive measures and, more broadly, changes in policy having a bearing on the OECD instruments. Members have also agreed to report potentially restrictive measures even if it is not clear whether they actually qualify as a reservation, derogation, or exception. Measures such as public monopolies that are not discriminatory are nevertheless reported in the interests of transparency.

Surveys of members' policies with respect to specific services provide descriptive material and an opportunity to analyze the reasons for and effects of these policies. Question-and-answer sessions provide an opportunity for informal exchanges of information and frank discussions of specific national measures.

Examination and Consultation

Reservations maintained under the Capital Movements Code, as well as the initial and continuing justification for any derogations, are examined country by country, each country being examined by the CMIT every three to four years. Ad hoc discussions are held as specific important issues concerning members' policies arise. Examinations under the Invisibles Code have thus far been conducted by sector rather than country by country. Discussions of exceptions to national treatment have focused on categories of exceptions, but recommendations have been addressed to individual members.

Examinations under the Capital Movements Code are carried out according to an established procedure. The country concerned submits a memorandum explaining its position under the code in light of its economic and financial situation and stating the reasons for any restrictive measures it wants to maintain. The secretariat then prepares a working document for the CMIT analyzing the situation and putting forward proposals for recommendations by the committee. After discussion by the committee, a report is submitted to the council, which makes the final decision on the committee's recommendation.

Experience has been somewhat different for each code. Under the Capital Movements Code, relatively little progress was achieved in the 1960s and 1970s, but in the 1980s liberalization has proceeded at a rapid pace—exchange controls on capital movements have been drastically curtailed or completely abandoned by one country after another. In the area of direct investment and establishment, significant progress has been made in dismantling restrictive authorization procedures. Countries that have taken important steps toward liberalization of inward investment include Australia, Canada, France, Japan, New Zealand, Spain, and Turkey. In some countries, including the Federal Republic of Germany, Switzerland, the United Kingdom, and the United States, this item, apart from a few minor sectoral exceptions, has been fully liberalized. Services is the main area in which restrictions on inward investment and exceptions to national treatment are still relatively important, but here too there has been an encouraging move toward liberalization. For example, in banking and financial services, no member country excludes foreign investment as a matter of principle, and restrictions have been substantially relaxed in recent years. It should be stressed that liberalization does not necessarily imply deregulation. Opening sectors up to foreign competition does not mean that nondiscriminatory regulations maintained for public policy purposes, such as prudential controls in financial services or safety regulations in transport, have to be abandoned; they may even have to be strengthened in some instances to meet the new challenges of global markets and internationalized transactions.

Within the areas covered by the Invisibles Code, progress has been uneven. Although by 1960, when the code was adopted, a considerable degree of liberalization of cross-border services had been achieved (especially in the field of payments for services rendered), during the 1960s and 1970s there was little further movement toward reducing the remaining barriers. Liberalization gained new momentum in 1979, when the OECD council decided to start updating the code (see "Updating and Revising the Instruments," below). Four sectors have already been covered: tourism, audiovisual services and works, insurance, and financial services. In each, the purpose is to expand the range of service operations subject to liberalization and to encourage members to relax or abandon any restrictions they have on those operations. Progress has been impressive in the field of payments for tourism services, which is now almost entirely liberalized within the OECD. In banking and financial services, most members have made efforts to open their national markets, but further progress is needed, particularly in insurance, where significant restrictions remain with respect to establishment and cross-border services. As several council recommendations have stressed, the case for liberalization of insurance related to international trade in goods is particularly strong and should be vigorously pursued.

Interpretation of the Instruments

In the course of notifications, consultations, and examinations, questions frequently arise as to the meaning of the instruments in a concrete situation. It was felt that the authority and effective application of any interpretation of the existing provisions could be best ensured if interpretation were entrusted to the committee in charge of the day-to-day implementation of the instruments. Accordingly, questions concerning interpretation of the codes are discussed by the CMIT, and its conclusions on important matters are usually submitted to the council for approval or information. Issues arising under the 1976 Declaration are dealt with by the CIME. Procedures regarding the OECD guidelines have been laid down in a council decision on intergovernmental consultation.[4] The clarifications of the guidelines provided by the committee in response to requests from governments and the OECD's Trade Union Advisory Committee during the period 1976–84 were compiled in OECD (1986).

In the area of national treatment, the relevant council decision does not refer explicitly to interpretation and clarification, but it is understood that this task is part of the committee's responsibilities in monitoring the application of the instrument. A publication issued in 1985 clarified the meaning of national treatment generally and in relation to six categories of measures in which exceptions to national treatment have been recorded: official aids and subsidies, tax obligations, government procurement, investments by established foreign-controlled enterprises, access to local bank credit and capital markets, and corporate organization (OECD 1985).

Updating and Revising the Instruments

Starting with a council decision in 1979, the CMIT has been engaged in updating the sectoral parts of the Invisibles Code to take account of technological changes, the increased importance of services, and the growing internationalization of economic activities. A complete inventory is made of members' restrictions on international trade and investment in the sector concerned. The reasons for and the relative importance of these measures are then analyzed, and proposals for revisions are elaborated. Finally, the remaining restrictions are examined under these new provisions.

Four sectors have already been covered: insurance, travel and tourism, audiovisual services, and financial services. In cooperation with the Committee for Information, Computer and Communications Policy, a new project has been launched to explore the possibilities for liberalization in the areas of value added network services, computer services, and computerized information services. The next area in which work could be started is professional services.

In May 1989 the council, acting on a joint proposal by the CMIT and the Committee on Financial Markets, adopted revisions to the Invisibles and Capital Movements Codes. The decisions affect three areas:

- Capital movements. Many operations are now subject to liberalization for the first time; these include short-term capital movements and some innovative activities—such as money market operations, short-term financial credits and loans, forward operations, swaps, and options—that were not covered previously.
- Banking and investment services, asset management, and agency services, such as investment research and advice

- Establishment. The provisions of the Capital Movements Code have been supplemented by an addition to the Invisibles Code establishing the general principle of equivalent treatment for branches and agencies of nonresident enterprises as compared with domestic enterprises and setting out detailed standards for assessing the observance of this principle.

These amendments, which extend the codes to all aspects of banking and financial services, will come into effect after the Council has examined the reservations that members wish to maintain with respect to the new items.

Apart from the sectors that are still considered "natural monopolies" in most countries (for example, basic telecommunications services and public utilities), it is in transport that restrictive regulations are most entrenched and liberalization is most difficult to achieve. In both air and maritime transport, many countries are still attached to the idea of maintaining national flag carriers even if these are not internationally competitive. Recently, however, there have been significant efforts to make air transport more subject to competition and to reduce the scope of economic regulation.[5]

A forthcoming study by the Committee on Competition Law and Policy concludes that there is no economic justification for maintaining entry restrictions and rate regulations in road transport where markets are fully "contestable" (OECD forthcoming). In this area, too, there is a strong case for promoting both national and international competition through regulatory reform and liberalization.

Conclusions

The instruments that make up the OECD framework for international transactions in services are varied and complex—a reflection of historical developments, the division of responsibility between government departments and OECD committees, and growing awareness of the economic importance of the service sector in all member countries. Although the instruments are based on firm principles and commitments, they nevertheless allow sufficient flexibility to reflect important differences in the economic and financial situations of member countries. They are evolutionary in nature, moving step by step toward greater liberalization and taking into account fundamental changes in technology and market conditions. Standstill and rollback commitments have been put in place to prevent backsliding from the level of liberalization already achieved.

The instruments are based on the belief that an open multilateral trading system is in the best interests not only of international welfare but also of individual participants. Reciprocity and discriminatory bilateral arrangements do not conform to that idea and, at most, should be admitted only as temporary expedients.

Taken together, the OECD instruments constitute a comprehensive international framework covering most aspects of international transactions in services. They are multidisciplinary in nature, combining general principles and sectoral arrangements and different modes of delivery of services—that is, cross-border services as well as establishment. Obligations undertaken by governments are supplemented by standards of behavior addressed to market operators.

Implementation procedures have been set up for notification, examination, consultation, interpretation, and review. The effectiveness of these procedures lies primarily in the political will of all participants, peer pressure, and the momentum created by a continuous process of discussion and negotiation. The progress thus far achieved has been significant.

Continuing vigilance, however, is needed to resist protectionist pressures and to preserve a truly multilateral framework for international transactions in services. The existing instruments have to be kept up to date to reflect changes in the economic and technological environment and the regulatory reforms being undertaken in member countries. Exchanges of views leading to a common understanding of the issues should involve not only governments but also nongovernmental groups representing the various actors in international transactions. Finally, international surveillance of countries' policies and compliance with the instruments needs to be reinforced.

Whatever the outcome of the Uruguay Round of negotiations on services, the OECD instruments will retain their relevance for cooperation among members. Their importance already extends beyond the OECD area as a point of reference for policy discussions among all those interested in an efficient service sector, which is fundamental to economic development.

Notes

1. Direct investment is defined as "investment for the purpose of establishing lasting economic relations with an undertaking much as, in particular, investments which give the possibility of exercising an effective influence on the management thereof."

2. The amendment states that the obligation to liberalize covers "regulations or practices applying to the granting of licenses, concessions, or similar authorizations, including the conditions of requirements attaching to such authorizations and affecting the operations of enterprises, that raise special barriers or limitations with respect to nonresident (as compared to resident) investors, and that have the intent or the effect of preventing or significantly impeding inward direct investment by nonresidents."

3. According to article 8 of the codes, "any member lodging a reservation under article 2(b) or invoking the provisions of article 7 shall, nevertheless, benefit from the measures of liberalization taken by

other members, provided it has complied with the procedure laid down in article 12 or article 13 as the case may be."

4. The relevant passages are:

> The Committee on International Investment and Multinational Enterprises (hereinafter called "the Committee") shall periodically or at the request of a member country hold an exchange of views on matters related to the guidelines and the experience gained in their application. The Committee shall be responsible for clarification of the guidelines. Clarification will be provided as required. The Committee shall periodically report to the council on these matters.
>
> The Committee shall periodically invite the Business and Industry Advisory Committee to OECD (BIAC) and the Trade Union Advisory Committee to OECD (TUAC) to express their views on matters related to the guidelines. In addition, exchanges of views with the advisory bodies on these matters may be held upon request by the latter. The Committee shall take account of such views in its reports to the council.
>
> If it so wishes, an individual enterprise will be given the opportunity to express its views either orally or in writing on issues concerning the guidelines involving its interest.
>
> The Committee shall not reach conclusions on the conduct of individual enterprises.

5. According to a report by the Committee on Competition Law and Policy,

> As deregulation in domestic markets increases the efficiency and competitiveness of carriers under the force of competition, it will provide a powerful incentive for those carriers to expand their services abroad and thus create pressures toward international liberalization. Progress in this field ultimately depends on the willingness of governments to accept a higher degree of international competition and a certain multinationalization of corporate structure in air transport, away from a strict policy of protecting national flag carriers. (OECD 1988, p. 79.)

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16

Developing Country Perspectives

Kenneth Heydon

A multilateral process of liberalization of trade in services offers significant opportunities for gain, whether through increased efficiency, as national barriers are reduced, or through export opportunities, as other countries' barriers are lowered. The impact of each of these elements will depend on the circumstances of individual countries. There is, nevertheless, a general presumption that a reduction of economic distortion in service activities and the adoption of national policies that provide similar incentives to production in the domestic and export markets will foster sustained growth and more resilience to external shocks. Moreover, given the nature of forward linkages from service activities, the political economy of service sector protection, and patterns of skills transfer, it is arguable that liberalization of the service sector may yield greater gains than might be expected on the basis of experience with the goods sector.

Whether individual developing countries realize gains from liberalization, however, does not depend only on a sustained commitment to liberalization at the national level. It also depends on the capacity of a multilateral, rules-based negotiating process to foster export opportunities for developing countries, to encourage the transfer of skills and technology, and to allow a gradual absorption of the adjustment strains that expansion of trade is likely to entail.

Adjusting to Liberalization

Liberalization of the service sector is likely to give rise to adjustment pressures—some specific to the sectors concerned, others of a more general, cross-sectoral nature. The concerns associated with these strains (or costs) do not constitute arguments against liberalization, but they should not be discounted either. The problems identified here are not exclusive to developing countries, and many parallels exist between the experience of developed and developing countries. But the degree of dependence of many developing countries may render the concerns more acute.

As trade expands, sector-specific adjustment will reflect the impact on the country concerned of increases in both imports and exports. On the import side, three examples illustrate the diversity of issues that are likely to emerge.

- The liberalization of transborder data flows and greater use of electronic information services from overseas sources may lead countries at all stages of development to be apprehensive about the dependency and vulnerability associated with the storage abroad of nationally important databases.
- Increased admission of foreign-based insurance companies may be seen as impinging on the host government's ability to monitor the insurance sector's role in macroeconomic management. (According to Okediji 1986, fund accumulation in the Nigerian insurance market, the largest in Sub-Saharan Africa, has enabled insurance companies to act as financial intermediaries and to invest large sums in the economy.)
- There may be concern that liberalization could inhibit access to the financial market by small enterprises or rural interests in developing countries if banks, whether domestic or foreign based, prove more interested in the modern urban sector.

Sector-specific adjustment strains associated with increased exports may arise when the market does not reflect and balance the full costs and benefits of the activities undertaken. Such stresses may be evident in the tourism sector of particular countries as increased flows of visitors raise concerns about environmental protection or cultural integrity. Export-related strains may also arise in the area of professional services as outflows (albeit temporary) of highly qualified nationals deplete the available human capital.

Beyond these pressures associated with individual sectors, two general concerns arise in all areas of service activity. At the macroeconomic level, these have to do with possible strains to the balance of payments; at the microeconomic level, they involve the impact of liberalization on indigenous service providers.

Concerning the former, it is necessary to distinguish two situations. In the first, persistent balance of payments strains that arise from the import of a particular service are invoked to support import substitution of that service. In the second, foreign exchange outflows that stem from the import of a particular service and cause short-term balance of payments problems are offered as grounds for temporary restrictions on foreign exchange. As to the first situation, liberalization of the service sector can indeed prompt a sustained balance of payments strain that may necessitate import contraction, adjustment of the exchange rate, or general demand restraint. But this will not always be the case. Liberalization may in fact have a positive effect on the balance of payments as a consequence of commercial presence as opposed to cross-border transactions, even taking into account the outflow of dividends or other remittances. For example, increased reliance on locally established foreign-based direct insurers with a substantial capital base may increase retention capacity, lower dependence on international reinsurance, and actually reduce outflows of foreign exchange. Foreign exchange savings may be realized in the construction and engineering sector through the "build, operate, transfer" formula, under which the foreign contractor assumes responsibility for project finance. Even where liberalization of the service sector is associated with sustained outflows of foreign exchange, the balance of payments argument cannot be used to support import substitution in any particular sector unless alternative opportunities for import saving and the relative costs of domestic production in each activity are considered.

As for the second kind of balance of payments problem, short-term restrictions on outflows of foreign exchange to cope with periods of temporary difficulty are likely to be regarded as legitimate as long as they are not used to limit or frustrate the relationship between a parent company and its overseas affiliate.

At the level of the firm, liberalization of trade in services may be perceived as placing strains on indigenous service providers and possibly eroding their market position. Again, however, this will not always be the case, as experience in the banking sector illustrates. Case studies of eleven developing countries suggest that there is considerable scope for complementarity of activities between domestic and foreign banks (Germidis and Michalet 1984). Although foreign banks' levels of activity are uniformly high in their traditional areas of operation—foreign exchange, international transfers, and export credits—the impact on local banks' traditional retail business is relatively modest. In Australia the entry of foreign banks has provided a catalyst for increased competition, and despite fears of foreign domination, local banks still account for about 90 percent of total assets. The net employment effect of liberalization is correspondingly difficult to determine. Liberalization that affects cross-border transactions may lead to employment losses as local producers are displaced, but these may be offset by employment gains from improvements in resource allocation and by possible dynamic efficiency gains. Moreover, there may be no first-round employment loss in the local industry if liberalization induces increased establishment-based transactions.

Development Opportunities: Reducing Domestic Barriers

A reduction in domestic barriers to service imports is likely to give rise to development opportunities in the short term. The reason is that gains in efficiency are realized as the quality of services becomes better, the costs of protection are lowered, and resource allocation is improved. In the longer term there are likely to be dynamic growth opportunities from the transfer of skills, frequently as a consequence of the operations of multinational service providers.

Efficiency Gains

For a wide range of sectors, protection of indigenous service providers, which limits access by foreign firms, reduces the quality of service on offer. This observation applies to countries at all stages of development, but it has particular relevance for many developing countries. In most developing countries the range of available financial services is limited—domestic sources of long-term funding are scarce, there may be no interest-bearing instruments for parking large volumes of short-term funds, and there is likely to be only minimal access to commodity and interest futures markets. Developing country experience suggests that legitimate goals of development and the protective environment they can engender may impose costs through reduced efficiency of the banking sector—in particular, through low direct mobilization of savings. Insurance services in developing countries are frequently more expensive and less efficient than those available in developed countries: premium rates are lower in foreign markets and the payment of indemnities is more generous and prompt. Import substitution policies in construction and engineering services, by limiting exposure to imported technology, have frustrated the development of design capability. In many developing countries restrictions on the flow of financial and human resources into government telecommunications monopolies have inhibited the efficient management of those resources.

Policies that restrict the operations of foreign providers of services may raise the income of local sellers but act as a tax on local buyers—for whom, in many cases, the services are inputs into the production and export of other goods and services. The widespread nature of user disability and intersectoral costs can be illustrated by the effects of restrictions on information, computer, and communications (ICC) services on manufacturing, primary industry, and other services. The experience of the maquiladoras—Mexican industrial plants that assemble semifinished products for U.S. firms—is an example. According to Barrera (1988), although the situation is now improving significantly, the telecommunications services provided between Mexico and Texas by Mexico's Secretariat of Communications and Transport not only have failed to satisfy the needs of the new border industries but have been a significant obstacle to the development and operation of new projects in the manufacturing sector. This case illustrates a broader point: improved access to producer services (through liberalization) may increase developing countries' opportunities to develop exports in the goods sector as the wider availability of ICC and financial services makes possible greater international fragmentation of manufacturing activity.

In primary industry self-imposed restrictions on transborder data flows and access to internationally traded information services deny governments the opportunities of transparent commodity markets and inhibit the efficiency of such markets in responding to changing circumstances. National policies that unnecessarily impede the movement of information or that require local duplication of information can also entail a high cost for other service activities. In 1981 Brazil's Special Secretariat of Informatics required Varig, the Brazilian international airline, to move its reservation system from Atlanta in the United States to Rio de Janeiro—a move that cost the airline $23 million in reinstallation charges.

Beyond these specific examples, there is a broader question: whether the service sector has characteristics that make the costs of protecting services higher than those normally expected for protection of goods. Three ways in which services may differ from goods are examined here.

- In the goods sector, it has long been acknowledged that a significant component of the cost of protection borne by unprotected industries is the increase in wages that is shifted on to them by industries that receive protection (Clements and Sjaastad 1984). Protection causes a general increase in nominal wages as import-competing industries expand and as labor seeks increased wages to compensate for the higher living costs brought about by protection. Those least able to absorb these costs are export industries, which are frequently price takers, constrained by international competition, and unable to pass on to consumers the costs of higher wages. This is why it can be said that a tax on imports is a tax on exports. On the basis of this analysis, the general equilibrium costs of service sector protection are likely to be particularly high when—as is not uncommon in developing countries—labor-intensive service industries that cater mainly for the domestic market receive relatively higher levels of protection than do manufacturing or primary industries, which are more dependent on export markets.
- Most service activities offer opportunities to benefit from expansion of markets or economies of scale. But in many developing countries that are seeking to develop services, such opportunities are likely to be only partly realized. In these circumstances significant costs may arise from the protection of services that are important inputs to other industries—frequently in the manufacturing or primary sector—where the existing scope for economies of scale is much greater.
- Producer services—precisely because of their strategic role—may receive a higher level of protection in many developing countries than do intermediate goods. Indeed, in many developing countries intermediate goods, unlike intermediate services, are likely to receive preferential import treatment. For example, India's machinery imports have increased greatly since 1980 as the interests of user industries, mostly government firms, have prevailed over equipment providers, mostly private businesses (Desai 1989). By contrast, many producer services, such as banking and insurance, involve significant government ownership and are more likely to be shielded from foreign competition.

The Transfer of Skills

Over the longer term, perhaps the strongest case for service sector liberalization has to do with the transfer of soft technology (management, technical, professional, and other skills) associated with the activities of foreign-based service providers. For example, experience with the development of tourism in Africa suggests that external partners are needed not so much for financial reasons (few African airlines have been unable to obtain external loans) as for gaining access to knowledge, communication, and organization (Green 1979).

The transfer of service sector skills frequently takes the form of formal training programs or of technology embodied in the service provided. It is at the day-to-day operational level, however, that transfer of skills appears to be most beneficial and widespread. The American International Group (AIG), in its insurance operations in Kenya and Nigeria, reserves for the home office decisions concerning the structure of the financial portfolio but has transferred to local entities 100 percent of motor vehicle underwriting (Wasow 1984). International accountants Arthur Andersen & Co., in their new practices overseas, seek to transfer ownership and management responsibility to local "national practice entities" (Rossi 1986). In maritime transport joint-venture arrangements with foreign partners in Guinea, Guyana, and Jamaica helped resolve technical problems with bauxite shipments (UNCTC 1982). In software production the risk that technological change will overtake developing countries' competitive strengths can be reduced through joint ventures and the associated transfer of technology. (In eighteen months up to mid-1986 Japanese firms established twelve joint ventures for software development in developing countries.) Finally, experience in the engineering and consulting sector illustrates how joint-venture activities can be a transition toward greater local responsibility. In the thirty years needed to construct the Caracas Metro, the Bechtel organization has been able to move from joint-venture participation to partnership with a Venezuelan engineering company that is increasingly assuming more responsibility and control (Stephenson 1984).

Experience in various sectors suggests that although some skills can be acquired on the open market without giving multinational enterprises access to the local service sector, there are particular benefits to be derived from the transfer of skills through the continuous, longer-term interaction of people within a well-organized framework of accountability. More generally, the UNCTC has identified extensive transfers of soft technology and has concluded that, in contrast to the situation of manufacturing companies, the skills required for production of services tend not to be centralized in parent companies but rather to be spread to host country operations. It seems that service firms are less able than manufacturing firms to split the production activities of their affiliated networks to match the factor proportions of subprocesses with the factor prices of host countries (UNCTC 1989).

The Scope for Benefits and the Level of Development

Clearly, the scope for individual developing countries to gain development opportunities from trade liberalization will depend on the extent of their barriers to service imports. Comprehensive data are lacking on the extent of service sector protection, particularly on the relative levels of protection for services and goods, which are important for general equilibrium analysis. Nevertheless, there is evidence over a wide range of sectors that developing country barriers to trade in services, whether they concern cross-border trade or establishment of foreign-owned firms, are sufficiently high to provide ample scope for development gains from liberalization. This is not to deny that developing country regulations are likely to be relatively sparse in areas of consumer protection or in rapidly evolving, technologically advanced service activities.

The opportunity for individual countries to derive development benefits from liberalization also depends on the nature of service linkages at different stages of development and the consequent impact of the cost of protecting service activities. Of particular importance are forward linkages, whereby services are inputs for other economic activities. Input-output data suggest that at all stages of economic development all types of manufacturing are more dependent on distribution services (notably transport and communications) than on all other types of services (Park and Chan 1989). Thus the costs of inefficiency in distributive services are high. At progressively higher stages of development, however, the relative importance of distribution services as inputs into manufacturing declines and that of producer services (notably banking, insurance, and professional services) increases. In a dynamic context, therefore, service sector protection is likely to have its most serious effect on development and growth prospects when it introduces inefficiency into producer services or frustrates transfer of skills in that area.

The Benefits of Multilateral Action

It is generally acknowledged that greater use of foreign-based services can contribute to significant improvements in quality and cost. But why should this benefit not be derived through unilateral liberalization rather than within a multilateral framework that might limit individual countries' room to maneuver and might impose obligations on them?

One answer is that the interests of smaller or more vulnerable trading countries are likely to be best served by a multilateral, rules-based framework. Recent developing country experience suggests that in practice, the alternative to multilateral liberalization is not unilateral dismantling of barriers but bilateral confrontation. For example, in July 1986, following extensive section 301 investigations, an agreement for improved access for U.S. insurers in the Republic of Korea was announced. Cho (1988) has suggested that since the Korean market remains partially cartelized, the limited admission of additional firms may create vested interests against a multilateral, rules-oriented approach to liberalization. Recent developments in the maritime transport sector—including the antidumping enquiry conducted by the European Commission against Hyundai Merchant Marine, Korea, and the investigation of Taiwan's shipping practices by the U.S. Federal Maritime Commission—also reflect bilateral pressures. The potential punitive measures associated with such investigations are considerable and, without casting judgment on the cases in question, it is likely that developing countries would be better off pursuing their interests within a multilateral framework.

Another, perhaps more contentious, advantage of a multilateral process is that it may facilitate a broader appreciation of the infrastructural disabilities of many developing countries and of the need for parallel action to address these deficiencies. This is directly related to the form that a services framework might eventually take. A critical question that can only be touched on here is whether the agreement on services should go beyond the present situation, whereby skills transfer is widely provided on the basis of private sector initiative, and seek to incorporate guarantees or conditions concerning the circumstances under which such transfers might be made.

Export Opportunities: Reducing Foreign Barriers

Trade expansion will create opportunities for countries that have viable service industries and a realized or potential export capacity. This section discusses competitiveness in the export of services, the benefits that may be realized from liberalization, which are different for countries at different levels of development, and the advantages of multilateral liberalization.

Developing Country Competitiveness

Although the nature of developing countries' competitiveness is difficult to characterize, there are indications of revealed comparative advantage that suggest a growing, if modest, role for these countries in international trade. Multinational banking institutions with a developing country as country of origin account for about 20 percent of branches and 6 percent of subsidiaries throughout the world; India, Mexico, Singapore, and Thailand are among the top 20 income earners in international tourism; and 33 of the 250 largest international construction and engineering contractors are from developing countries. Moreover, for many developing countries services are likely to represent a growing component of exports, even though the amounts involved may not be large in global terms.

Opportunities for developing country exports may reflect, in part, attributes peculiar to the countries concerned—physical and cultural characteristics that attract international tourism; strong links with host countries (which have helped foster intradeveloping country trade in construction and engineering services); and linkages between national service providers and their clients of the sort that prompted developing country banks to expand their overseas operations in the wake of the expansion abroad of nonfinancial corporations.

Other opportunities reflect characteristics of the industries themselves: declining entry costs in ICC services as advances in microelectronics reduce communications costs; opportunities for niche markets such as the keypunching services exported by the Philippines to the United States; and the requirement for familiarity with "mature" technology such as that gained by Brazil's construction firms through their work in tropical and arid regions.

In many of the activities listed above, the critical factor in translating potential export opportunities into realized competitiveness will be labor intensity and the advantage that many developing countries have in their ready supplies of low-cost personnel. Many service activities have important areas that are relatively labor-intensive: in the tourism sector, labor in hotel operations accounts for about 50 percent of costs; the operational aspects of construction and engineering services use large amounts of labor; in maritime transport, a principal element of shipping costs is the direct wage bill for crew; and in the distribution side of banking and financial services, labor is still the largest component of costs, even in technologically advanced banks. Some entire service activities, such as data input and software production, are at present heavily labor-intensive.

Two factors complicate any assessment of the real nature of the services competitiveness of individual countries, whether developing or developed. First, strength in labor-intensive subsectors may not translate into a genuine comparative advantage for the sector as a whole. Second, in most sectors the nature of competitiveness will be obscured by the presence of significant government support. For example, a study of comparative advantage in various service sectors found that Brazil, Korea, and Taiwan have a revealed comparative advantage in maritime transport substantially above the level predicted on the basis of relative factor endowments. In each case, however, the government provides significant support to its own maritime fleet through subsidies or protective cargo regulatory measures (Sapir and Lutz 1981).

The Scope for Benefits and the Level of Development

Countries at relatively early stages of development may find that, as new entrants, they are constrained from effective participation in some service activities because of an inability to achieve the necessary economies of scale. Local insurance companies in some developing countries are likely to be undercapitalized and to have unbalanced portfolios; premium income may not be high enough to meet liabilities because the local market does not produce enough income to allow sufficient spread. In ICC services, costs of entry may indeed be lower if all that is required is simply to "plug in" to the network. But this will not be the case if an independent network is needed or if there are significant deficiencies in the basic telecommunications infrastructure.

Competitiveness based on low labor costs is not static. As development progresses, wage levels are likely to rise, blunting the competitive edge. To illustrate, as low-wage countries acquire skills needed for support functions, their airlines become more viable, but competitiveness diminishes as the skill factor is more than offset by the rise in the general wage level (Findlay and Forsyth 1986). Rising wage levels were a primary reason for the fall in Korea's share in international construction activity, from 11.2 percent in 1982 to 2.8 percent in 1987. An important corollary, however, is that although some countries lose competitiveness as their wage costs rise, opportunities may open up for other countries at earlier stages of development. The proportion of Korean nationals working on Korea's overseas projects fell from 93 percent in 1979 to 47 percent in 1986 as low-cost labor began to be drawn from Indonesia, Pakistan, the Philippines, and Thailand.

There are also exogenous limits to labor-intensive competitiveness, as technological change alters the relative importance of labor and capital inputs or directly reduces the labor intensity of particular functions. The most pervasive influence is related to the use of ICC services, whether through the growing importance of electronic information networks in tourism or the extensive automation of routine work in banking and financial services. Within the ICC sector itself, technological change may also undermine some elements of labor-intensive competitiveness. Examples include the generalization of computerized character recognition for data input and computer-aided software production.

These constraints on competitive opportunities for service exports by developing countries—while indicating that such opportunities, however real, must not be exaggerated—should not be invoked as arguments against liberalization. Indeed, they underline the benefits of liberalization that is instrumental in fostering the transfer of skills and technology.

The Benefits of Multilateral Action

How much developing countries' export opportunities will benefit from multilateral trade liberalization will depend in part on the extent to which the multilateral framework facilitates concerted international action to reduce barriers to services in which developing countries have a particular interest. This in turn will depend in large measure on the treatment of labor-intensive services and of services that require significant short-term relocation of providers. Of central importance will be the extent to which agreement can be reached on the notion of "essentiality" in respect to temporary movement of service providers (as a condition for effective delivery of a service) and how this is interpreted in the course of bilateral negotiations and the exchange of "concessions."

Some Policy Implications

The fact that liberalization may create adjustment strains does not mean that it should not be pursued, but it does mean that the liberalization process should take account of those problems. Similarly, the fact that domestic support for local service industries may create distortions does not mean that all support should be eschewed, but it does mean that assistance should be provided in a way that minimizes distortion. This section looks at some policy implications, first in a national framework and then in the context of a multilateral liberalization process.

National policies of support for the service sector will be least likely to compromise the attainment of liberalization goals if assistance is time bound, so that it does not discourage necessary innovation and flexibility, and neutral as between production for the domestic market and for export. Neutrality is likely to mean less emphasis on import restrictions, which foster domestic sales but tax exports, and more on support for necessary service infrastructure, which yields comparable benefits for both the domestic market and export activity. Paradoxically—given the case for policy neutrality and nondiscrimination among broad industry groups—where specific support for individual services is judged to be warranted, it is likely to be more effective if it is applied selectively. Westphal (1981) suggests that support for infant industries is unlikely to succeed if it is applied to a large number of different activities within an economy.

Experience in the banking and financial services sector suggests two other national policy considerations that may be relevant for particular countries. First, if overall welfare gains are to be realized, liberalization measures may need to be accompanied by broad macroeconomic adjustment. Where there is financial distress, the relaxation of restrictions on foreign financial institutions without more general financial reform may enhance competition only marginally while exacerbating solvency problems in the financial system (Gelb 1988). Second, care may need to be taken in the sequencing of liberalization between sectors. Experience in Latin America suggests that if liberalization of the financial sector is carried out before liberalization of the current account, it may, through induced capital inflows, encourage a rapid and destabilizing appreciation of the real exchange rate.

At the international level, as noted earlier, the success of a multilateral services framework in fostering the liberalization opportunities open to developing countries will depend in part on its role in reducing barriers to services in which developing countries have a particular interest and in promoting those forms of trade that encourage transfers of skills and technology. If the concerns of developed and developing countries about adjustment strains are to be allayed, the negotiating framework will have to ensure, first, that liberalization is achieved gradually, allowing individual countries to accommodate increased trade flows according to their particular circumstances, and, second, that a clear distinction is drawn between liberalization and deregulation. Most of the sector-specific adjustment concerns discussed earlier relate to the need for a sound regulatory framework. Although deregulation and liberalization tend to go hand in hand in the sense that progress in one creates strong pressures for movement in the other, they are not the same. Individual countries, in seeking to remove their discriminatory restrictions on trade in services, will not be required to abandon all of their market regulations. Indeed, in countries that have only a rudimentary regulatory framework, the more dynamic environment frequently associated with trade liberalization may require that particular regulations, especially those relating to consumer protection or prudential control, be strengthened.

Developing countries need not regard service sector liberalization as a negative-sum game. Progressive liberalization will provide opportunities for the fuller realization of export potential, for more efficient allocation of domestic resources, and for steady increases in the stock of service sector skills and knowledge. If national policies are outward oriented and if the international framework helps countries to address the adjustment process, developing countries, whatever their circumstances, can expect to find opportunities for net benefits in a multilateral, rules-based process of liberalization of trade in services.

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17

Mexico

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Mexico has been experiencing great changes in trade policy. Over the past three years virtually all of the protectionist framework that characterized the country's international trade has been dismantled. In 1986 Mexico became a member of the GATT, and two years later about 90 percent of all its imports had been fully liberalized, with 20 percent the maximum tariff. In fact, trade liberalization has gone well beyond any agreement with the GATT, essentially out of a conviction that trade is inherently good for the development of the economy. Although some sectors—notably motor vehicles, microcomputers, and pharmaceuticals—remain to be liberalized, the Mexican government's thrust toward modernization and integration into the world economy is clear. Except in these industrial sectors, all quotas and import-permit requirements have been eliminated. In addition, foreign investment has been deregulated and foreign investors are now on the same legal footing as any domestic investor.[1] All-out trade liberalization in goods and services, however, will require significant policy action in the area of domestic regulations. Furthermore, services of interest to Mexico will have to be included in any Uruguay Round agreement.

Liberalization of trade policy has been made possible by a change in the government's perception of the importance of international trade and economic reform for the development of the country. In the past the Mexican government was dominated by protectionists who favored discretionary decisionmaking processes in matters of trade, investment, and economic policy in general. Not surprisingly, conflict rather than cooperation characterized relations among the ministries involved in trade policy. Starting in 1985 the government began to incorporate free traders into its ranks at the highest levels. Trade policy became a battleground as the protectionists tried to stave off liberalization and domestic deregulation. In 1985, for instance, the Ministry of Trade and Industry (SECOFI) blocked the implementation of a mechanism devised by the central bank (Banco de México) that would have allowed exporters to import goods by means of a "certificate of right to import for exports" (DIMEX—the Spanish acronym). SECOFI's opposition to modest liberalization meant that liberalization, when it came in 1987, was thoroughgoing. The elements that had fostered liberalization consolidated their positions in the administration that began its term in December 1988.

The rationale for liberalization and deregulation is both economic and political. The current economic team is convinced that freer trade will be beneficial for the economy and for the development of the country and that a stronger economy will make for a politically stronger nation. Thus freer trade is seen as a vehicle for both economic recovery and political consolidation.

These changes in attitude have had a significant effect on trade policy. A strong conviction that trade is inherently good for the country, along with greater homogeneity and cooperation within the administration, gives policymakers more room to maneuver and enables them to be strong and effective advocates of Mexico's national interest (as distinguished from sectoral and special interests). This broader view does not mean that Mexico will be easier to deal with in the new round of GATT negotiations. A coherent policy approach, strong convictions about liberalization, and a commitment to liberalization and deregulation—all aspects of Mexico's "visionary" outlook—are likely to make the country one of the toughest players in the process.

The new policy environment has important implications for negotiations on services. First, the current leadership of SECOFI, the government office directly in charge of trade negotiations, sees foreign trade as an instrument of development rather than as a hindrance to it. This means that the three industrial sectors still under protection will be gradually liberalized. Actual liberalization in motor vehicles, pharmaceuticals, and microcomputers may be slower than in the rest of the economy (which faced almost complete liberalization in less than eighteen months), both because of the complexity of these sectors and, ironically, because the absence of political pressures from other ministries means that liberalization of these sectors can proceed at a steadier and more rational pace. The thrust will not change, but all the parties involved will have more time to adjust. Negotiations on services, by contrast, will involve technically oriented ministries, such as Communications and Transport, that do not see trade as an inherent source of wealth. But the influence of the economic ministries may be the decisive element in liberalizing services and carrying out a profound transformation of Mexico's economy.

Decisions on services, despite being politicized, are likely to be swifter than were those on liberalization of goods—not because the ministries responsible for services are so willing to liberalize, but because of the overall process of economic transformation that the country is undergoing. Liberalization of services will involve government offices—for example, the Ministry of Communications and Transport and the Ministry of Ecology and Urban Development—that so far have not had any experience with trade politics and have not had to deal with foreign competition (or, for that matter, any kind of competition). Furthermore, many offices within these ministries are traditionally suspicious of competition, regardless of its origin, and heavily inclined toward discretionary decisionmaking processes. What can be expected is dynamic and complex behind-the-scenes negotiations between trade negotiators and the technical ministries.

In the negotiations on the liberalization of services, government positions will be closely tied to other key variables such as macroeconomic policy, liberalization of imports, and overall deregulation. Opposition by the technical ministries will be significant and politically eroding. Concessions in the context of Uruguay Round negotiations will be possible only if sectors and issues of interest to Mexico (such as labor-intensive services) are included. But should such key issues become negotiable, Mexico is likely to be an active supporter of rapid liberalization of services, as of trade in goods.

Sectors

Services include various economic areas, of which some have many competitive players whereas others are characterized by virtual or legal monopolies. Liberalization of foreign competition would affect each sector differently. What follows is a description of the main service sectors and an assessment of how foreign competition would alter the current structure of each. The main emphasis is on the domestic impact of foreign competition—a decisive factor in the political process of liberalization—but barriers to access of Mexican services abroad also receive attention. The section concludes with an assessment of the potential comparative advantages and disadvantages of each service area.

Banking and Financial Services

Mexico's financial sector is integrated mainly by two types of financial intermediaries: banks and brokerage houses. There are nineteen commercial banks—national, multiregional, and strictly regional—and eight development banks. (There are also more than forty development funds that allow commercial banks to discount credit for specific purposes with subsidized interest rates). Mexico has more than 30 brokerage houses and 150 investment partnerships (*sociedades de inversión*). The commercial banks represent roughly 60 percent of the financial market. For decades the nonbanking part of the financial industry suffered from regulations and market conditions that strongly favored the development of the banks. The expropriation of the private banks in 1982 led to a dramatic reshuffling of financial resources and savings and a consequent rapid growth of nonbanking financial entities.

The financial sector is tightly regulated by the Ministry of the Treasury, by the Banco de México, by the National Banking and Insurance Commission, and by the National Securities Commission. Until recently, interest rates for deposits were set by the Banco de México; commercial banks had to maintain at the central banks high levels of reserve deposits, which were used to finance the government deficit; and commercial banks had to lend up to 20 percent of their funds at concessionary interest rates for such purposes as agriculture and low-income housing. Beginning in April 1989 all three features began to change. Interest rates are now being set by individual banks; reserve requirements have been reduced to a minimum and are now intended to guarantee the financial stability of the banking system rather than to finance the government; and concessionary funds have been reduced to less than half their former size.

Domestic financial deregulation is being undertaken for two reasons. The first rationale is to increase the efficiency of the market and to improve the banks' ability to compete in a financial system that, with the growth of the brokerage houses as full-fledged intermediaries, has become very competitive. The second rationale is more subtle; its ultimate target has not yet been disclosed to the public. For years, foreign banks and nonbanks have been active participants in domestic financial markets. Since they are functioning within a legal framework that is to a large extent obsolete, more often than not they operate outside the boundaries of the law. Many of the foreign banks for instance, are involved in de facto intermediation; for a fee, they accept "loans" from companies and lending to other parties, often under the guise of an exchange of "matching funds" between a company with excess cash and one in need of money.[2] Domestic deregulation is clearly meant to incorporate all financial entities in the country into a modern legal and regulatory framework. It might seem obvious that deregulation looks toward an eventual liberalization of the system with respect to foreign competition, but whether this will actually happen remains to be seen.

But even before the recent deregulation, market forces had long (since 1982) compelled the banks to become more competitive. In 1988, for example, traditional sources of deposits (certificates of deposit, savings bonds, and the like) fell dramatically: in September 1988 nontraditional sources of funds (securities of all sorts) represented 1 percent of total deposits in commercial banks, but by February 1989 they had grown to 78.9 percent of all deposits (CAIE 1989). These changes reflect a continuing restructuring of the financial sector that began with the expropriation of the commercial banks in 1982 and is being accelerated by the rapid deregulation of the industry that has been taking place since 1988. Banks have had to compete with other financial intermediaries, both domestic and foreign, in an increasingly sophisticated arena. The process of financial deregulation clearly responds to these circumstances.

Can the financial system be competitive if it is fully opened to foreign competition? The answer is not clear-cut. Undoubtedly two or three large banks with national coverage that have invested heavily in technology and communications and have begun to build international networks of offices and services could readily attain the levels of efficiency and competitiveness needed for success in an open market. Most of the regional banks, which have clearly demarcated geographic locations and offer specialized services, could successfully compete on their own. The multiregional banks and some large national banks that have failed to invest in technology are likely to collapse when confronted with foreign competition. A strong case could be made that, as part of the process of liberalization and domestic deregulation, the government should consider privatizing these banks by selling them to foreign banks or intermediaries. This could facilitate deregulation and introduce a competitive financial sector while reducing the losses of the existing players (as entities). As for the brokerage houses and other nonbanking intermediaries, a few entities could withstand competition and others could not. In comparison with the banking industry, available expertise and experience is thinner, and the capital base of the largest and most competitive institutions is very small. Hence foreign competition would probably affect nonbanking intermediaries as a sector more than banks.

Two issues have to be resolved when considering liberalization of the financial markets: the costs of liberalizing and the costs of not liberalizing. A more competitive financial sector would reduce costs (by decreasing financial margins and by developing tailor-made products and services) and would make the rest of the economy more competitive. Furthermore, an open financial system would free resources to finance the government deficit (if any) without crowding out the private sector and would give Mexican firms access to Mexicans' savings abroad (the "flight capital" that has accumulated in foreign banks). An open financial system would presumably expand the pool of savings available for lending and investing, including, as a matter of course, Mexicans' savings abroad. Liberalizing the financial sector would entail losses for the shareholders of the (probably few) entities that would fail. It would not bring about unemployment, for the most obvious way for foreign entities to compete in Mexico would be to hire precisely those professionals with experience in the business. Moreover, it is not self-evident that foreign financial intermediaries legally competing in the domestic market would be more efficient than efficient domestic entities. At present that is the case, but it is largely because the "rules of the game" (reserve requirements and preferential sectors) are ubiquitous for domestic players but nonexistent for de facto competitors outside the boundaries of the law.

It is the costs of not liberalizing that should be carefully assessed. Foreign banks and nonbanks regularly operate and compete in Mexico's financial markets. They have an extreme advantage over domestic firms owing to the laxity with which they interpret laws and regulations and to their much lower costs. Their costs are lower because they do not have to comply with onerous reserve requirements or to maintain a network of offices throughout the country—an enormous burden for domestic banks. For the regulators, not liberalizing is the worst of all worlds, for they have virtually no control over foreign entities. Liberalization would allow greater rationality in the financial system and would add competitiveness to the economy as a whole, all at a relatively small cost.

Insurance

The insurance market has traditionally been reserved for Mexican companies, although reinsurance is almost entirely run by foreign firms. Large international insurance firms have representative offices in the domestic market, but their role is limited to a small, albeit critical, sector. Altogether, there are forty-eight domestic insurance firms, of which two are government owned, two are in reinsurance only, and two are mutual companies. Of the total, 56 percent offer the whole range of insurance services and policies (life, accident, health, automobile, professional risk, damage, buildings, civil responsibility, and so on), 25 percent are concentrated in life only, and the rest are specialized in individual markets. Six firms, including the two owned by the government, which insure all government property and employees, represent the bulk of the insurance business. The total size of the insurance market is minuscule: in 1981 it represented 0.91 percent of gross domestic product (GDP) and in 1987, 1.04 percent. Life insurance accounted for 0.36 percent of GDP and damage insurance for 0.68 percent (Malpica 1988).

The insurance business is regulated by the National Banking and Insurance Commission and is governed by the Law of Insurance Institutions, the Law of Insurance Contracts, and several specific regulations. All of these hinder foreign individuals or firms from owning shares of domestic insurance firms and prohibit Mexicans from contracting policies with foreign insurance entities (a rule often ignored).

As in the banking system, de facto foreign competition exists in Mexico. This is because a significant number of Mexicans own personal insurance policies (mainly life and health) contracted with foreign insurance firms. Unlike banks, insurance companies need no physical presence, except in reinsurance, and they do not have significant risk assets in the country aside from their own portfolio investments. As in banking, foreign companies do not have to abide by the regulations that apply to domestic firms. This makes liberalization (with deregulation) an attractive proposition in that it would put all insurance companies on an equal footing. But foreign competition would most likely signal the demise of the domestic insurance sector. The small size of the domestic firms and of their market—and therefore of their capital base and reserves—makes them sitting ducks for foreign competitors, unless newcomers are forced to operate within the restrictive and competition-restrained regulatory framework. In that case, foreign companies would be able to share in the market, thus affecting local firms' profitability, but they would add no benefits to the economy at large. Such a scheme would add no competition but would maintain the monopoly position of those firms, both national and foreign, that decided to participate in the market, whereas liberalization—within new and appropriate regulations—would probably lead to the death of most local insurance companies except for those that merged with or were acquired by foreign companies.

Construction and Engineering

Construction represents about 5.5 percent of GDP, above the average for the developing world (3–5 percent) and below that for the industrial countries (5–9 percent). Consulting in engineering and construction represented 0.24 percent of GDP in 1987. (In Brazil the share was twice that, and in the United States it was four times the share in Mexico.) Construction involves 12,976 firms, the largest 5 of which represent more than 80 percent of the market. The largest firms compete successfully in the international markets—mainly in Latin America—against other international construction giants, particularly in hydroelectric projects, pipelines, and water systems. But these firms' competitiveness is limited because construction and engineering firms in other countries are subsidized by their own governments. Furthermore, there are many barriers to access: in the United States, for instance, foreign construction firms must post a bail bond amounting to 125 percent of the construction value—a cost no Mexican firm could afford.

Domestic regulations in this industry are similar to others, but with two important differences. First, given the nature of the sector and the frequency of earthquakes in Mexico, construction, particularly as regards structures, is heavily regulated, but these safety regulations are not designed to restrict foreign firms. Second, the government is the largest contractor in the country, and the power inherent in government procurement constitutes a barrier to access by foreign firms.

With the minor exceptions of some construction and engineering consultants that do not directly compete with Mexican firms, foreign construction and engineering companies do not operate in Mexico. This sector could remain strongly competitive and could become one of Mexico's winners, largely because of its relatively strong presence in export markets. Consulting firms in this sector would be complementary rather than competitive.

Maritime Transport

According to recent statistics, Mexico's maritime fleet ranks fortieth in the world in size, well below the fleets of Brazil and Argentina (UNCTAD/PNUD/SECOFI 1988, p. 4). Mexican-flag vessels transport only 21 percent of all maritime cargo, 4 percent of ocean trading, 60 percent of coastal trade, and less than 3 percent of exports.

The Mexican fleet consists of ferries, tankers (mostly owned by PEMEX, the country's oil monopoly), cargo ships, and a container transport firm. Altogether there are about ninety-nine ships of more than 1,000 metric tons capacity (UNCTAD/PNUD/SECOFI 1988, p. 6). In each case, regulations have created a monopoly that excludes competition, both domestic and foreign, and raises transport costs. Government rules and regulations have also centralized and made discretionary the issuing of permits and concessions for loading and unloading ships—a situation that has made maritime transport an extremely expensive and unreliable mode of shipment. One evidence of unreliability is that of the country's 133 ports, only 27 are physically in condition to function as ports and only 14 of these are actually used for cargo loading or unloading. Because of the lack of modern equipment in Mexican ports, virtually all container cargo is shipped overland into Mexico from U.S. ports.

Coastal shipping is reserved to Mexican liners, and ocean trading is tightly regulated by the Ministry of Communications and Transport. The rationale for these regulations is to combat unfair practices when competing with ships of other countries and to seek maritime self-sufficiency. As a result of this policy, about 10 percent of all nonfactor expenditures in the balance of payments, or about $500 million, is accounted for by maritime transport costs.[3]

The reality of the industry being so different from the pretensions implicit in the regulations, it is obvious that foreign competition would harm only a few large monopolies and would greatly benefit the economy at large. The potential benefits of liberalization for users of the service and for consumers would be enormous and quick to appear. Most ocean trade is already handled by foreign ships, and it appears that the only relevant Mexican company in this business would be able to remain competitive. Thus, most of the costs of liberalization would be borne by the companies involved in coastal shipment. For liberalization of maritime transport to succeed, however, domestic land transport would also have to be deregulated. At present, regulations concerning the domestic handling of foreign containers, customs, land transport services, schedules, and tariff decisions are so narrow and so biased toward monopolies that even the most efficient maritime transport system could not undo the extreme costs implicit in the domestic transport system. At writing, the land transport system was undergoing radical deregulation, but the change will not be complete until the existing law is modified.

Air Transport

Of the 286 domestic air transport companies, 2 have national coverage and an extensive foreign network, 9 provide regional services, and the rest offer air taxi services. Altogether there are 5,162 aircraft, of which 728 are used as commercial liners. In 1987 the two large commercial airlines moved 13.5 million people among 70 cities; 68 percent of their passenger traffic was within Mexico. Total cargo volume in 1987 was 73,369 metric tons inside Mexico and 79,612 to or from the country; 46 percent of the latter was handled by Mexican carriers (Nacional Financiera 1988, p. 233).

The laws, rules, and regulations governing this industry are established by the Ministry of Communications and Transport. All air service, be it passenger or commercial, requires a concession, a permit, or both. Concessions for regular commercial service are usually given for a maximum period of thirty years, which can be extended for ten years at a time. Concessions for nonregular services (taxi and private jet) are granted for one year at a time.

Mexico has signed with several countries reciprocal agreements and treaties that guarantee the "third, fourth, and fifth freedoms"—transport of passengers, cargo, and mail. More than twenty-five foreign airlines offer regular service to and from Mexico, mostly as a consequence of such agreements. In addition, Mexico has granted eight unilateral concessions.

Aside from the obvious benefits that liberalization of air transport would entail for overall efficiency and competitiveness in the industry, the only other advantage to be expected from liberalization would be the "eighth freedom"—the right of a foreign airline to provide service between two or more domestic cities. There are two things to consider here. First, given the share of foreign passenger trips that are handled by foreign companies, it is highly unlikely that the domestic market would be dramatically changed. At present about 40 percent of international passenger traffic is handled by domestic carriers; under liberalization probably not more than 40 percent of all domestic passenger service would end up being handled by foreign operators,[4] although the latter would probably gain some additional foreign traffic. Increased competition and reliability of service might well translate into more demand for service, which might entail a net growth in the potential share of foreign companies in the market and a decrease in domestic airlines' share. The influence of Mexico's geography should be kept in mind: liberalization would probably bring with it enormous competition in the northern region of the country and in a few highly profitable corridors while leaving the rest of the nation unaffected. In fact, many U.S. regional carriers already offer service between several northern Mexican and southern American cities.

The other consideration is also related to Mexico's geography. Although the impact of liberalization in most services may well be the same in Mexico as elsewhere, transport is clearly a different issue. If the Mexican government is committed to liberalization in services, transport—particularly land and air—presents a dilemma: how to balance the interests of the consumer and the service providers in an industry in which the providers are unlikely ever to be capable of competing on any grounds other than their ability and efficiency. But the situation is more complex than it appears at first sight, for even if transport services were fully liberalized, some areas would benefit greatly and others could even be worse off, creating politically untenable regional differences. The other side of this equation is that an efficient transport system would liberate forces and resources in unheard-of ways, fostering economic growth and exports. Hence the only long-term solution to this dilemma is to liberalize all transport services while fostering niches for existing transport companies so that all regions of the country are properly covered.

Professional Services

Two types of Mexican professional services—marketing and consulting—are very competitive worldwide. The marketing sector has a large number of firms, but the fifteen largest cover about 80 percent of the market. Eleven of the fifteen largest firms are representatives of or partners with large international marketing companies, and four of the five largest firms are branches of such concerns. Yet the largest marketing firm is wholly Mexican owned. Competition among these firms is intense; in fact, the large Mexican firms have begun to export their expertise and have started a network of representative offices in other countries, primarily the United States. Most of the services related to marketing (such as audio and video, design, photography, drawings, and recording facilities) are available in Mexico at competitive prices and qualities.

For all practical purposes, the marketing subsector has been open to competition for decades; although the laws on foreign investment restrict access to foreign concerns, most, if not all, world marketing giants are already in Mexico through partnerships or representative offices. Hence, liberalization would not affect this area of business significantly. Since cultural differences make it necessary for foreign marketing firms to maintain structures similar to those currently existing, liberalization may strengthen the bargaining power of foreign partners but is unlikely to alter the overall nature of the business. But related services could experience tough competition from their counterparts abroad. These services use high technology and require multimillion-dollar investments to become competitive worldwide. Although some Mexican suppliers could afford such investments, most could not, and it is this subsector that will suffer most.

Consulting is similar to marketing. There are more than 1,500 consulting firms in the country, but the largest 15 represent about 80 percent of the market. Of these, virtually all have direct links with the world's largest consulting firms. In fact, most of the largest international consulting firms are represented through wholly owned subsidiaries. Barriers to access are small and relatively unimportant. Still, many Mexican firms have been able to develop their own market niches, many compete frequently and successfully with large concerns for consulting services awarded by entities such as the World Bank, and others have developed particular areas of expertise that have allowed them to win contracts over their foreign competitors in third countries, including the United States.

Thus, in both consulting and marketing, liberalization—which in this case simply implies the elimination of petty restrictions to access—would represent additional opportunities for development rather than bankruptcy. In fact, consulting and marketing may prove to be two sectors in which liberalization could bring net benefits as a result of exports. Since these are, to a large extent, "people businesses," and since most, if not all, employees of consulting and marketing firms in Mexico are Mexican nationals, the potential for future competitiveness in these sectors is virtually unlimited. These two areas also show that foreign competition, even if somewhat restricted through laws such as that on foreign investment, does not necessarily hinder domestic competition and, furthermore, can strengthen domestic firms over time.

Information and Communications

The broad field of information and communications is characterized by a variety of firms, regulations, laws, and practices. Firms range in size from small software manufacturers to the telephone company, which had assets worth about $5 billion in 1987. Each segment of this sector faces different types of competition, and the ability to compete also varies widely. Some sectors are already experiencing direct competition whereas others have never been subjected to it. In some cases, actual practice has altered the thrust of regulations, making the sector quite competitive. Value added services require permits or concession from the Ministry of Communications and Transport, but these are usually granted without any distinction between nationals and foreigners.

In general, those services in this sector that are government-owned or -operated monopolies have tended to be of relatively poor quality and incapable of competing at present. In some instances these deficiencies have been partially overcome. The postal service, for example, is a government monopoly, but foreign courier services have grown dramatically over the past decade; most or all of these are either fully owned subsidiaries of foreign firms or partnerships with Mexicans. Although these courier services have affected the postal system's market, they have also added a new dimension to the sector. At first, most courier services handled international service between Mexico and the rest of the world, but over the years the same type of service has become available for the domestic market. The couriers, in fact, provide an alternative to an inefficient and antiquated postal service. Similarly, Teléfonos de México, a monopoly owned mainly by the government, has been incapable of offering the kind of service an open economy requires and will increasingly demand. Many substitutes for its service have been created (such as microwave communications systems and private satellite links), but these are all private, although they require government concessions or permits.

There are two broad areas in which competition, both national and foreign, could have a significant impact on communications. First, there are several specific markets—cellular communications, visual communications, and so on—that are not formally within the scope of the government monopoly. These markets are all open to private investment, and since technology is the cornerstone of the business, foreign investors will be the obvious suppliers and investors, whether in partnership or through wholly owned subsidiaries. Liberalization of services will not change this process; as in other areas, it may strengthen the bargaining power of foreign investors with respect to their Mexican counterparts (and potential partners) but will not alter the structure of the market one iota. In comparison with other services such as consulting and marketing, however, Mexican partners would be at a severe disadvantage. In sectors in which human capital is the key to the business, such as consulting, marketing, and even banking, Mexican partners would maintain their ability to negotiate regardless of laws and regulations restricting access to foreign investors, but in sectors in which the key is technology and capital, potential Mexican partners would lose their monopoly power once the law grants equality to national and foreign investors.

The other area in which competition would have a significant impact on communications is at the core of the business. At present, the telephone company maintains a monopoly in the basic telephone services, as it does in local services in the rest of the world. Current debate centers on two critical issues: how and where to liberalize the service while making the best use of the existing network, and how to charge competing companies for the use of the network in a way that impedes Teléfonos de México from charging monopoly prices. Implicit in the debate is the definition of "basic services" or, more specifically, whether long distance would be subject to competition. The latter is not an irrelevant issue, for at present 84 percent of Teléfonos de México's earnings comes from long distance services.[5] Whether and how the telephone company is privatized are two critical competitive issues, for a private monopoly may be less politicized than a government-owned monopoly but no less predatory.

In the area of informatics, there are two, largely undeveloped, subsectors in which Mexico could easily find a comparative advantage. One is software development. It is estimated that between 1984 and 1988 software sales increased at an average annual rate of 26 percent, whereas hardware sales grew 17 percent a year. Purchases of computer software in Mexico were estimated at approximately $135 million in 1987 (Verut 1988). This is the fastest-growing market segment of the computer industry. Although imports have traditionally dominated the software market—they represent 72 percent of total consumption, with the United States accounting for a 90 percent share of imports—several Mexican firms are developing competence in software designed in Spanish for the Mexican and U.S. markets. (Both markets represent $42 million and could be expanded rapidly by adding other Spanish-speaking countries.) But in spite of some powerful examples of successes in exports of software, this field is largely unexplored. Liberalization will do little to change the current domestic picture, since legal and illegal importation of software has forced all domestic suppliers to be competitive.

The other area in which Mexico could easily have a comparative advantage is in data processing, a field in which both its costs and its local ingenuity could allow it to compete successfully in the world market. This subsector, however, has not been developed at all.

Comparative Advantages and Disadvantages in Services

The only obvious competitive advantage that Mexico currently enjoys is in the price and skills of its labor force, which constitutes the single most important source of competitiveness in the country's exports today. Although there are many other service sectors in which the Mexican economy might develop comparative advantages and compete successfully in the international market, as of today, Mexico has a proven comparative advantage only in labor-intensive services. The prospect of not obtaining liberalization in this "sector" would create a politically difficult environment for liberalizing other services, even if liberalization is (and is perceived to be) in Mexico's best economic interest.

Mexico appears to have potential comparative advantages in sectors such as marketing, consulting, information processing, software, financial services (in some respects), and construction—provided that barriers to entry are eliminated. (There are no specific export barriers in services.) The monetary importance of these sectors today is rather small, but the potential—in the context of liberalization—is enormous. Two unlikely industries—air and maritime transport—could find competitive niches. Given Mexico's geography and the relatively small U.S. maritime fleet, it is not inconceivable that Mexican firms could develop competitive regional businesses. The same may be true for some regions and corridors in the air transport business along the Mexico-U.S. border, where small Mexican airlines could develop their own market niches.

Conclusions

There are three critical considerations in assessing the likelihood of liberalization in Mexico and its potential benefits and costs. The first is the domestic policy and regulatory framework and how it may affect and be affected by liberalization. The second concerns the price that Mexico will demand as the bare minimum from its GATT partners in exchange for liberalization. The third is how the potential perceived benefits might impinge on the process of decisionmaking about liberalization of services.

Probably the most important issue for both the long-term development of Mexico and for liberalization of services is the existing regulatory framework. Current regulations tend to restrict competition in most sectors and to generate monopoly situations, the costs of which are paid by domestic users of the services in the form of high prices and low quality. Liberalization, unless accompanied by the dismantling of those barriers to access and of the discretionary and antiquated regulations would only slightly alter the present general picture. Competitiveness would be somewhat improved by liberalization of services, but without deregulation (or, more exactly, without a thorough overhaul of existing regulations) liberalization would fail to realize its two most important potential benefits: adding competitiveness to the rest of the economy and forcing Mexican suppliers of services to become competitive. Although a modernization of the entire regulatory framework affecting the economy is currently in process, its success depends on ministries other than the one that is attempting to carry out key changes, and the changes affect areas that have traditionally given those ministries their sources of discretionary power. One scenario of the outcome of this process would be that regulations are unequally modernized and that many critical issues remain unresolved, reducing the economy's overall potential for competitiveness or, more appropriately, keeping the economy from being as competitive as it might otherwise be. The foremost issue of the Mexican economy in the next two or three years will be precisely the scope and depth of changes in present regulations. Privatizing government concerns will be crucial to deregulation, for without deregulation, greater competitiveness of the economy as a whole cannot be attained.

The second consideration has to do with the definition of services. At present, the Uruguay Round agenda reflects—although it is not limited to—the interests of those countries that have an obvious comparative advantage in services, and the list of services currently under discussion reflects their priorities. From the perspective of countries that could experience losses in service sectors as a result of liberalization, the question has to be, what kind of tradeoff might make this prospect politically bearable? For Mexico, the main issue is the inclusion of labor-intensive services as a full-fledged service. From its point of view, labor is as much a service as any other. Undoubtedly, the issues involved differ from those in other sectors. But, ultimately, each sector has peculiarities that raise sensitivities in various countries. In the case of Mexico's labor-intensive services, the United States would have to radically alter its immigration laws and liberalize flows of people—a prospect that poses political difficulties. But liberalization creates political problems for Mexico and for every country in the negotiations. Why should it be easier for Mexico to modify long-standing laws in sensitive areas such as communications, foreign investment, intellectual property rights, and so on? The argument for liberalization has nothing to do with other countries' actions; Mexico will benefit from freer trade. But for political reasons, negotiators should attempt to maximize the benefits for Mexico's exporters, including exporters of labor-intensive services. Liberalization of one's own market carries its own benefits, but liberalization of both one's own market and one's export markets is the best of all worlds.

The third consideration has to do with the rationale for liberalizing services. With a few exceptions, Mexico's service suppliers will suffer heavy losses from liberalization. Unlike the case of trade in goods, however, the losses will fall solely on shareholders; workers and employees will have to adjust but will not be out of jobs, and consumers—individual and industrial—will be net beneficiaries, both as direct recipients of services and through the indirect efficiencies and cost reductions that liberalization of services might bring with it.

In fact, the rationale for liberalizing services ought to dwell on the benefits to the rest of the economy rather than on the possibility of generating extraordinary results in some areas of services in exchange for losses in others. An analysis of the foremost service sectors in the Mexican economy demonstrates that there is substantial potential for benefits in some subsectors, while the losses in others are likely to be punitive. Yet the benefits for the economy as a whole in terms of, for example, an efficient transport system or a modern communications network cannot be ignored. Some limited losses in a few service sectors could translate into significant gains for the economy and for society at large. Furthermore, exports of goods may become more competitive as a result of increased efficiencies or lower costs in key services.

As in any other process of liberalization, some sectors would gain while others would decline. Such specialization is naturally to be expected from a process of liberalization and deregulation. But the analysis suggests that a few sectors could not only survive but could become extraordinarily successful. Others would gradually decline until they virtually disappeared. Attempting to help all sectors to survive would be self-defeating, for that would be not only extraordinarily costly but also unsustainable. The rationale for liberalizing should be precisely to promote specialization so that comparative advantages, whether in services or elsewhere, become obvious and are exploited. More efficient and less costly production of goods as a result of liberalization of services would in itself be a significant benefit.

Liberalization of services should be seen as an instrument of policy aimed at a stronger economy as a whole. That is the rationale that has prevailed in the case of goods. There is no reason why it should be different for services.

Notes

1. The new foreign investment regulations liberalize investment in both goods and services. There are, however, specific sector regulations in all services, and some of these limit or hinder foreign participation.

2. The only existing statistic, which probably understates the market, indicates that foreign banks handle about $1.5 billion in peso-denominated assets and about 10 percent of the money market. In addition, foreign banks handle Mexicans' capital abroad, which may amount to $40 billion. Everything together would be 50 percent of the Mexican financial system (Peñaloza Webb 1989).

3. UNCTAD/PNUD/SECOFI (1988), p. 11. Total transport costs, including land transport and port services, were SDR 853 million in 1987, of which SDR 415 million was in shipment. Some undisclosed, but probably small, part of the remaining SDR 438 million was in port services (IMF balance of payment statistics, 1988, p. 450).

4. This does not hold true for cargo traffic, where foreign companies, particularly overnight carriers, are increasing their share of handling service.

5. *El Financiero*, March 8, 1989.

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18

East Asian Countries

Chung H. Lee

This chapter discusses patterns of trade in services for six developing countries of Asia—Indonesia, the Republic of Korea, Malaysia, the Philippines, Singapore, and Thailand. It reviews these countries' policies on trade in services and the main features of their regulatory framework in three specific service industries—telecommunications, banking, and ocean shipping. The chapter concludes with policy recommendations and an analysis of the possible consequences of the recommended options.

Trade in services is here defined broadly to include transactions that result from foreign direct investment in services and from temporary international movements of labor, as well as cross-border transactions in services that parallel trade in goods. Hence, trade in services includes international transactions, whether carried out across a border or by foreign affiliates, in accounting, advertising, banking, building, construction, engineering, franchising, hotels and motels, insurance, leasing, legal services, motion pictures, telecommunications, data processing, and information services, tourism, and transport. Also included are remittances by workers employed abroad.

Services: The International Dimension

Table 18–1 illustrates the importance of the service sector in the developing Asian countries. In 1960 the share of services in GDP ranged from 33 percent for Indonesia to 79 percent for Singapore. Except in Indonesia, services constituted the most important sector in these countries. Between 1960 and 1986 the share of services in GDP increased for Indonesia, Korea, and Thailand but decreased for Malaysia, the Philippines, and Singapore. The decrease for Singapore may seem puzzling, since the country had a rapid rate of economic growth during this period and the service sector normally expands in relation to other sectors as the economy grows. The answer may be found in the unique history of Singapore as an entrepôt city. With development, the economy has diversified into manufacturing, and the service sector has consequently contracted.

Table 18–2 presents data on trade in nonfactor services (passenger services, travel, other transport, and private goods, services and income). In all of the countries under study, exports of services grew rapidly; the average annual growth rate ranged from 29.7 percent for Indonesia to 10.4 percent for Singapore. Imports of services also expanded during this period, at average annual growth rates varying from 18.4 percent for Korea to 3.3 percent for the Philippines. The high growth rates of imports occurred during a period when these countries maintained relatively restrictive policies on imports of services. Imports might thus have increased more rapidly under a more liberal trade regime for services.

It is possible that the quality of data on services simply improved in the 1980s as trade in services began to attract more attention and that trade in services therefore appeared to have grown faster than it actually did. To test this hypothesis, the average annual growth rate of trade in nonfactor services was calculated for two subperiods, 1977–80 and 1981–86. According to table 18–2, trade in services grew faster during the first subperiod, except in Indonesia. The high growth rates for the whole period can thus not be attributed to improved collection of data on trade in services in the 1980s.

It has been argued that the industrial countries will gain comparative advantage in the services sector as they become transformed into postindustrial economies (Shelp 1981). If this is true, industrial countries should have a surplus on the services account in the balance of payments, and the developing countries should have a deficit. The available evidence does not, however, support such an argument. Among the developing Asian countries, only Indonesia and Malaysia run a deficit in services; the rest, especially Singapore, do not. During 1976–86 Singapore had a significant surplus in its services account, reflecting its status as a service-oriented

Table 18–1. *The Structure of GDP in Six Developing Countries of Asia*
(percentage of GDP in current prices)

	1960				1970			
	Agriculture	*Manufacturing*	*Other Industries*[a]	*Services*	*Agriculture*	*Manufacturing*	*Other Industries*[a]	*Services*
Indonesia	51	9	6	33	45	10	9	36
Korea, Rep. of	37	14	6	43	26	21	8	45
Malaysia[b]	33	8	10	49	29	12	13	46
Philippines	26	20	8	46	28	23	7	43
Singapore	4	12	6	79	2	20	10	67
Thailand	40	13	6	41	28	16	9	46

a. Includes mining, utilities, and construction.
b. Constant prices.
Sources: Asian Development Bank (1988); World Bank (1987, 1988); and World Bank data tapes 1988.

Table 18–2. *Trade in Nonfactor Services, 1976–86*

Country	*1976*	*1977*	*1978*	*1979*	*1980*	*Average annual growth, 1977–80*
Indonesia						
Credit	96	98	186	244	251	31.5
Debit	1,414	1,538	1,839	2,172	2,588	16.4
Net	-1,318	-1,440	-1,653	-1,928	-2,337	—
Korea, Rep. of						
Credit	1,138	2,162	2,989	3,063	3,375	35.2
Debit	978	1,666	2,473	2,616	3,002	34.8
Net	160	496	516	447	373	—
Malaysia						
Credit	335	413	497	609	876	27.5
Debit	707	879	1,061	1,604	2,255	34.2
Net	-372	-466	-564	-995	-1,379	—
Philippines						
Credit	467	464	648	684	933	20.2
Debit	579	667	703	827	998	14.7
Net	-112	-203	-55	-143	-65	—
Singapore						
Credit	2,391	2,615	2,890	3,401	4,612	18.3
Debit	907	1,086	1,230	1,577	2,221	25.5
Net	1,484	1,529	1,660	1,824	2,391	—
Thailand						
Credit	352	408	600	735	1,051	32.1
Debit	618	691	765	1,007	1,212	18.6
Net	-266	-283	-165	-272	-161	—

n.a. Not available.
— Not applicable.
Note: Nonfactor services include shipping, passenger services, other transport, travel, and other private goods, services, and income.
a. 1977–85.
Source: IMF balance of payments statistics, data tapes, 1988.

1980				1986			
Agriculture	Manufacturing	Other Industries [a]	Services	Agriculture	Manufacturing	Other Industries [a]	Services
24	13	29	34	26	14	18	42
15	30	11	44	12	30	12	45
22	21	17	40	21	17	20	42
23	24	13	40	26	25	7	42
1	30	9	60	1	27	11	62
25	20	9	46	17	21	9	53

1981	1982	1983	1984	1985	1986	Average annual growth, 1981–86
382	458	511	557	829	n.a.	28.3 [a]
4,134	4,282	3,956	4,010	5,157	n.a.	17.1 [a]
-3,752	-3,824	-3,445	-3,453	-4,328	n.a.	—
4,568	5,630	5,567	5,772	4,964	5,174	8.6
3,556	3,603	3,749	3,983	3,905	3,777	4.1
1,012	2,027	1,818	1,789	1,059	1,397	—
1,119	1,433	1,744	1,890	1,922	1,708	12.7
2,401	2,955	3,728	4,215	3,877	3,135	6.9
-1,282	-1,522	-1,984	-2,325	-1,955	-1,427	—
1,297	1,379	1,417	1,359	1,843	1,820	13.1
1,275	1,535	1,450	1,073	775	664	-4.2
22	-156	-33	286	1,068	1,156	—
7,221	8,700	8,605	7,290	6,185	5,296	5.2
2,737	3,244	3,504	3,888	3,738	3,363	7.8
4,484	5,456	5,101	3,402	2,447	1,933	—
1,278	1,461	1,623	1,811	1,869	1,857	10.2
1,451	1,406	1,688	1,763	1,674	1,463	3.9
-173	55	-65	48	195	394	—

entrepôt economy. The Philippines' surplus is probably largely attributable to its exports of construction services to the Middle East, and such exports accounted for a significant portion of Korea's services exports in the second half of the 1970s and the early 1980s (Kim 1988; Lee 1985). Although many traded services tend to be intensive in the use of technology and capital, giving the industrial countries a comparative advantage in these services (Sapir 1985), there are other services in which the developing Asian countries have a comparative advantage, as the experience of Korea and the Philippines illustrates. It is thus unwarranted to presume that liberalization of trade in services will lead to a global restructuring of economies in which the industrial countries rapidly become postindustrial service economies while the developing countries are becoming industrialized.

As an indicator of the importance of trade in services in the overall balance of payments of a country, the ratio of nonfactor services traded to merchandise traded was calculated for both exports and imports for 1976–80 and 1981–86 (table 18–3). During the first period the annual average ratio of services exports to merchandise exports ran from 2 percent for Indonesia to 37 percent for Singapore, whereas the annual average ratio for imports ranged from 13 percent for Singapore to 26 percent for Indonesia. The figures for the second period do not vary much from those for the first period except for the Philippines, where the export ratio increased from 20 to 33 percent.

For Indonesia services exports were insignificant in comparison with merchandise exports, whereas for Korea, the Philippines, Singapore, and Thailand they were significant, accounting for a large portion of these countries' foreign exchange earnings. Furthermore, since in Korea and Singapore merchandise exports expanded rapidly during these periods, the parallel expansion in their services exports indicates that merchandise and services exports need not be substitutes for each other.

It is tempting to infer from table 18–3 that Singapore has a comparative advantage in services, whereas Indonesia and Malaysia do not. Since trade in services has been generally restricted in these countries, such figures cannot be relied on to reveal comparative advantage. But they do indicate that some industrial countries have a comparative advantage in certain services such as banking, insurance, and telecommunications, whereas some developing countries have a comparative advantage in construction services, ocean shipping, and domestic services.[1] This implies that if trade in services is liberalized, exports of services will increase for both developing and industrial countries.

Since services are in general intangible and require the movement of providers or demanders for the exchange to take place, sales of services by foreign subsidiaries of multinational enterprises may be expected to be far more important than cross-border trade in services (Lee and Naya 1988). For instance, the revenues generated by foreign subsidiaries of U.S. service firms are approximately 120 percent of their direct exports (OTA 1986). Thus, what is of concern to the governments of the developing Asian countries is whether firms in their service industries will be able to compete with the subsidiaries of foreign multinational service enterprises (MSEs) and whether some of their own firms will be able to become successful MSEs.

Because a country's comparative advantage and the competitiveness of its firms are not the same, these are issues that are different from the question of comparative advantage. As Lipsey and Kravis (1985) point out, firms in certain industries may be highly competitive in foreign countries even though their home country, given its internationally immobile factors of production, does not have a comparative advantage in these industries. Thus it is quite possible that although some of the developing Asian countries have a comparative advantage in certain service industries, firms in those industries may not possess the competitive edge to become MSEs or may not even be able to compete with foreign subsidiaries in their own country. Liberalizing trade in services could therefore lead to an expansion of MSEs based in industrial countries without a similar expansion by service firms in the developing countries, although the latter countries may increase their exports of services. The success of Korea's construction firms in exporting construction services indicates, however, that MSEs from developing countries can compete successfully with those from industrial countries.

The importance of foreign MSEs in the developing economies of Asia is demonstrated by the share of direct foreign investment in services. During 1982–86, 44.5 percent of foreign investment in Korea, or $785.4 million, was in services. The corresponding figures for Taiwan were 21.3 percent ($600 million), and those for Thailand were 31.6 percent ($434 million). Indonesia is an exception, with only 8.8 percent ($619.6 million) of foreign investment in services.

In recent years, Korea, Taiwan, and some other developing Asian economies have begun making direct investments in other parts of Asia. As of 1986 Korea had invested $92.6 million in Indonesia, Malaysia, the Philippines, Singapore, and Thailand, and as of 1987 Taiwan had invested $86 million in these countries. This investment is now mostly in labor-intensive manufacturing industries, in which Korea and Taiwan are losing comparative advantage owing to rising wage rates and currency appreciation. It is likely, however, that direct foreign investment in services, especially financial services, will soon follow as the demand for such services by manufacturing subsidiaries in other countries increases.

Recently it has been argued that the returns on foreign direct investment, whether in manufacturing or in services, should be included in trade in services, as they are the payments for services provided by multinational enterprises to their subsidiaries (Rugman 1987). Al-

Table 18–3. ***Ratio of Nonfactor Services Traded to Merchandise Traded***

Country	*1976–80*	*1981–86*
Indonesia		
Export	0.02	0.03 [a]
Import	0.26	0.29 [a]
Korea, Rep. of		
Export	0.25	0.24
Import	0.18	0.16
Malaysia		
Export	0.08	0.13
Import	0.24	0.30
Philippines		
Export	0.20	0.33
Import	0.18	0.18
Singapore		
Export	0.37	0.38
Import	0.13	0.15
Thailand		
Export	0.17	0.25
Import	0.20	0.20

a. 1981–85.
Source: IMF balance of payments statistics, data tapes, 1988.

though there is a dispute as to the share of the returns that can be attributed to services provided by multinational enterprises (Ramstetter and Lee 1989), it is now widely recognized that provision of services within multinational enterprises is critical to the continued existence of the enterprises (see, for example, Rugman 1980). If it is accepted that some of the returns on foreign direct investment should be regarded as trade in services, liberalizing trade in services would mean liberalizing foreign direct investment not only in services but also in manufacturing and natural resources; that is, it would mean liberalizing all direct foreign investment.

Government Policies toward Services

As is true in most countries, service industries in the developing Asian countries are regulated to an extent unmatched in other industries. Some regulations are explicitly protectionist in intent; others are not, although they may function as barriers to trade in services. As Alexander and Tan (1984) pointed out in their study of barriers to U.S. service trade in Japan, a regulation does not have to be overtly protectionist to be an obstacle to trade in services. Thus, an examination of the laws or regulations pertaining to a service industry is not enough to determine whether there are barriers to trade in services. In the absence of clearly identifiable barriers such as tariffs, the following principles and procedures proposed in the U.S. Study on Trade in Services (USTR 1985) provide a useful guideline for identifying such barriers.

1. National treatment. "Foreign services and their suppliers should be treated on the same basis as domestic firms supplying these services." In other words, laws and regulations should be applied without discrimination to domestic and foreign firms.
2. Least restrictive regulations. If regulation of an industry is justified, it should be done in the least restrictive manner possible.
3. Nondiscrimination. This is the most-favored-nation principle extended to services.
4. Right to sell. This principle would prohibit the practice of denying market access to foreign service firms, provided that access does not conflict with "sovereign goals and interests."
5. Transparency. "Regulations that hamper or distort trade in services should be transparent, i.e., open and unambiguous."

It is clear from the above list and from the barriers found in the developing Asian countries (see appendix 18A) that most barriers to trade in services are obstacles to the establishment and operation of foreign subsidiaries and to the employment of foreign personnel. Negotiations for liberalizing trade in services can therefore be expected to be much more complex and complicated than their counterpart for merchandise trade, since they must deal with the right of establishment, foreign direct investment, and the international movement of labor, as well as with standard tariff and nontariff barriers.

To highlight some of the difficulties involved in negotiations on services trade, we will take a close look at three industries—telecommunications, banking, and ocean shipping—that differ greatly in terms of the types, motivations, and effectiveness of regulatory policies. Telecommunications represents an industry with new and rapidly changing technology; banking is an industry that has been used as an instrument for industrial policy in many developing Asian countries; and ocean shipping represents a case of an infant industry or of national security.

Telecommunications

Historically, telecommunications links and systems have been introduced under the protective aegis of state monopoly. This has been so for a number of reasons, most prominently economies of scale, national security considerations, and, in certain instances, the suppression of political dissent. In many developing Asian countries government post, telegraph, and telephone (PTT) monopolies were the norm well into the 1970s and still persist in some cases. The main ways in which telecommunications networks are regulated and protected from competition are monopolization by a single enterprise run or chartered by the government; government-mandated technical standards; state procurement practices that favor a select circle of large suppliers; restricted entry of foreign entities such as manufacturers or network operators; and state-run radio and television broadcasting.

In all countries licensing of radio and television broadcasters is tightly controlled by national authorities. The basis for such restrictions has been the presumed scarcity of the radio frequencies available for broadcasting. Recent developments in transmission, modulation, and switching techniques have, however, greatly increased the available capacity, and the scarcity of radio frequencies and television channels can no longer be used as a basis for regulating the radio and television industries.

Singapore has a government-owned telecommunications authority, but it is run on a commercial basis. It provides news services at subsidized costs, and its radio-paging and mobile communication systems help the business community compete effectively in global markets. Indonesia's government-owned PTT system is also run on a commercial basis. The Palapa satellite system provides cost-efficient telephone and television services to remote islands of Indonesia, linking them together in a modern telecommunications network. Malaysia privatized its PTT system several years ago and now provides a commercially operated optical fiber cable link for its southern region. The link will be extended to Hong Kong, Indonesia, and Thailand (Jussawalla 1989).

Domestic liberalization of telecommunications in these countries does not mean that they would welcome foreign telecommunications services. There are strong nationalistic sentiments for preserving the national cultural heritage and identity, which some think would be undermined by the internationalization of telecommunication services and the consequent influx of Western values and ideologies (Clairmonte and Cavanagh 1984). Whatever validity this argument may have, it is a force opposing the internationalization of telecommunications services.

In investigating the motives for protecting the telecommunications industry, one must recognize the importance that many governments attach to the acquisition and development of modern technology. According to Pack and Westphal (1986), Korea, Singapore, and Taiwan have protected certain industries in which they do not have a static comparative advantage in order to help them acquire the technical, institutional, and marketing tools to achieve international competitiveness.[2] This motive is different from the rent-seeking motive for protection and from cases that are explained in terms of the "capture" theory of regulation.[3] Korea and Singapore, among others, see service industries such as telecommunications as the next logical step in technological advancement and as industries in which to achieve international competitiveness. For them the protection of these industries is necessary for economic development and for catching up with the industrial countries.[4]

Banking

In developing Asian countries domestic banks are protected from foreign competition through such practices as banning or limiting the establishment of branches by foreign banks; not allowing foreign banks to underwrite government securities; forbidding foreign banks to offer certain services, such as managing trust funds or issuing negotiable certificates of deposit; and prohibiting the purchase of local property or business premises. These practices are carried out, however, with varying degrees of intensity. At one extreme, Indonesia, Malaysia, the Philippines, and Thailand impose severely restrictive conditions on foreign banking. At the other end is Singapore, probably one of the most open countries in the world in terms of banking. According to one study, foreign banks hold 89 percent of all financial assets and 75 percent of all deposits in Singapore (ASEAN-U.S. Business Council 1988, p. 62). Between the two polar cases is Korea, which began banking liberalization in the early 1980s. Foreign banks are now allowed to borrow from the Bank of Korea, the country's central bank, and to sell negotiable certificates of deposit. They are, however, still restricted in such activities as investment trusts and securities investment, and they cannot invest in mortgages, since foreigners are not allowed to acquire land as an investment asset in Korea (Young 1989). Many of these restrictions will be lifted after 1992; foreigners will then be allowed to invest directly in Korean securities up to a certain limit, and foreign securities companies will be able to establish branches and joint-venture securities companies.

There is no need to rehearse here the arguments in favor of deregulating the banking industry and opening it up to commercial and investment activities by foreign banks. Barriers such as those noted above curtail the ability of banks to offer attractive interest rates to their depositors, to realize capital growth and control costs, and to facilitate customers' access to their deposits. Although restrictive banking regulations may confer benefits on the small number of citizens who are in a position to marshall financial resources and to profit from lending them for domestic development, and although the timing of banking deregulation might be in dispute, the overall effect of regulation is definitely antithetical to economic development (McKinnon 1988).

Domestic financial liberalization should precede the opening of the market to foreign banks, and it has to go beyond liberalization of interest rates. For instance, in Taiwan, where most banks are managed by the government, liberalization of interest rates is unlikely to produce competition among the banks (Lee and Tsai 1988). In such a market foreign banks are likely to carve out their own monopolistic niche, leaving the economy worse off.

In some developing Asian countries restrictive measures on the entry and operation of foreign banks have existed for more reasons than to protect domestic banks from foreign competition. Government control over financial institutions, especially banks, has been the most important instrument for controlling the allocation of credit and, thus, of real resources (see, for example, Cole and Park 1983; Lee 1988). Liberalizing the banking system means the loss of control over the allocation of resources and the reduction and alteration of the government's role in the economy. It goes further than deregulating an industry to achieve competitive efficiency; it means a fundamental change in what has been regarded in many of these countries as the appropriate role of the government in promoting economic development.

Ocean Shipping

In recent years many governments have intervened actively in ocean shipping as maritime aspirations led to the development of national fleets (Sien and Trace 1988). Indonesia, Malaysia, the Philippines, and Thailand have adopted a policy of cabotage—of reserving domestic shipping and government cargo for national-flag ships. In some countries "government cargo" is defined so broadly as to include almost all cargo (Miklius 1988).

The most popular new policy instrument is the cargo-sharing agreement, which is the result of bilateral negotiations between trading countries or is declared unilaterally. Flag discrimination through cargo-sharing agreements, although in use much earlier, was legitimized by the adoption in 1974 of the Convention on a Code of Conduct of Liner Conferences.

Many developing Asian countries have negotiated cargo-sharing agreements or have adopted them unilaterally (Brooks 1985). In late 1983 Thailand signed an agreement with Korea for a 40-40-20 cargo allocation rule in trade between the two countries. Malaysia has signed agreements with Bangladesh, Turkey, and Indonesia, and Indonesia has negotiated bilateral agreements with Japan, Korea, and Taiwan for carriage of logs and with Taiwan for carriage of general cargo. Even Singapore, which maintains a fairly liberal policy on ocean shipping, signed a 50-50 cargo-sharing agreement with Indonesia for Indonesia-Singapore trade.

The Philippines adopted its first cargo reservation legislation in 1976. The legislation specified that all government cargoes, including any cargoes being moved by private corporations that received financial benefits from the government, were to use Philippine ships. In 1982 the government of the Philippines, to support its failing fleet, extended cargo sharing on a 40-40-20 basis for all liner cargo unilaterally, by executive order. This led to a confrontation with the United States. Faced with action by the Federal Maritime Commission that would effectively have barred Philippine-flag vessels from U.S. ports, the government was forced to withdraw the executive order (Brooks 1985).

In addition to cargo sharing, countries have adopted financial assistance schemes that include such measures as reduced income and other taxes, tax holidays, lower interest rates on loans to finance ship purchases, and lower (or no) import duties. Other schemes include equity participation and government ownership and operation of shipping companies. These financial aids are responsible for some of the problems of overcapacity currently facing the shipping industry. For instance, in the 1970s, following the first oil shock, the Korea Maritime and Port Administration began offering subsidies to designated large shipping companies as a way of expanding the fleet. In response to the subsidies, the companies rushed into the world market, picking up second-hand vessels at an inflated "Korean rate." As was to be expected, the Korean shipping industry is now burdened with a huge debt and a fleet of aging ships.

Recent Experiences with Liberalization

Under pressure from the U.S. government, the Korean government agreed on July 21, 1986, to open its insurance market to a certain number of U.S. insurance firms. The agreement provided that (a) two U.S. firms would participate in the fire pool by July 1986; (b) the member companies would determine the method of sharing pool premium income; (c) one U.S. firm would be licensed to enter the life insurance market by the end of 1986; and (d) qualified U.S. firms would be permitted to enter both the life and nonlife insurance markets (Cho 1988). It is clear from these agreements that the Korean insurance market had been a regulated market before being opened to the U.S. firms, and it still remains so, but now with U.S. participants. As Cho points out, opening a regulated market to a few foreign firms may have made Korea worse off, as the gains from increased competition may be more than offset by the loss of monopoly rents.

A similar point has been made by advocates of a slow and gradual process of financial liberalization in Korea. Chung (1988) argued that the price-earnings ratio in the Korean stock market was too low (at the time of his writing) and that the opening of the market to foreign investors should wait until the ratio went up high enough to prevent the newcomers from reaping excessive capital gains. Chung attributed the low price-earnings ratio to a deep-rooted distrust of the securities market among Korea's public, which sees little difference between the market and a gambling house, and to its general mistrust of business firms.

If these are the reasons for the low price-earnings ratio, and if the public's perception is correct, foreign investors would lose by investing in the Korean security market; only in the opposite case would they gain. It seems that unless the government knows better than the public, there is no reason to prohibit foreign investors from investing in Korea and from making mistakes that the Korean public is trying to avoid. If foreign investors have better information than the Korean public, their participation will improve resource allocation in Korea, although in the process they will gain financially. It seems, then, that unless the government knows better than the public, there is no compelling reason not to open the capital market to foreigners soon. If the government does know better, it should provide its information to the public as quickly and as widely as possible.

Korea has begun opening its financial and capital markets. As a first step it established two corporate-type funds—the Korea Fund in 1984 and the Korea–Europe Fund in 1987. In 1985 the government authorized Korean companies to issue convertible bonds in overseas markets, and at present foreign securities firms are allowed to own up to 10 percent of the paid-in capital in large Korean securities companies. Furthermore, according to a timetable announced by the Korean government in December 1988, foreign investors will be allowed to make direct purchases of Korean stocks in 1992.

Foreign banks have operated in Korea since the mid-1960s but have been subject to many discriminatory restrictions. Lately, these restrictions have been phased out. Foreign banks may now obtain membership in the Korea Federation of Banks and the Clearing House. They may engage in trust business, have access to the central bank rediscount window, and issue certificates of deposit. Foreign banks, however, still face restrictions in acquisition of real estate (Nam 1989).

In recent years the information sectors of the industrial countries have become increasingly liberalized, and their multinational enterprises have gained much from the process. This is not surprising, since much of the liberalization has been directed at the demand or user side, at the insistence of firms that have joined into effective domestic and international lobbying groups in favor of deregulation.

Even in developing countries the pressure for liberalization seems to have come from the user side. For instance, in 1987 the Korean Computer and Communication Promotion Association, which consists of providers of databank and computer power services, requested the government to eliminate all restrictions on the use of leased lines for domestic as well as international nonvoice data communications.

There was, however, external pressure as well. Talks between the United States and Korea regarding U.S. access to the Korean telecommunications market began in 1987 and continued through 1989. Pressure from the United States increased with the passage of the Omnibus Trade Act of 1988. The United States requested complete opening of the telecommunications market, with some exceptions such as telephone and telex services. Korea basically agreed to open the market and introduce more competition, but in gradual steps (Sung 1989).

The international business community has benefited in two main ways from liberalized government policy toward information services. First, intrafirm communications, whether domestic or international, have become less expensive and more convenient. The reduction in costs and the improvement in services have been achieved in part by establishing intrafirm data and voice networks. For example, General Motors, IBM, and General Electric all have their own worldwide private data systems that operate independently of the common carriers. These corporations have to lease lines from the common carriers, but the prices of leased lines have fallen close to costs (Jussawalla 1989). Second, value added or third-party services are now available to customers in greater quantity and variety and at lower costs than previously, as a result of liberalization. Both processes, particularly the latter, have contributed substantially to the volume of international trade in information services among the principal industrial countries.

Although the initial beneficiaries of liberalization are the business communities of industrial countries, there is every expectation and indication that liberalization of the information sector will eventually benefit the developing countries as well. As Snow (1985) points out, such liberalization is both a cause and a symptom of economic development. In recognition of this, some countries, such as Korea, have begun considering initial steps toward deregulation of the information sector, particularly in data communications. Hong Kong, where the telecommunications networks have been in private hands for some time, is acting as a catalyst for the construction of modernized telecommunications networks northward across the Chinese mainland in anticipation of its absorption into China at the end of the 1990s.

Policy Recommendations

On the basis of the information and arguments presented in the preceding sections the following initiatives are recommended.

Greater Liberalization and Privatization in the Information Sector

The developing Asian countries should examine the benefits to be gained from relaxing the often onerous regulatory and nonregulatory controls in their telecommunications and other information-intensive industries. In particular, domestic and overseas telecommunications networks and the services they provide merit special consideration as the nerve center of the information-intensive sector. Specific policies could include high-level inquiries into changes in telecommunications policies—an initiative already undertaken by virtually all the principal industrial countries; partial or complete privatization of networks or network components; and easing of restrictions regarding procurement, standard setting, licensing, and the like.

Privatization does not necessarily lead to improvements in welfare; the outcome may simply be a private monopoly. But if it is accompanied by the opening of the market to international competition, even the private monopoly will behave competitively. For example, Korea used to have only one private air carrier, Korean Air, which practiced price discrimination between the closed domestic market for international travel and the more competitive international market. When airline deregulation in the United States and the entry of more U.S. carriers brought about increased competition within the Korean domestic market, this price discrimination virtually disappeared.

Relaxation of Foreign Equity Control

The developing Asian countries are very diverse, but each reduces its ability to attract foreign investment in service industries by placing restrictions on the extent of foreign ownership. These restrictions especially limit the inflow of investment in high-technology industries, where intellectual property rights are the main motivating factor for investment, and they thus inhibit transfer of technology from industrial to developing countries.

Relaxation of Controls on Foreign Banking

For the reasons mentioned above, some developing Asian countries have adopted protectionist legislation that is heavily disadvantageous to foreign banks. These banks have to contend with limits on the range of services they may offer, prohibitions against the purchase of local properties or business premises, restricted access to host-country government funds, and inability to underwrite host-country government securities. Relaxation of these controls should be carried out in a manner that does not provoke speculative capital inflows; otherwise the result could be a loss of domestic monetary control and, consequently, economic instability. The painful experiences of Chile and Argentina in the 1970s make clear the importance of containing short-term speculative capital inflows during financial liberalization.

Relaxing Limits on Professional Services by Foreigners

Understandable protectionist impulses have given rise to legislation in the developing Asian countries that sharply limits the ability of foreign professionals to practice their occupations. These restrictions are typically found in such professions as financial planning, architecture, engineering, construction, law, telecommunications, and accounting. Some of these industries are the technologically most advanced ones, and allowing foreign professionals to practice their occupations locally could permit a beneficial transfer of technology.

Relaxing Restrictions on Foreign Construction Services

Some developing Asian countries, especially Korea, have demonstrated that their construction services can compete internationally. Their exports are, however, limited mostly to other developing countries because of severe restrictions in the industrial countries. The export of construction services is a complicated issue, as it is related to immigration policy. A way needs to be found to distinguish international migration for temporary employment from immigration and to treat the former as trade in services.

Conclusions

Many internationally traded services are intermediate services that enter into the production of goods and other services. Local service firms may not be able to compete with imported services or services provided by foreign affiliates, but as cheaper or better services become available, local manufacturing or service firms that use these services will become more competitive internationally. This linkage effect has been widely observed in the industrial countries, and there is no reason why it would not be the same in the developing Asian countries that have many successful manufacturing industries. What these countries need to consider is whether to develop their own service industries, meanwhile suffering a competitive disadvantage in industries that rely heavily on these services, or to utilize imported services and become more competitive internationally.

One benefit to the host country of allowing direct foreign investment is the transfer of technology. There is no a priori reason why such benefits would not accrue to the host country when the investment is in a service industry. Since services are generally provided by their producers in direct contact with consumers, there are probably more opportunities for technology transfer to the host country.

There are good reasons why many infrastructural and other activities—such as electricity, water, transport, health, broadcasting, and education—remain in government hands during economic development (Snow 1988). To the extent that particular sectors such as telecommunications become privatized or deregulated, however, they serve as a touchstone against which users, voters, and taxpayers can measure the relative efficiency and flexibility of the public sector, which may then be compelled to operate more efficiently.

Finally, an argument may be made against liberalizing trade in services on the grounds that it has a negative effect on the balance of payments of the developing Asian countries. But, on the contrary, it may have a positive effect by fostering improved efficiency in service industries and hence a decrease in the prices of service-intensive commodities. If those commodities are exportables, liberalization will bring about an increase in the country's exports; if they are importables, it will lead to a decrease in imports. Liberalization will thus have a favorable effect on the merchandise account in the balance of trade, although it may have an adverse effect on the services account. The effect of liberalization of trade in services on trade in goods needs to be further elaborated and empirically estimated. Only by taking into account linkage effects such as this can a country make correct policy decisions on its trade in services.

Although the preceding arguments point out the advantages of liberalization, whether unilateral or multilateral, they do not address the problems involved in implementing liberalization. Given the above-mentioned advantages, one would wonder why so many of the developing Asian countries have not carried out liberalization unilaterally.

The responses of the developing Asian countries to liberalization in services have varied, reflecting differences in their comparative advantage in trade in services and the relative service-sector shares in their economies. For instance, among ASEAN countries Singapore and then Thailand are the most enthusiastic for liberalization, whereas Malaysia, Indonesia, and the Philippines, with their deficits in services trade, are less so. The latter group is especially cautious about opening up sectors such as banking, insurance, transport, and telecommunications, since opening of these sectors, unless accompanied by reciprocal opening of sectors in which they have a comparative advantage, would mean further deterioration in their balance of payments. Even if this deterioration is short-term, it is not a problem these countries can easily ignore. Multilateral liberalization should alleviate this concern.

Another benefit of a multilateral process of liberalization is that it helps a pluralistic, democratic government to overcome opposition to liberalization by domestic groups that have benefited from protection. To counter this opposition the government needs to garner support for liberalization from groups that are potential beneficiaries, and a greater number of domestic groups emerge as gainers under multilateral liberalization than under unilateral liberalization. The government may thus be able to get the support and overcome domestic opposition to liberalization. Given the political liberalization that is at present taking place in many developing Asian countries, this political economy case for a multilateral process may well be the most important of the arguments that have been made in favor of the process.

Notes

1. It has been proposed that in return for more liberal treatment of imports of services from the United States, countries of the Association of South East Asian Nations (ASEAN) should be allowed to send their nationals to work on a temporary basis in the United States as construction workers or domestic maids (Lee 1988). This position is consistent with Bhagwati's (1987) proposal that if direct foreign investment in services is to be included in trade in services, the mobility of foreign labor and its service on a temporary basis should also be included.

According to Miklius (1988), (non-Japanese) Asian ocean carriers have only a 4 percent cost advantage over nonsubsidized U.S. carriers on a 1,700 TEU (twenty-foot equivalent unit) vessel, although Asian crew costs are about 30 percent of the U.S. costs. This is so because the cost differential is primarily in the area of crew wages and insurance, U.S. crew costs are about 25 percent of total marine expenses, and marine costs are 19 percent of total costs. Miklius expects that the trend toward larger container vessels will continue and that thus the comparative advantage the developing countries have in ocean shipping will erode further.

2. This is not the same as an infant industry argument, which justifies the protection or, preferably, the subsidization of an industry unable to compete as yet with foreign competition. According to Pack and Westphal (1986), the former underlies the industrial strategy of the East Asian governments, which is designed to achieve "dynamically efficient industrialization" by managing technological change.

3. According to the "capture" theory of regulation, members of the regulated industry indirectly capture the regulators' powers and use them to their own benefit (Stigler 1971).

4. It should be noted, however, that if a given industry is to be promoted, providing a cost advantage to domestic producers with subsidies is superior to placing a cost disadvantage on foreign producers (Hindley 1988).

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Appendix 18-A. *Barriers to Trade in Services*

Indonesia

- Insurance. Market access is denied; foreign insurers are not permitted to establish branches or subsidiaries.
- Leasing. The application process for obtaining authorization for new leasing operations is not transparent, as it lacks specified criteria; there are percentage limitations on foreign ownership and expatriate employment; and leasing of imported goods is not permitted.
- Motion pictures. There are quotas on film imports; market access is denied to foreign film distributors.
- Franchising. Trademarks are poorly protected, and trademark litigation involves costly court proceedings.
- Maritime transport. There is a percentage requirement for national-flag carriers.

Republic of Korea

- Accounting. Market access is severely limited, and activities are restricted to foreign joint-venture firms.
- Advertising. Radio and television commercials produced abroad are forbidden, and equity ownership by foreign firms in agencies that purchase media space and time is prohibited.
- Banking. Branch banking is restricted, equity participation is limited to 50 percent. Foreign banks may not acquire title to property such as real estate, vessels, and aircraft.
- Motion pictures. There are quantitative restrictions on film imports and screening quotas for local films on television.
- Maritime transport. Foreign carriers are prohibited from owning assets such as trucks, chassis, or facilities in Korea.

Malaysia

- Advertising. All broadcasting materials must be produced locally, using local labor.
- Insurance. Market access is denied; foreign insurers are not permitted to establish branches or subsidiaries.
- Leasing. There are percentage requirements for foreign ownership and expatriate employment.
- Motion pictures. Use of foreign technical experts is restricted.

Philippines

- Banking. Foreign ownership is limited; establishment of foreign bank branches is prohibited.
- Franchising. The central bank must approve all contracts calling for royalty payments.
- Insurance. Cessions to unauthorized foreign reinsurers are limited.
- Leasing. There are percentage limitations on foreign ownership and expatriate employment.
- Motion pictures. There are quotas on film imports.
- Air transport. The national carrier receives preferential treatment in charter flight operations and pays lower taxes than foreign carriers.
- Maritime transport. The national-flag line receives preferential tax treatment.

Singapore

- Banking. Entry and operations are restricted, and foreign banks may not have branch operations.
- Insurance. Market access is denied, foreign insurers are not permitted to establish branches or subsidiaries, and a portion of reinsurance must be purchased locally.
- Motion pictures. Use of foreign technical experts is restricted.
- Maritime transport. There are discriminatory bilateral agreements.

Thailand

- Advertising. Market access is limited; the establishment of wholly owned or majority-owned branches or subsidiaries is not permitted.
- Banking. Establishment of new foreign banks and additional branches is banned.
- Insurance. Market access is denied; foreign insurers are not permitted to establish branches or subsidiaries.
- Leasing. There are percentage limitations on foreign ownership.
- Motion pictures. Use of foreign technical experts is restricted.
- Air transport. The national carrier has a monopoly on ground handling services.

Source: USTR (1985).

19

India

Surjit S. Bhalla

The service sector in India has become an important topic for three reasons. First, economists and policymakers have recognized that the service sector is an integral part of the development process rather than a stepchild to the formerly overriding priority of industrialization. Second, the role of trade in services has expanded rapidly enough to draw the attention of those who make rules and policies. Third, India, along with Brazil, has been a leader of the Group of Ten (G–10), which has taken a position on trade in services that is in direct opposition to the position not only of the developed world, led by the United States, but also of the rest of the developing world.

A surprising aspect of growth in the developed world over the past two decades has been the significant rise in the share of the service sector. For example, in the United States the share of services in gross domestic product (GDP) increased from 59 percent in 1965 to 67 percent in 1986. It was expected that in developing countries the growth of services would be slower and that as the share of the primary sector decreased, a large proportion of the decline would be absorbed in the "lead" manufacturing sector—the "engine of growth."

But this expectation has been belied in India's case. As table 19–1 shows, the share of manufacturing in GDP increased from 15 percent in 1965 to 19 percent in 1986, but this growth was markedly less than in, for example, Thailand (from 14 to 21 percent during the same years) and Turkey (from 16 to 25 percent).[1] Meanwhile, the service sector (including other services) expanded from 37 percent in 1965 to 47 percent in 1986.

Three observations may be made about the figures in table 19–1.

1. The banking and insurance sector has grown tremendously; its share in GDP increased from 1.2 percent in 1960 to 3.5 percent in 1986. It is noteworthy that the rate of expansion of this sector was not much different for the two decades 1960–70 and 1970–80. The banking sector was nationalized in 1969 and the insurance sector in 1971, with the stated purpose of providing services to the "credit-starved" rural sector. Although the data are indirect and incomplete, the similarity of growth rates for the periods before and after nationalization suggests that a marked acceleration of value added in banking was not one of the outcomes of nationalization.

2. "Other services" have been stagnant, at around 6 percent of GDP, for the past three decades, whereas the tourist trade component (hotels and the like) increased from 9.4 percent in 1960 to 12.6 percent in 1986.

3. Government services (public administration and defense) increased steadily, from 3.8 percent in 1960 to 4.7 percent in 1980. During the past six years this share has increased to 5.8 percent. This "expansion" is important for assessing rates of growth; given the difficulty of measuring productivity in government, it might be questioned whether the purported acceleration of the Indian growth rate during the 1980s (from 3.5 to 5.0 percent per capita) is not in large part attributable to the growth of the government sector.

Tables 19–2 and 19–3 present data for different components of services exports and imports. Again, three findings emerge.

1. The share of service exports (excluding official transfers) in total exports rose from only 25 percent in 1960 to almost 40 percent in 1986.

2. The three components of service exports that have shown the most expansion are travel (that is, tourism), miscellaneous (a catchall category that includes consulting, data processing, accounting, financial services, and the like) and private transfers (remittances of Indian nationals). The last category has burgeoned since the mid–1970s, reflecting the export of labor services to the Persian Gulf countries. In 1980 such transfers accounted for one-fifth of total exports, but the share fell to only 15 percent in 1986.

3. These three categories are also the ones that show a surplus in the net account (table 19–3). Travel shows a surplus not because tourism is flourishing (there are fewer than 750,000 visitors a year from countries exclud-

Table 19–1. ***The Share in GDP of the Nonservice and the Service Sectors at Factor Cost***
(percentage of GDP)

Sector	*1960*	*1965*	*1970*	*1975*	*1980*	*1984*	*1986*	*1987*
Nonservice sector	65.0	62.8	62.7	58.9	57.3	55.2	53.1	52.5
Primary sector	50.8	47.6	48.5	43.3	39.6	37.2	34.3	33.3
Manufacturing	14.2	15.1	14.2	15.6	17.7	17.9	18.8	19.2
Service sector	35.0	37.2	37.3	41.1	42.7	44.8	46.9	47.5
Utilities	10.0	10.9	11.5	11.5	11.3	13.0	14.1	14.5
Construction	4.6	5.0	5.8	5.0	5.0	5.3	5.6	5.8
Electricity, gas and water supply	0.6	0.8	1.1	1.3	1.6	2.0	2.2	2.2
Transport, storage, and communications	4.9	5.0	5.1	5.3	4.7	5.7	6.3	6.6
Services	24.9	26.4	25.8	29.6	31.4	31.8	32.7	33.0
Trade, hotels and restaurants	9.4	10.4	11.0	13.8	12.0	12.4	12.6	12.5
Banking and insurance	1.2	1.6	1.8	2.7	2.8	3.4	3.5	3.6
Real estate	4.3	3.9	4.0	3.7	6.0	5.1	4.9	4.8
Public administration and defense	3.8	4.5	4.5	4.9	4.7	5.2	5.8	6.1
Other	6.2	6.0	4.6	4.6	5.8	5.7	5.9	6.0

Source: Central Statistical Office, National Accounts Statistics; Old Series for 1960–79, New Series for 1980.

ing South Asia, and that number has remained stagnant for several years) but because Indians cannot easily obtain foreign exchange for travel abroad. The figures on net travel earnings thus reflect an artificial surplus. Exports of travel (tourism) are encouraged but because of various bottlenecks, including the overvalued exchange rate, tourists prefer other countries. And imports of travel (business travel or tourism by Indian citizens) are effectively curtailed because a traveler can obtain only the equivalent of $500 in foreign exchange only once every three years. Business travelers have to go through cumbersome procedures to get foreign exchange. The net result is a black market for foreign exchange that is aided and abetted by official policy. It is unlikely that total travel receipts (black and white) show a trade surplus for India.

India's Position at the Uruguay Round Negotiations

At the ministerial meeting in Punta del Este in 1986, India (with Brazil) led the developing countries' opposition to the introduction of services within the GATT framework. This stand was based on several rationales; the following list is meant to be comprehensive, although "unofficial."

Table 19–2. ***Merchandise and Service Exports as a Share of Total Exports***
(percent)

Type of exports	*1960*	*1965*	*1970*	*1975*	*1980*	*1984*	*1986*
Merchandise	74.6	75.3	77.1	74.5	54.7	60.5	62.2
Services	25.4	24.7	22.9	25.5	45.3	39.5	37.8
Travel	1.8	1.4	1.5	3.4	9.7	4.5	7.5
Transport	5.3	5.1	5.9	4.6	3.0	3.3	3.2
Insurance	1.0	1.1	0.6	0.7	0.4	0.4	0.4
Investment income	1.7	1.0	2.7	2.1	7.1	3.0	3.0
Government	6.0	4.4	1.7	1.9	0.7	0.5	0.6
Miscellaneous	4.3	2.5	3.0	3.2	5.5	12.0	8.8
Private transfers	5.3	9.1	7.5	9.7	18.9	15.8	14.3

Note: Exports exclude official transfer payments. Miscellaneous services lumps together producer and business services such as computer software, data processing, research, management, legal and other consulting, engineering and design, advertising, market studies and public relations, accounting, maintenance and quality control, and banking and financial services.

Source: Reserve Bank of India, *Report on Currency and Finance.*

Table 19–3. ***Gross Exports and Imports of Services***
(millions of dollars)

Type of service	*1960*	*1965*	*1970*	*1975*	*1980*	*1984*	*1986*
Travel							
Exports	32.1	31.7	36.9	219.1	1,477.7	755.4	1,284.7
Imports	25.4	22.7	23.5	25.2	114.4	344.3	295.6
Net	6.7	9.0	13.4	193.9	1,363.3	411.1	989.1
Transport							
Exports	93.7	112.6	140.9	300.4	458.1	541.5	548.8
Imports	51.7	58.6	103.7	226.3	449.9	772.0	596.6
Net	42.0	54.0	37.2	74.1	8.2	-230.5	-47.8
Insurance							
Exports	17.0	24.6	15.5	44.3	61.3	74.7	66.3
Imports	12.2	12.8	16.1	28.2	43.1	70.7	81.0
Net	4.8	11.8	-0.7	16.1	18.2	4.0	-14.8
Investment income							
Exports	29.8	22.9	64.2	134.3	1,083.4	492.9	511.2
Imports	130.0	283.5	362.7	329.7	470.3	1,330.9	1,507.7
Net	-100.2	-260.6	-298.6	-195.7	613.1	-838.0	-996.7
Government							
Exports	107.1	95.5	39.8	120.5	110.9	88.1	105.9
Imports	44.7	32.8	30.4	37.7	59.7	70.8	108.3
Net	62.4	62.8	9.4	82.9	51.2	17.2	-2.4
Miscellaneous							
Exports	76.9	54.2	73.3	208.1	841.3	1,986.9	1,510.0
Imports	72.7	103.7	102.7	197.8	848.6	1,092.0	1,184.7
Net	4.2	-49.6	-29.4	10.3	-7.3	894.8	325.3
Private transfers							
Exports	94.3	199.3	180.4	625.4	2,874.6	2,621.5	2,435.0
Imports	35.3	33.2	17.5	15.5	14.7	12.8	11.8
Net	59.0	166.1	163.0	609.9	2,859.9	2,608.7	2,423.2
Total services							
Exports	507.6	540.7	0.0	1,652.1	6,907.3	6,561.0	6,461.6
Imports	371.9	547.2	656.7	860.6	2,000.7	3,693.6	3,785.7
Net	79.0	-6.5	-656.7	791.5	4,906.6	2,867.4	2,675.9

Note: Figures exclude official transfers.
Source:: Reserve Bank of India, ***Report on Currency and Finance***..

- The introduction of services within the GATT would deflect the GATT's attention from other, more pressing issues such as nontariff barriers and agricultural subsidies.
- Since the GATT has not been effective in "protecting" or advancing developing countries' interests in the area of trade in goods, it would be singularly irrational to expect it to help those countries in the area of services.
- Services trade is a form of neoimperialism; service industries are dominated by multinationals, and opening up trade is an invitation to be gobbled up.
- In any case, services is such a new sector that even the economists (including the GATT's own) have difficulty in defining it. Hence, it would be just a futuristic indulgence to try to figure out what would happen if trade in services were to be liberalized.
- Liberalization of trade in services "may not result in comparative advantage and protection of infant service industries in [developing countries]. Besides, it may impinge on national sovereignty and economic ambitions."[2]

Do these positions represent genuine economic concerns or are they meant for political consumption? If the latter, then what are the *real* reasons for India's leadership of the opposition to introducing services into the GATT? The validity of each of the above arguments is examined below.

• *No services in the GATT because the GATT agenda is already full.* Implicit in this argument is the belief that there are diseconomies of scale to a bureaucracy. There is truth in this argument, although it is ironic that India, which has one of the world's largest bureaucracies, should be advancing it.[3] But in this case, if services were under the rubric of the GATT, economies of scale would be realized because issues of protection, comparative advantage, and the like would apply equally to goods and to services. Furthermore, since the distinction between goods and services is becoming blurred, it would not be rational to have two different organizations arguing about jurisdiction.

It is unlikely that the Indian negotiators were unaware of these factors. Rather, their stand might have been motivated by the time-tested maxim that if you do not want something to happen, set up a committee to study the problem. Even if an alternative GATT-like organization were eventually set up, it would probably be plagued by startup problems concerning its proper domain and the distinction in specific cases between goods (which would belong under the GATT) and services.

- *GATT has not been effective in protecting developing country interests.* This view is completely consistent with India's stated position on political and economic "realities"—that the outside world is largely responsible for domestic problems. In India this is labeled the "foreign hand position." Nayyar (1987), for example, gives the following explanation for India's bad export performance: "The increasing incidence of protectionism in the industrialized countries, embodied in the escalated tariff structures and a *range of unquantifiable* nontariff barriers, also places a *limit* on the growth of manufactured exports" [italics mine]. But Indian exports (manufactured and total), instead of rising to a ceiling imposed by outside restraints, have shown a steady and persistent *decline* in market share since the 1950s. Unless, as is unlikely, the "foreign hand" was explicitly aimed at India, a legitimate question arises: wasn't something else besides lack of foreign demand responsible for the export debacle of the past forty years? Several authors (for example, Manmohan Singh 1964, Bhagwati and Srinivasan 1975, Lucas 1986, and Bhalla 1989) have argued that the price demand elasticity for Indian exports is not less than unity. It is therefore likely that the explanation for the lack of growth of Indian exports has more to do with domestic policy than with the policies of the GATT or the developed world. It is also difficult to imagine that the Republic of Korea, Taiwan, and now China would argue that the GATT and the world trade system had not advanced their interests.

But what about, for example, textile quotas? True, these barriers exist, and in the interests both of trade and of textile-producing countries such as India it is important that they be removed. A call to dismantle such developed country barriers would be a good negotiating position for India. The tragedy, however, is that India cannot avail itself of this negotiating opportunity because it has not been adversely affected by textile quotas. Jethanandani (1989) notes that "the only year in which [textile] quotas were fully utilized was 1987, while for the remaining years [India's] quotas were grossly underutilized, especially the European quotas. Even in 1987, our quotas for some commodities like bed-linen and made-ups were underutilized."

To sum up, although the argument that nontariff barriers have hurt developing country exports has merit, it is not an argument that Indian policymakers can convincingly advance.

- *Services trade is neoimperialism (visions of Citibank and AT&T dominating the world market).* This is identical with an earlier view that opening up the world market for goods would lead to General Motors' owning the world. Then came Ford; then came Mercedes-Benz; then came Toyota; then came Hyundai; then came Pronto-Saga. The "neoimperialism" argument is singularly anachronistic and has an autarkic implication: since trade leads to domination by foreign nationals, self-reliance is the only course left.
- *Trade will not protect infant service industries.* Again, there may be validity to this argument. Indian policymakers and industrialists, however, have been crying themselves hoarse for forty years about their need for protection *now* so that they will be able to compete later. And while the future has arrived, Indian industrialists are still not competitive internationally. Infant industry protection has been in force from independence in 1948 to the present, and India's share in world trade has declined, from approximately 2.5 percent in the early 1950s to barely 0.5 percent. These are certainly not logical grounds on which to argue for the advantages of infant service industry protection, at least from the Indian point of view.

The clue to the persistence of the infant industry argument lies in the political economy of India. The industrialists are loathe to give up protection—indeed, a leading Indian industrialist seriously suggested that the way to solve the problem of the government deficit was to raise the import tariff. (With tariff rates estimated at about 125 to 175 percent, India may already have the highest tariff structure in the world; see table 19–4.) A new empirical twist is now advanced to support the case for import protection: Japan and Korea succeeded with restrictions on imports, so why cannot India? This argument is repeated ad nauseam at government meetings, and it would not be amiss to classify it as yet another Indian mantra. Its proponents (and they include many distinguished Indian academicians and policymakers) fail to mention that the Koreans and others had to

Table 19–4. *Comparative Nominal Tariff Rates, 1985*
(Mean Ad Valorem Tariffs, by Country)

Country	*Intermediate goods*	*Capital goods*	*Consumer goods*	*Manufacturing sector*
Argentina	21.2	25.0	21.9	22.9
Bangladesh	97.9	80.5	116.1	100.8
China	78.9	62.5	130.7	91.2
Hungary	14.2	15.0	22.6	20.9
India	146.4	107.3	140.9	137.7
Mexico	25.5	23.5	32.2	24.7
Morocco	21.6	18.1	43.0	27.3
Pakistan	75.0	73.8	127.3	89.8
Philippines	21.8	24.5	39.0	28.0
Thailand	27.8	24.8	8.5	33.6
Turkey	29.4	54.9	55.3	37.1
Yugoslavia	18.0	20.7	20.0	19.0

Note: The tariff rates are for 1985 or the most recent year. Includes CET and other import duties and flat duty (if any).
Source: World Bank SINTIA country tariff files.

export in order to expand and survive; hence government import policy was a nonbinding constraint on efficiency.

India's Position and Its Domestic Policy

As hinted above, there seem to be few "genuine" reasons for India's opposition to the introduction of services within the GATT framework. What, then, accounts for India's position?

Clues to the real rationales can be found by examining India's domestic economic policies. Further, clues to possible changes in India's position can be derived by examining the changes (such as they are) in Indian economic policy. And, extending this line of argument, clues to the G–10 position can be gleaned by examining the collective performance of the G–10 countries in the world economy.

The G–10 countries—those leading the fight against the introduction of services in GATT—are Argentina, Brazil, Cuba, Egypt, India, Nicaragua, Nigeria, Peru, Tanzania, and Yugoslavia. With few exceptions, the correlation between membership and lack of good domestic or foreign economic performance is striking. It is doubtful whether any objective analysis would conclude that this group, collectively or individually, represents a desirable path of development for any developing country. Interestingly, the group includes no Southeast Asian countries and no countries with an enviable record of development.

There is an additional political explanation for India's membership and leadership of this club. India has always prided itself on being a leader of the Third World. This is a hangover from the heady days of nonalignment and Nehru, Nasser, and Tito—and it is no coincidence that Egypt and Yugoslavia are also members of the G–10. The economic performance of India over the past forty years can, at best, be described as disappointing, and the search for leadership on the basis of traditional (and increasingly archaic) Third World views concerning capitalism and neocolonialism is considered a worthy substitute for the lack of domestic growth and glory.

There are other factors which explain India's stand and show that Indian policymakers and negotiators cannot be accused of inconsistency. They have to do with the domestic policy environment, which is characterized by a plethora of domestic controls, regulations, and restrictions. These restrictions have been documented extensively and eloquently in the literature (see, in particular, Bhagwati and Desai (1979) and Bhagwati and Srinivasan 1975). That things have not changed that much for the better is documented in Srinivasan (1989) and in table 19–4, which clearly shows that India has by far the highest rate of tariff protection in the world. Ahluwalia (1989) has demonstrated that this high level of protection has been associated with zero total factor productivity growth (for the years 1960 to 1983). But the policymakers have not yet budged from their stance that protection is needed for infant/geriatric industries.

If the policymakers deem protection desirable for goods, then it is a minor extension to demand it for services. The arguments are the same, the reasoning is the same, and the fallacies are the same. Hence there is no inconsistency in India's stand—its view is that freer trade in goods will not benefit India and neither will freer trade in services.

The next section briefly examines domestic policy in some important service sectors and the expected impact of trade liberalization on these sectors.

Foreign Investment

An important aspect of the political economy of India, and one that affects all sectors (goods and services), is the Indian attitude toward foreign investment. The lapse of time between application to invest and eventual approval is inordinately long, and foreigners find it costly—hence their eventual decision to invest elsewhere. As world trade and international investment have burgeoned in recent years, foreign investment has also exploded. While China was obtaining $2 billion to $3 billion in fresh foreign investment inflows every year during the past few years (before the tragic events of June 1989), India was limping along with, at most, a couple of hundred million dollars. Reform of policies toward foreign investment can affect export growth, as a comparison of India and China indicates. The two large economies had almost identical levels of manufactured exports in 1977—$3.73 billion for India and $3.68 billion for China. The average annual growth rate for the decade 1967–77 was also fairly similar—16.8 percent for India and 15.1 percent for China, in nominal dollar terms. But after the policy change in China in 1977, manufactured exports grew to $27.6 billion in 1987, whereas the figure for India was only $8.9 billion in 1987. That India's foreign investment policy has not changed is indicated by the fact that foreign investment in India is estimated to have *increased* to $250 million in 1988, whereas in smaller economies such as Malaysia and Thailand the figures are in the billions.

There is a simple reason why foreign investment in India is extremely low: the rules and regulations are too stringent. Equity of more than 40 percent is not allowed, and that is the "good news." India, because of its political stability and potential for economic growth, does offer an attractive investment proposition, as is indicated by the costs that corporations have incurred to obtain a foothold in the protected Indian market. The recent example of Pepsi-Cola is a graphic reminder of the tribulations and the gains involved in foreign investment. This firm had to lobby intensively for at least three years before it was allowed to enter India on condition that its export-to-import ratio would be five to one (exports included processed foods). The fight against Pepsi-Cola's entry was led by an Indian industrialist who is a leader in the domestic soft drink market.

The opposition to foreign investment—whether in goods or in services—is led by two groups. The first, and obvious, group consists of the industrialists and entrepreneurs who have thrived in the regulated market; it includes both the private sector and, in the case of services (banking, insurance, telecommunications, and so on) the public sector. In the name of self-reliance and profits, the doors to foreign investment and new technology are slammed shut. It is no wonder that this group opposes the introduction of trade in services; it resists other Indian entrants, so how do foreign investors stand a chance?

The second group is made up of Indian policymakers who believe it inappropriate to allow foreign investment to take "the cream of the cream." Their argument is that the domestic market is regulated and provides rents; why should foreign corporations obtain rents at the expense of Indian corporations? These policymakers feel that in a first-best world of competition, there would be no reason for opposing foreign investment.

This argument is an important one, both because it has a basis in economic theory (rather than narrow self-interest) and because it has many followers in India. That foreign investors would obtain the cream is not in doubt. But it is not clear why one should have to wait for the nirvana of the first-best world to obtain economic growth by way of foreign investment and technological upgrading. Clearly, supposing that foreign investment is allowed and that foreign investors compete with Indian investors and export more than they import (through remittances or inputs), why should one care whether a foreigner or an Indian industrialist makes the profit? This is especially so since in a fast-changing technological world it is at best presumptuous to believe that Indian firms can deliver new technology. And should not the Indian industrialists' profit be weighed against losses to the Indian consumer through bad-quality goods or bad service? But there is an important lesson in the answer to the last question: consumer choice has been systematically and deliberately neglected by Indian policymakers.

Telecommunications

It is amusing to note that in this important and advanced technological field the argument most often bandied about is that of self-reliance. The architect of this policy was until recently a leading executive in telecommunications in the United States. Although this attempt to bridge the technological gap by a country not known for its technological prowess would ordinarily be questionable, the special circumstances behind the "foreign stamp of approval" provided by the policymaker returned from abroad was considered sufficient reason to bet on success. Some money would have been lost, however, since the policy targets are three to four years behind schedule—and foreign investment may now be allowed in.

Apart from the pursuit of self-reliance, there is a genuine economic reason for India's not wanting any competition within the telecommunications industry: "the manufacture of public switching equipment is a government monopoly and equipment supply is regulated by the

Indian government" (Saxena 1989a). The private sector and foreign corporations (for example, NEC and Ericsson) are allowed in telecommunications manufacturing (facsimile devices, cordless telephones, pay telephones, and so on) on condition that the approved companies will transfer technology and increase exports.

Software

The growth of the world computer software industry in recent years has been explosive. Unfortunately, the Indian software industry, notwithstanding the often-repeated claim that India possesses one of the largest technological manpower bases, has not partaken in this growth. In 1987 Indian software exports were less than $75 million—in a worldwide industry estimated to be close to $80 billion. Could India have done better?

There are two reasons why India has not done well in this area in spite of a comparative advantage. The first pertains to the desire for self-reliance common to many Indian policymakers. A recent news magazine story reported how the claims of a major U.S. insurance company are sent daily for computerization and processing in Ireland. This exercise provides jobs, much-needed foreign exchange (in terms of salaries), and experience in software development. Contrast that with the situation in India, where such an arrangement could be treated as a foreign intrusion.

The second reason has to do with Indian policy towards computer hardware. Domestic industry has been encouraged (at the expense of quality and technology), with the result that, according to reports, there are more than a hundred firms assembling personal computers (PCs) in India, and their total production in 1987 was 40,000. (The World Bank considers that a single assembly plant should optimally handle about 55,000 computers.) A simple Indian-made PC (now obsolete in the United States) sells for $1,500, and a more advanced computer for about $3,500—prices that are about two to three times the world price. This fact is not unknown to some domestic policymakers; a recent study by the Bureau of Industrial Costs and Prices (BICP) found that the Indian computer assembly industry was characterized by negative value added. The conclusions of this study are a valid commentary on India's misguided industrial policy of high tariffs and domestic competition:[4]

> Delicensing and deregulation was meant to generate internal competition which would lead to decline in prices, and widening of the market. However, the absence of export-thrust, in conjunction with liberalisation of imports, have resulted in an internationally uncompetitive price structure. This led to the emergence of kit-assembly units and fragmentation. PMP (Phased Manufacturing Program) has been a failure and indigenisation has remained a dream." (BICP 1989, p. 2.)

No action, of course, is expected by anybody (including the BICP) on the recommendations contained in this important study.

Apart from the fact that a lot of domestic assemblers receive rent (and that many obsolete computers are sold to computer-illiterate officials),[5] the sad reality is that a potentially profitable service industry such as software is not allowed to develop. Development of nonobsolete software requires modern machines—and modern software. And it is highly unlikely that domestically assembled PCs or minicomputers will allow Indian software engineers to partake in the world market. Edward Yourdon, the publisher–editor of *American Programmer*, commented concerning India's claims to be counted among the leaders (potential or actual) in software development, "If an analogy is drawn between software development and the aircraft industry, then the software being programmed in India is at the Wright brothers' stage, while the world demands are for advanced Boeings" (*Economic Times*, August 30, 1989).

Again, the moral is the same. The domestic policy regime makes it impossible for Indian entrepreneurs to benefit from the changing and expanding world environment. The potential, however, is certainly there, in terms both of absolute numbers and relative wages. A well-trained software engineer can be hired in India for less than $500 a month. But the policymakers would rather protect a few computer manufacturers than allow the Indian software industry to develop.

The experience of a small Indian consultancy firm is telling. On the basis of an export order for consultancy services, the firm wanted to import a software product called SAS. Ostensibly, software has been placed on open general license (OGL), and any importer can import items on OGL without official permission as long as an import duty (60 percent in the case of software) is paid. The firm placed the order for the software, little realizing that a Kafkaesque end-game was in store. Just before the payment was due to be released, the firm was informed that the item was not on OGL after all and that it could be imported only with the permission of the Reserve Bank of India (RBI). Permission was duly sought from the RBI, and after much signing of documents, the import of SAS was about to be approved. But a snag was discovered: prior permission of the Department of Telecommunications was needed. Documents were dutifully forwarded and meetings were requested and held, only for the firm to be told that SAS was within the domain not of that department but of the Department of Electronics. Unfortunately, foreign firms are not accustomed to inordinate delays in payment for minor transactions of only $2,000, and the domestic firm was in danger of losing both the consultancy contract and the acquisition of SAS. The firm approached the Department of Electronics, where the officials, on learning that the software to be imported was a data management and statistical package, objected that packages that manage data and do regressions were domestically available. The case was referred back to the RBI. After three months of trying, permission to import was not granted. It is tempting to dismiss the above story as apocryphal, but it is unfortunately true. And it happened in a year when an export drive was on and income from exports was exempt from income taxation.

Banking and Insurance

The banking industry was nationalized in 1969. At present there are twenty nationalized banks, in addition to the State Bank of India and its eight associate banks. Foreign banks in India are not banned—Citibank, American Express, and others are allowed in India on a limited basis with the proviso that each new branch has to be approved. Foreign banks are allowed to have only one branch in large cities such as New Delhi. At the end of 1987 there were 21 foreign banks (none with equity of more than 40 percent), operating 136 branches. In contrast, nationalized Indian banks had more than 50,000 branches, with about 6,000 in the metropolitan cities. Although the domestic expansion of India's banks has been rapid (deposits have increased twentyfold since 1969), expansion abroad has been painfully slow—from 45 branches in 15 countries in 1969 to 147 branches in 25 countries in 1984 (Saxena 1989b).

The nationalized domestic banks have to lend to the "priority" sectors at subsidized rates. But they are not subsidized in turn and have to make up the losses by setting interest rates on consumer deposits below market rates. Why cannot the banks be subsidized for the subsidy they offer to "priority sectors" and the banking sector be opened up to competition? It is politically not possible. And why is it not politically possible? Which political interest group (besides the public sector banks themselves) would lose if competition were introduced? None; but the subsidies, it is stated, would increase the budget deficit. And would not the increase in banking efficiency increase economic growth through more productive investments (see McKinnon 1988) and therefore increase incomes and reduce the deficit?

Banking is a labor-intensive and now a computer-software-intensive industry. At present, the banks have little incentive to provide service, since the customer can only go to another nationalized bank. Overseas, there is a growing number of Indians who, if given adequate service, would readily open an account with an Indian bank, particularly because of the economies of scale in transactions (for example, remittances to India). Indians abroad, however, shun such banks simply because of the memory of bad service received at home.

How would liberalization in banking services affect India? Again, without domestic policy reform, participation in the world system will entail losses. Customers would seek out companies that provide service, and nationalized Indian firms may not have heard of this particular commodity. And if nationalized Indian firms open more branches abroad, will Indians and non-Indians flock to them? It is doubtful. The moral is the usual one: if a service industry has no incentive to provide service, it will not do so.

Insurance

Insurance is yet another industry nationalized in the national interest. A single firm, the General Insurance Corporation of India, has the entire market in its domain. Nationalization of insurance took place under the rubric of "garibi hatao," or removal of poverty, in 1971, two years after the "experiments with socialism" were begun by Prime Minister Indira Gandhi. Indian insurance companies operate through subsidiary companies in thirty-two countries; they sold insurance worth $50 million in 1986—only $1.5 million per branch per year. Since insurance is nationalized, the profitability of these foreign subsidiaries is unclear, but it is unlikely that many non-Indians (or Indians) are buying policies from these firms.

What will liberalization of trade in services do to the domestic insurance industry? It will hurt it—which is why trade in insurance activity will be futile until the domestic industry is deregulated. If that happens, it is likely that Indian firms, in this highly personalized activity, will do much better than foreign entrants—if they are allowed access to the latest technology. But that would mean a decrease in self-reliance.

Labor Migration

Labor movement is the only area in which liberalization without domestic policy reform will benefit the Indian economy. Indeed, it is the one "service" area in which liberalization should be a major demand of the Indian negotiators. Rather than arguing that services do not belong in the GATT, Indian negotiators should take the opposite line: services do belong in the GATT, and labor services are an essential component of trade in services. As was shown above, such trade (primarily with the Persian Gulf countries) has accounted for 15 to 20 percent of India's export earnings. Semiskilled labor is abundant and relatively cheap in India, and it is in India's comparative advantage to export such services. There is little in economic theory or practice to suggest that such services are outside the purview of negotiations.

There is a genuine meeting point between those countries (such as the United States) that argue against the introduction of labor services (the United States) and those that might argue for completely free entry. Countries such as the Federal Republic of Germany have shown that labor can migrate (for example, from Turkey) on a job basis without immigrating.

Conclusions

This chapter has attempted to convince the reader of a simple and often-repeated point: that much of Indian economic policy has been a wrong for the past forty years and that it is futile to attempt to make economic calculations about the potential gains and losses from the introduction of a trade in services agreement under the GATT or any other organization. Nor is it worthwhile to examine India's international position on such matters (for purposes of negotiation), since the positions are those of a bit player in international trade in goods and services and do not themselves have much economic content.

The straightforward fact is that the economic calculus has not been a factor behind economic decisions in India (although a marginal improvement has been observed in recent years). The policymakers have been involved in a loop of their own making, and, as with all loops, only a tangential attempt will allow escape. It should also not be forgotten that the policymakers (bureaucrats, intellectuals, industrialists, and politicians) have benefited enormously, in both monetary and nonmonetary terms, from the existing apparatus of discretionary decisionmaking.

Only a major economic reform will allow India to change its stance on international issues. There is a creeping realization that India has lost out in the development race and that a principal reason has been its autarkic policies. Once economic reform allows genuine competition, gains from external and internal trade in goods and services will automatically follow.

Notes

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1. Figures for other developing countries are available in Hoekman, this volume.
2. Prem Kumar (India's Commerce Secretary) in *New York Times*, October 2, 1985; quoted in Prasad (1989).
3. Heller and Tait (1984) report that among about sixty countries considered, India had the largest share of government employees in nonagricultural employment—54.35 percent. The next highest were Benin (49.8 percent) and Botswana (33.8 percent).
4. The logic is eminently simplistic: since the belief is that competition will lower prices, why not self-reliant competition in the form of high tariffs and lots of inefficient domestic firms?
5. The BICP study reports that almost 60 percent of total purchases of PCs is by the public sector. Further, "most PCs are used merely as word processors, which is a very high-cost substitution for traditional typewriters in a resource-scarce country" (BICP 1989, p. 2).

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20

Brazil

Carlos Alberto Primo Braga

Brazil has traditionally played an active role in multilateral organizations, and the negotiations under the General Agreement on Tariffs and Trade (GATT) are no exception (see Martone and Primo Braga 1988). The discussions on extending GATT disciplines to international trade in services provide a contemporary example of Brazil's engagement in the multilateral arena.

This diplomatic activism has not precluded free-rider behavior in the previous GATT rounds. (Brazil entered the Uruguay Round with only 600 tariff positions—approximately 5 percent of the total—bound under the GATT.) Since the end of the Tokyo Round, however, industrial countries have been stepping up their demands for reciprocity in trade negotiations, particularly with respect to newly industrialized countries, and Brazil has been one of the principal targets of this campaign. The growing demand for reciprocity and the U.S. push to include the "new themes" in the GATT agenda posed problems for Brazilian negotiators. In the Uruguay Round Brazil is for the first time being asked effectively to match trade concessions offered by other contracting parties. In addition, several issues on the table are perceived by Brazil as "zero-sum games" in which benefits for industrial countries would imply losses for Brazil. The negotiations on services constitute one of the most important cases in this regard. (Other topics in the negotiating agenda that are considered to be against Brazilian interests are trade-related aspects of intellectual property rights—TRIPS—and trade-related investment measures—TRIMS. See Martone and Primo Braga 1988, table 10; Primo Braga 1989a.)

Brazil's resistance to negotiations on trade in services has been both ideological and pragmatic. At the ideological level, Brazil refuses to accept as a development policy the rule of static comparative advantage under free trade. At the pragmatic level, Brazil is concerned about foreign direct investment in this area under the misapprehension that free trade in services is synonymous with laissez-faire. It is argued here that the Brazilian economy would be best served by the use of regulatory instruments other than restrictions on foreign capital investment in services.

Brazil and the Multilateral Negotiations on Services

As table 20–1 shows, service activities, as defined for national income accounts purposes, have maintained a relatively stable share of the gross domestic product (GDP) over the past five decades. The share of employment in services in the total labor force has increased from 24 percent in 1950 to 31 percent in 1965 and to 42 percent in 1980 (ILO 1986; World Bank 1988). All of these figures tend to underestimate the real economic size of the service sector because they do not adequately cover the informal sector, which is highly intensive in service activities. (See Bhagwati 1987c, pp. 20–21, on problems with developing country data on services.) The relative stability of the share of services in GDP masks significant structural changes in the sector. During the 1980s, for instance, communications and financial activities grew at a much faster pace than other service industries such as commerce and transport.[1] Although it would be inappropriate to assume that Brazil is about to enter a tertiary stage of economic development, knowledge-based service industries have been among the most dynamic sectors in the Brazilian economy in the 1980s.[2] Furthermore, the sheer size of the service sector suggests the importance of trade negotiations in this area for Brazil.

The pressure to broaden the scope of the multilateral negotiations to include trade in services may be traced back to the 1970s (see Feketekuty 1988). It was only in November 1982, however, that the United States formally presented at the GATT ministerial session in Geneva a proposal for a new round of multilateral trade negotiations that would emphasize the "new themes"—services, TRIPS, TRIMS, and high-technology products.

Table 20–1. *Sectoral Shares of Gross Domestic Product, Brazil, at Factor Cost and Current Prices*
(percent)

Year	*Agriculture*	*Industry*	*Services*
1939	16.9	25.5	57.6
1950	17.8	30.1	52.5
1960	15.0	32.5	52.4
1970	10.1	35.9	54.0
1980	13.0	34.0	53.0

Source: Conjuntura Econômica (various issues).

The proposal encountered strong resistance from developing countries. Although this opposition and the European Community's lack of enthusiasm about the idea of a new round in the middle of an economic recession derailed the U.S. campaign, the Ministerial declaration did include a recommendation that interested contracting parties prepare national studies on services and that the GATT be used as an informal forum for exchanging the study results.

Throughout this process, Brazil opposed the U.S. initiatives for both practical and ideological reasons. Practically, the natural negotiating strategy for Brazil, given its structure of comparative advantages, was to emphasize the backlog of problems in the multilateral trade system. (This theme also allowed Brazil to capture the high moral ground by stressing the numerous industrial country trade policies that were maintained in open defiance of GATT disciplines.) There was also a perception that the U.S. campaign tended to stress liberalization in service industries in which Brazil was not competitive, and this perception was transformed, by way of a mercantilistic calculus, into the concept of a zero-sum game. The ideological motivation reflected the belief that the U.S. proposals were nothing more than a sophisticated new form of colonialism aimed at reserving knowledge-intensive industries for the developed countries.[3]

The "blockade" strategy, which centered on the issue of GATT's competence to address trade in services, succeeded in delaying the negotiating process. But as time went by, its effectiveness decreased; the reaction of the industrial countries led to a gradual isolation of the "hard-liners" led by Brazil and India. In 1985 Brazil took the initiative in offering a compromise, formally presenting the "dual track" approach as a way of addressing the "old" problems of the multilateral trade system in parallel with negotiations on services (see Maciel 1986; Bhagwati 1987a, 1987b). Under this proposal, however, the negotiations would not necessarily be under GATT auspices or use GATT procedures, and linkages between negotiations on goods and on services were considered unacceptable.

After tense negotiations that at times led analysts to fear for the future of the GATT, the eighth round of the multilateral trade negotiations was finally launched in September 1986. A dual-track approach was adopted as a compromise between the conflicting views on services. There were, however, some important differences with respect to Brazil's original proposal. The negotiations were to be conducted under GATT auspices, procedures, and practices. And even though the Uruguay Round was launched "as a 'single political undertaking' comprising two legally independent negotiating processes, one on goods within GATT and the other outside GATT on services" (Nogueira Batista 1987, p. 21), the ministers of the contracting parties authorized the Group on Negotiations on Services (GNS) to report to GATT's Trade Negotiations Committee. The central issue of whether these negotiations would lead to an extended GATT (the U.S. position) or to a "services compact" outside the GATT (the Brazilian position) was not explicitly addressed by the Punta del Este declaration.

In the initial stages of the negotiations Brazil adopted a "muddling-through" strategy designed to buy time. It argued that not enough was known about service industries in developing countries. and that the negotiating experience already accumulated by the countries of the Organisation for Economic Co-operation and Development (OECD) in this area put developing countries at a disadvantage. Brazil accordingly suggested that initial efforts should be directed toward data collection, and it refused to accept proposals for "fast-track" negotiations on services. The United States in its turn pushed the negotiations in the direction of the application of GATT principles to services and pressed for a fast pace (see Yeutter 1986, 1988).

In a parallel movement, Brazil raised doubts about the wisdom of pursuing negotiations without a better understanding of basic concepts—for example, of what exactly constitutes trade in services. The target here was the U.S. emphasis on "rights of establishment" as a necessary component of a move to liberalize trade in services. Brazil refused to accept the idea that services transactions of subsidiaries of transnational corporations in a country's domestic market should be treated as international trade (see Brazil 1988a). Brazil also pointed out that trade liberalization was not an end in itself but a possible means of promoting economic development. It argued that the whole negotiating process should be informed by this ultimate goal and that developing countries should be granted special and differential treatment.

The intellectual underpinnings of Brazil's conceptual queries can be summarized as follows.

- *Legal.* Brazil argued that since GATT does not cover foreign direct investment or guarantee that a contracting party should have access to the resources of another contracting party, there was no GATT legal precedent for the U.S. position that restrictions on foreign direct investment should be considered barriers to trade.[4]
- *Economic.* Brazil challenged the validity of the comparative advantage concept as a basis for understanding trade in services (see Dias 1988; Brazil 1988a). The pervasive existence of noncompetitive market structures in services, the importance of intrafirm trade, the use of restrictive business practices by transnational corporations, the perception of significant positive externalities, and, in many cases, the requirement of factor mobility were cited as indications that the positive and normative prescriptions of conventional trade theory could not be applied to trade in services. Government intervention in trade in services was accordingly presented as economically justifiable.
- *Political.* Such noneconomic considerations as the importance of national control of services for national security and cultural integrity were cited as further arguments against restricting the sovereign right of a nation to regulate domestic economic activities at will.

Despite Brazil's resistance to discussions on the applicability of GATT disciplines to trade in services, the debate in the GNS rapidly evolved in that direction, under the influence of several proposals from developed countries. At the same time, the coalition of developing countries regarding negotiations in services was weakened; some of these countries adjusted their negotiating agendas to reflect other priorities (Argentina and agriculture, for example) or developed a more explicit negotiating position on services (India and the issue of labor-intensive services; see Balasubramanyan 1987). On the eve of the Montreal ministerial meeting in December 1988, Brazil had already adapted to these developments. It continued to refuse to discuss issues related to foreign direct investment, but it brought up a series of considerations on the applicability of GATT concepts—transparency, for example—to services, and it acknowledged that multilateral disciplines should contribute to the gradual elimination of restrictions on international trade in services (see Brazil 1988b).

The future of Brazil's participation at the GNS seems to be inevitably entangled with the evolution of the debate on foreign direct investment in services. Brazil's policies toward the service sector should not, however, be discussed only from the perspective of the trade negotiations. The relevant issue for Brazil is to identify the set of domestic policies for the service sector that will maximize the country's economic welfare. To address this question, the next two sections survey the competitiveness of Brazilian service industries and the principal regulations that apply to the sector.

The Competitiveness of the Brazilian Service Sector

Table 20–2 summarizes the services account in Brazil's balance of payments. As is well known, this type of data tends to underestimate the importance of international trade in services.[5] Nevertheless, the table suggests that the Brazilian economy has been experiencing a recurring deficit in its service transactions with the rest of the world. As one would expect of a country that has historically relied on foreign savings for its development, the items related to past capital flows (interest, profits, and dividends) are the main sources of this chronic deficit. It is true that these items—particularly interest income that banks earn on foreign loans—are not included in the most frequently used definitions of trade in services. (The debate on definitions is summarized in Feketekuty 1988, ch. 5; see also Sapir 1982 and Sampson and Snape 1985.) The performance of the remaining service-related components of the balance of payments, however, confirms the picture of Brazil as a net importer of services.

From 1982 on, the deficits in nonfactor services as well as in transactions associated with technological transfers tended to decrease. This development, however, was related more to macroeconomic factors than to improvements in the competitiveness of the country's service industries or technological capacity. In response to the foreign debt crisis Brazil initially adopted a mix of trade and macroeconomic policies designed to enhance its balance of trade surplus.[6] As a consequence, the deficit in transport (the main item among nonfactor services) fell significantly as imports declined and the demand for registration and operation of foreign ships under the Brazilian flag diminished. (As noted in GATT 1989, p. 33, "Brazil records shipment only when foreign carriers are involved, and not when its substantial merchandise exports are transported on Brazilian carriers.") In a parallel development, the principal import among technology-related services, specialized technical services, fell dramatically as Brazil's economic crisis led to a curtailment

Table 20–2. *Services Account, Brazil, Selected Years*
(millions of dollars)

Item	*1950*	*1960*	*1970*	*1975*	*1980*	*1982*	*1984*	*1986*	*1988*[a]
Total	-283	-459	-815	-3,238	-9,740	-15,526	-12,743	-13,246	-14,370
Receipts	43	193	378	1,328	3,144	3,294	3,203	2,783	3,046
Payments	-326	-652	-1,193	-4,566	-12,884	-18,820	-15,946	-16,029	-17,416
Capital income[b]	-74	-155	-353	-1,674	-6,621	-11,940	-10,999	-10,678	-11,371
Interest	-27	-115	-234	-1,440	-6,311	-11,354	-10,203	-9,327	-9,832
Receipts	2	3	50	364	1,146	1,197	1,246	918	759
Payments	-29	-118	-284	1,804	-7,457	-12,551	-11,449	-10,245	-10,591
Profits and dividends	-47	-40	-119	-235	-310	-586	-796	-1,351	-1,539
Receipts	—	1	—	2	234	277	3	41	2
Payments	-47	-41	-119	-237	-544	-863	-799	-1,392	-1,541
Other services	-209	-304	-462	-1,564	-3,119	-3,588	-1,744	-2,568	-2,999
International travel	-3	-48	-130	-313	-241	-846	-153	-509	-589
Receipts	5	24	30	71	126	65	65	85	117
Payments	-8	-72	-160	-384	-367	-911	-218	-594	-706
Transport	-121	-78	-185	-917	-1,936	-1,456	-760	-826	-1,015
Receipts	16	46	159	356	814	998	1,295	1,147	1,314
Payments	-137	-124	-344	-1,273	-2,750	-2,454	-2,055	-1,973	-2,329
Insurance	-9	-7	-13	2	86	-18	-114	-117	132
Receipts	1	4	10	54	138	84	37	60	337
Payments	-10	-11	-23	-52	-52	-102	-151	-177	-205
Government	-38	-12	-69	-237	-112	-122	-120	-193	-558
Receipts	9	31	36	82	59	62	74	52	65
Payments	-47	-43	-105	-319	-171	-184	-194	-245	-623
Sundry	-38	-159	-65	-99	-916	-1,146	-597	-923	-969
Receipts	10	84	93	398	628	610	484	480	452
Payments	-48	-243	-158	-497	-1,544	-1,756	-1,081	-1,403	-1,421

a. Preliminary.
b. Does not include reinvested profits.
Source: Central Bank of Brazil.

of investment.[7] As table 20–3 illustrates, trade in services (including nonfactor services and technology-related service activities) did not expand during the 1980s either as a proportion of trade in goods or in relation to GDP.

The picture that emerges from this data reinforces the perception of Brazil as an inward-oriented economy. At the world level, Brazil's participation in trade in nonfactor services remains marginal. In 1984, for instance, Brazil was ranked thirty-fourth among exporters of nonfactor services, with a share of 0.50 percent of world exports, and twenty-sixth among importers of these services, with a share of 0.85 percent of world imports (OTA 1987, p. 69). Of course, sectoral analyses qualify these observations. International trade has always been important for service industries such as shipping, tourism, and motion pictures. For others, such as engineering and construction services, the degree of international involvement has increased significantly since the mid-1970s. Furthermore, several Brazilian companies are important actors on the international scene. In 1986 Varig was the only developing country carrier to rank among the top fifteen international air freight carriers, as classified by metric ton-kilometers logged.[8] And a few Brazilian construction firms—for example, Mendes Jr. and Norberto Odebrecht—won a place among the leading international contractors in the early 1980s (see Verillo 1988, pp. 181–86; OTA 1987, table 14).

Even with these qualifications, the analysis of the degree of internationalization of the Brazilian service industry presented so far is incomplete. An important channel for the internationalization of service activities at the global level has been foreign direct investment. Many analysts have called attention to the fact that foreign direct investment in services has been growing at a faster pace than trade in services (as defined for balance of payments purposes).[9]

Transnational corporations are the main actors in this process whereby service-related investments have been responsible for a growing share of the total flow of investments originating in developed countries. Brazil has maintained that the right of establishment should not be addressed in the Uruguay Round (see Brazil 1988b, p. 2). There are two basic problems with this approach.

Table 20–3. ***Trade in Services as a Share of Trade in Goods and of GDP, Brazil, 1980–88***
(percent)

Trade in services as share of	*1980*	*1982*	*1984*	*1986*	*1988*
Trade in goods	15.4	18.3	13.8	17.1	15.6
GDP	2.8	2.5	2.6	2.3	2.2

Note: Trade in services is defined as exports plus imports of nonfactor services and transactions associated with technological transfers.
Source: Compiled by the author on the basis of Central Bank of Brazil data.

First, in the case of services the distinction between barriers to trade and barriers to investment is even more imprecise than in the case of goods. Physical proximity between consumers and providers—or, in more general terms, factor relocation—is often a necessary condition for the efficient provision of many services. As a consequence, the broader the scope of the negotiations, the larger the potential benefits of trade liberalization will be. Second, Brazil's approach does not address the question of the proper policy toward foreign direct investment in service activities. The possibility that unilateral liberalization may be attractive on its own economic merits is often missed when the debate is dominated by a mercantilistic calculus, as tends to occur in trade negotiations. (This point is also made by Hindley 1988.)

Regulations That Affect Foreign Direct Investment and Trade in Services

The history of foreign capital involvement in Brazil's services sector dates back to the nineteenth century.[10] In the first decades after independence in 1822, foreign interests were concentrated in shipping and import-export activities, including trade financing. In the second half of the nineteenth century, foreign direct investment played a significant role in building up the country's infrastructure. By 1929, on the eve of the modern industrialization era in Brazil, the sectoral distribution of foreign direct investment showed a heavy concentration in service-related activities, particularly railroads and urban public utilities.[11] Since then, foreign capital has gradually shifted away from the service sector and toward manufacturing. This evolution was basically the resultant of two forces: the impact of government regulations and the proindustrial bias created by Brazil's development and trade policies.

The overall environment for foreign direct investment in Brazil remained favorable until the 1980s. The constitutions of 1946 and 1967 and the constitutional amendment of 1969, as well as ordinary laws and regulations, were relatively liberal in their treatment of foreign capital. (For a summary of the modern evolution of Brazil's legislation toward foreign capital see Almeida 1989.) Service industries, however, were increasingly affected by government regulations. This development was not surprising, in that services are regulation-prone both for economic reasons (the existence of natural monopolies, imperfect information markets, and perceived externalities) and for noneconomic reasons such as concern about national sovereignty (see Hindley and Smith 1984). In the case of Brazil, the impact of growing regulation was magnified by macroeconomic instability; control of the rates charged by public utilities, for instance, fostered the gradual nationalization of these companies, given the prevailing inflationary environment.

The adoption of an explicit import-substituting industrialization strategy in the second half of the 1950s increased the attractiveness of the Brazilian market for foreign manufacturing companies. Foreign direct investment became a natural "tariff-hopping" tactic, and transnational corporations were major beneficiaries of the rents generated by the Brazilian trade regime. This also contributed to diminishing the relative weight of service-related foreign direct investment with respect to foreign direct investment in the manufacturing sector.

By the late 1970s foreign direct investment in services (including reinvestment) accounted for only 19 percent of the total stock of foreign capital in the Brazilian economy (see table 20–4). And this figure, which has remained relatively stable, overstates the weight of service-related investments to the extent that it includes foreign direct investment in holding companies that control activities in manufacturing, mining, and agriculture.[12] Of course, this aggregate stability masks changes in the composition of foreign direct investment in services over time. The participation of foreign capital in financial services, for instance, has increased faster than in most other service industries. The aggregate data, however, suggest that internationalization of the services industries through foreign direct investment is not occurring in Brazil with the same vigor as in industrial countries. Foreign direct investment in services accounted for approximately 40 percent of the world stock of foreign direct investment by the mid-1980s, and about 50 percent of new worldwide foreign direct investment flows are now service related (GATT 1989, p. 42). This difference between these figures and those for Brazil may be explained in part by the asymmetry in macroeconomic performance between Brazil and the industrial nations during the 1980s (see Primo Braga 1989c). But the

Table 20–4. *Foreign Direct Investment (FDI) in Services, Brazil, 1971–88*
(millions of dollars; figures in parentheses are percentage shares)

Sector	*1971*	*1975*	*1978*	*1980*	*1982*	*1984*	*1986*	*1988*
Public utility services	157	219	238	43	45	44	55	58
	(36.3)	(15.5)	(9.3)	(1.2)	(1.0)	(1.0)	(1.0)	(0.9)
Production and distribution of electricity	142	205	210	0	0	0	0	0
	(32.8)	(14.5)	(8.2)	(0)	(0)	(0)	(0)	(0)
Production and distribution of gas	6	..	7	6	..	..	..	..
	(1.4)	(..)	(0.3)	(0.2)	(..)	(..)	(..)	(..)
Maritime and river transport	9	11	7	9	17	18	17	20
	(2.1)	(0.8)	(0.3)	(0.3)	(0.4)	(0.4)	(0.3)	(0.3)
Highway transport	..	3	12	25	25	23	33	33
	(..)	(0.2)	(0.5)	(0.7)	(0.6)	(0.5)	(0.6)	(0.5)
Air transport	..	..	1	1	1	2	3	3
	(..)	(..)	(..)	(..)	(..)	(..)	(0.1)	(..)
Sewerage	0	..	1	2	1	1	1	2
	(0)	(..)	(..)	(..)	(..)	(..)	(..)	(..)
Water supply	0	0	..	..	..	..	1	1
	(0)	(0)	(..)	(..)	(..)	(..)	(..)	(..)
Financial services	81	369	496	572	771	849	1,129	1,496
	(18.7)	(26.2)	(19.5)	(16.5)	(17.3)	(19.4)	(21.2)	(23.6)
Commercial banks	67	180	260	328	467	552	772	943
	(15.5)	(12.8)	(10.2)	(9.5)	(10.5)	(12.6)	(14.5)	(14.9)
Investment banks	14	169	207	217	222	219	258	295
	(3.2)	(12.0)	(8.1)	(6.3)	(5.0)	(5.0)	(4.8)	(4.6)
Other financial institutions	0	20	29	27	82	78	99	258
	(0)	(1.4)	(1.1)	(0.8)	(1.8)	(1.8)	(1.9)	(4.1)
Other services	195	822	1,812	2,853	3,637	3,494	4,148	4,796
	(45.0)	(58.3)	(71.2)	(82.3)	(81.7)	(79.6)	(77.8)	(75.5)
Real estate	3	35	62	107	120	121	140	166
	(0.7)	(2.5)	(2.4)	(3.1)	(2.7)	(2.8)	(2.6)	(2.6)
Insurance	8	19	51	87	81	84	94	100
	(1.8)	(1.3)	(2.0)	(2.5)	(1.8)	(1.9)	(1.8)	(1.6)
Tourism	4	12	19	20	21	27	28	29
	(0.9)	(0.9)	(0.7)	(0.6)	(0.5)	(0.6)	(0.5)	(0.5)
Consulting, property management, advertising, and so on	77	464	1,152	1,798	2,337	2,067	2,649	3,080
	(17.8)	(32.9)	(45.2)	(51.8)	(52.5)	(47.1)	(49.7)	(48.5)
Technical services and auditing	19	89	147	201	265	324	190	233
	(4.4)	(6.3)	(5.8)	(5.8)	(6.0)	(7.4)	(3.6)	(3.7)
Trade, including export and import	82	203	381	640	813	871	1,047	1,188
	(18.9)	(14.4)	(15.0)	(18.5)	(18.3)	(19.9)	(19.6)	(18.7)
Publicity	2	0	0	0	0	0	0	0
	(0.5)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
Total FDI in services	433	1,410	2,546	3,468	4,453	4.387	5,332	6,350
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)
FDI in services/total FDI (percent)	14.9	19.3	18.5	19.8	21	19.2	19.1	20.7

... Less than $0.5 million or 0.2 percent.
Note: All data refer to the FDI position (investments plus reinvestments) at the end of the year, except for 1988 data, which refer to the end of June.
Source: Compiled by the author on the basis of Central Bank of Brazil data and Gonçalves (1988, p. 103).

dynamism of knowledge-based service industries in Brazil throughout the decade indicates that something else is at work.

The explanation seems to be related to the evolution of government policies toward service activities. In addition to the growing array of regulations for service industries, Brazil has implemented an explicit import substitution policy for the sector. The role of transnational corporations, diminished significantly in comparison with the experience with import substitution in manufacturing. In part, this difference simply reflected preexisting restrictions on foreign control in some sectors—for example, certain transport activities and the news media—or the nationalization of the sector, as in telecommunications.[13] In other cases new regulations were introduced with the explicit goal of promoting domestic entrepreneurship in knowledge-intensive sectors such as telematics (computer software, data processing, information services, and the like).

The new regulations were not created in a vacuum; they were closely associated with the adoption of interventionist policies designed to foster high-technology sectors in the Brazilian economy. The best-known example in this area is the market reserve policy for locally owned minicomputer and microcomputer companies.[14] This policy began to evolve about 1976 and was made law with overwhelming congressional support in 1984. A company that wishes to operate in the mini and micro segments of the computer market must have at least 70 percent of its stock under Brazilian ownership, and if there is a minority foreign partner, Brazilian control of the technology is required. A parallel development occurred in telecommunications equipment (see Banco Nacional de Desenvolvimento Economico e Social 1988; Inter-American Development Bank 1988; Mody 1989). TELEBRAS, the state-owned holding company for the telecommunications sector, has used its monopsonist power to force transnational corporations to transfer majority voting rights to Brazilian partners as a condition for continuing to qualify as suppliers for TELEBRAS' affiliates. The company has also used procurement policies to foster local research and development. Despite these discriminatory policies, transnational corporations are allowed to maintain majority equity positions in their joint ventures, and there have been no attempts to impose technological control as in the case of the market reserve for computers.

As one would expect, these policies are tantamount to a tax on the provision of knowledge-intensive services. Prices for microcomputers and minicomputers—and, to an even greater extent, for peripheral equipment—are well above international levels. Telecommunications equipment also sells at a premium in the protected Brazilian market. (see Inter-American Development Bank 1988, pp. 159–66).

Strategic trade policy—basically, the concept of market reserve—was enshrined in the Brazilian constitution of 1988. The overall tone of the new constitution regarding foreign capital is not as liberal as that of its predecessors. The possibility of explicit discrimination is hinted at by the introduction of the concept of the "Brazilian company of national capital" (see Brazil 1988c, art. 171). It is true that the constitution's ultimate impact on foreign capital will depend on the complementary legislation, but its general thrust does not seem to favor trade liberalization or foreign direct investment.

To sum up, Brazilian service industries operate in a highly regulated environment.[15] The regulations have a significant antitrade bias, as the information summarized in table 20–5 suggests. Some of these regulations are similar to nontariff barriers and basically restrict trade in nonfactor services. Others control the movement of service suppliers, mainly through restrictions on foreign direct investment. And some regulations cartelize certain service activities by restricting the access of new entrants, whether foreign or national.

Some analysts tend to dismiss the utility of regulation inventories by arguing that national "regulation of the services sector is constituted by state intervention in the pursuit of national policy objectives which remain within the sovereign right of governments" (Nayyar 1987, p. 12). This is a truism that does not address the basic economic question posed by these regulations: their net economic cost. Accurate estimates of these costs would require detailed sectoral analyses—a task that is beyond the scope of this article. There are, however, many indications that these costs are substantial.

Brazil's financial sector, for instance, has one of the lowest efficiency indexes in Latin America.[16] Knowledge-intensive service activities are burdened by high-cost inputs developed under market reserve conditions. The Reinsurance Institute of Brazil (Instituto de Resseguros do Brasil), a government organization that has the monopoly on reinsurance operations in the country, accumulated huge losses when it was exposed to export rivalry in an ill-fated attempt to export services during 1975–82 (see Soares 1986, pp. 47–48). Many analysts regard the Brazilian fleet for general freight as technologically outdated (see Sanson and Garlow 1986; Motta Veiga and others 1988). Against this background, the next section analyzes the costs and benefits for Brazil of liberalization of trade in services.

Liberalization of Trade in Services: Benefits and Caveats

The economic benefits of liberalization for Brazil would tend to take the form of a more efficient service sector; Brazilian firms and consumers would have available services with a better combination of price and quality. Given the large size of the Brazilian service sector, a liberalization movement could be expected to yield significant welfare gains—the more so because most of these services are intermediate inputs for other productive activities.

There are, however, important qualifications to these conclusions, derived from the normative prescriptions of the theory of comparative advantage. First, trade liberal-

Table 20–5. *Impediments to Trade in Services in Brazil*

Sector	*Type of barrier*	*Description*
Air transport	Entry restrictions	Foreign companies can serve the Brazilian market only if authorized by bilateral agreements
		Regional transport is reserved for national regional airlines
	Domestic requirement	Computerized reservation systems can be provided only by local companies
	Government procurement policies	Government favors national companies in its acquisitions of air services
Banking	Prohibition of certain kinds of deposits and services	Foreign investment in the savings and loan sector is not permitted
	Limitation on expansion of branch networks	In practical terms, Brazilian authorities have not allowed foreign direct investment in commercial banking, even through the expansion of existing subsidiaries and branches of foreign banks
	Restrictions on access to government deposits	Banco do Brasil and state-owned banks are the bankers for the public sector
	Constraints on investment portfolios	Foreign banks are allowed to have a maximum voting control of 33 1/2 percent and up to 50 percent ownership of the capital investment banks
Business services		
Advertising		
	Government procurement policies	National companies are favored in contracts controlled by the public sector
	Quotas	No more than one-third of advertising may be of foreign origin
Accounting, law, management consulting	Personnel qualifications	Professional requirements are tantamount to barriers to practice by holder of foreign degrees
Construction and engineering	Domestic requirement	Two-thirds of employees must be Brazilian national- Tax discrimination
	Tax discrimination	Tax rate is higher for foreign than for local engineers
	Personnel qualifications	Foreign engineers (graduated after 1961) are required to take a qualifying exam to practice
	Bureaucratic barriers	Technical service contracts provided by foreign companies must be approved by the Instituto Nacional de Propriedade Industrial
Films, television, radio, and video products	Entry restrictions	Television and radio stations may be controlled only by Brazilian nationals
	Quotas	Cinemas are required to program Brazilian films at least 140 days a year
		At least 25 percent of the titles offered by video outlets must be Brazilian films
	Domestic requirement	Local work and local contract requirements apply to film production
		Short Brazilian films must be screened
Insurance	Entry restrictions	Since 1966 no new authorization to transact insurance has been granted

Sector	*Type of barriers*	*Description*
	Constraints on investment portfolios	Foreign capital may control no more than 50 percent equity and 30 percent of voting stock
	Restrictions on foreign supply	Import insurance has to be placed with national companies
	Government procurement policies	State companies are required to use 100 percent nationally controlled firms
Shipping	Domestic requirement	The owners, the commanders, and at least two-thirds of the crew members of national ships must be of Brazilian citizenship
	Cabotage restrictions	Inland and coastal waterways are reserved exclusively for national shipping, except if public necessity dictates otherwise
	Cargo preference	40 percent of general cargo in international trade is to be carried by Brazilian-flag ships
Telecommunications and telematics	Entry restrictions	Telecommunications activities are a state monopoly
		Market reserve or "law of similars" apply to the provision of certain information services (for example, provision of software)
	Control of transborder data flows	Commercial data processing abroad not allowed except under exceptional circumstances
	Government procurement policies	Government may favor the acquisition of software produced by national companies
	Discriminatory fiscal benefits	Special income tax deduction for users of national software
Tourism	Discriminatory treatment	Fiscal and credit incentives only available to companies under national control

Note: There are many other trade barriers that are not service-specific but that affect trade in services. Among them is Brazil's complex system of foreign exchange controls.

Sources: Based on information available in Brazil (1988c); Coopers & Lybrand (1986); Gonçalves (1988); Kasper (1988); Lee and Walters (1988); Motta Veiga and other (1988); USTR (1989); Walter (1988); White (1988); and Wildman and Siwek (1988).

ization in itself is not a sufficient condition for a more efficient supply of services in the domestic market. For example, if the opening of the service sector to foreign direct investment is not accompanied by the correction of faulty government regulations, the end result will be a mere redistribution of the rents generated by the regulations. (See the analysis of the opening of the Korean insurance market in Cho 1988.) Such an outcome may even generate negative welfare effects from a national point of view. Second, there are legitimate doubts about the adequacy of conventional normative prescriptions for liberalization of trade in services—for example, in the case of a country that faces a monopolistic foreign supplier. Accordingly, general statements such as those presented above are often disputed.

Some of these doubts usually evolve into noneconomic arguments for protection. For example, comparative advantage may be cited as a rationale for trade that requires factor relocation. But concerns about transnational corporations' command of market power and about the potential for interference by these firms in domestic politics may be strong enough to foster protectionist measures despite considerations of efficiency. The most interesting qualifications, however, appear in the context of noncompetitive market structures or service activities that promote positive externalities.

The provision of many services requires significant investments in infrastructure and expensive maintenance of distribution networks—transport and telecommunications are examples. These high fixed costs open the possibility of increasing returns to scale and thus of imperfect competition. Imperfect competition does not alter the conventional wisdom about the superiority of free trade over autarky, but it does raise the prospect that government intervention will improve welfare more than will the market outcome (see Krugman 1987). Knowledge-intensive sectors, in turn, not only are characterized by economies of scale (because of the fixed-cost aspect of research and development) but also offer many learning possibilities that can lead to intertemporal positive externalities.

The "new interventionism," which is quite popular in Brazil, provides a fresh rationale for continuing a development strategy based on import substitution and the pursuit of dynamic comparative advantage. The implications of this rationale, of course, are not confined to service activities. But the characteristics of many service industries make them natural candidates for strategic trade policies.

The use of protectionism to capture high-rent sectors or to foster industries with potential positive externalities is, however, a tricky business. Most often, the political economy of the process transforms these interventions into implicit transfers to powerful interest groups at the expense of society as a whole (see Dixit 1987; Krugman 1987); the Brazilian informatics policy provides a good example. Furthermore, protectionist measures are clearly second-best policies for protecting industry. As Hindley (1988) has pointed out, the economic ranking of import-substitution instruments provided by conventional trade theory does apply to trade in services. In other words, Brazil would be better off if it subsidized "strategic" sectors instead of trying to promote them through barriers to trade and foreign direct investment.

Hence, both on efficiency grounds and from a political economy perspective, there are reasons for Brazil to pursue liberalization of trade in services and indeed to liberalize unilaterally while at the same time carrying out broad economic reforms designed to promote across-the-board economic efficiency. (For a summary of the main policy reforms required in this context see Martone and Primo Braga 1987.) Needless to say, the pace and the order of this liberalization movement pose daunting problems for Brazilian policymakers. Some of the usual concerns with respect to the economic implications of services liberalization, however, are misplaced. For example, the impact on the balance of payments is often presented as an impediment to trade liberalization (see Kume and Carvalho 1987, p. 24; OTA 1987, p. 70). This concern reflects partial-equilibrium analyses focused on the results of a relaxation of trade restrictions; in reality, the net effect on the balance of payments is uncertain. Other factors to be taken into account are the possibility that exports of both goods and services will expand in response to the reduction of the antiexport bias in the economy and that the reform will induce additional capital inflows. Furthermore, the fact that Brazil has consistently been a net importer of services must not be interpreted as a demonstration of across-the-board lack of competitiveness in services. Brazil has already demonstrated its international competitiveness in several activities, such as civil engineering and construction, and in others, such as tourism and production of software, the potential for growth in a competitive environment is significant.

The identification of winners and losers in the event of a liberalization movement is not an easy task. Given the high degree of distortions in the Brazilian economy, marginal liberalization movements at the sectoral level may even bring some unpleasant surprises. The distortions also tend to qualify the usefulness of designing liberalization strategies that are designed on the basis of revealed comparative advantage. And educated guesses derived from conventional trade theory such as the Hecksher-Ohlin-Samuelson model have to deal with the complex question of the treatment of information as "a genuine production factor" (Lanvin 1989, p. 114).

The most dynamic service activities, such as communications, management, finance, and professional and technical services, tend to be information-intensive. Production, however, may in many cases be competitively organized along labor-intensive lines. Banking provides a good illustration. The principal national private banks, BRADESCO and ITAU, are organized as labor-intensive systems built around a high-technology core that allows sophisticated interbranch operations. Although this operational profile may not provide a sound basis for international expansion, it would probably be able to withstand a higher level of foreign competition in the Brazilian market. Software production is another sector in which Brazil may attain positive results by exploiting its relatively cheap skilled labor force. Construction and engineering activities provide an interesting counterexample. The successful outward drive of some large Brazilian contractors in the early 1980s was not sustained over time, partly owing to the economic crisis that dominated most developing economies (the main markets for the Brazilian companies) from 1982 on. In any case, the Brazilian "success stories" cannot be explained by the possibility of sending cheap low-skill workers abroad. Firms that relied on this type of arrangement soon found that the costs were much higher than expected.[17] To the extent that the Brazilian construction sector seems to be losing international competitiveness (Gonçalves 1989, p. 359), one could think of it as a potential loser from liberalization.

For more "traditional" tradable services, such as tourism and transport, orthodox trade theory seems to provide more robust predictions. In the case of tourism, for instance, Brazil has typical Ricardian comparative advantages. Additional efforts toward international advertisement of the country, the correction of distortions in the foreign exchange market (the "câmbio-turismo" introduced in January 1989 was a major step in this direction), and deregulation of air transport would certainly translate into a much better performance of the international travel account in the balance of payments. By contrast, the fate of domestic transport services in a more competitive environment does not seem very bright. This is particularly true with respect to sea transport. High capital intensity, a technologically outdated fleet (a casualty of diminished capacity to invest during the 1980s), and worldwide overcapacity suggest that Brazilian shipping companies would be among the losers in a liberalization movement.

Finally, another frequently voiced concern with respect to liberalization of trade in services stems from the misconception that it is synonymous with an argument for laissez-faire (see Corden 1974). In reality, this link does not exist, and there are many circumstances in which government intervention is required to correct market distortions. The basic point made here is that trade protection is an inefficient way of dealing with these distortions.

Concluding Remarks

The economic argument for liberalization of trade in services has been reviewed here from the point of view of the Brazilian economy. As noted above, Brazil may extract significant benefits from a liberalization movement tailored to the peculiarities of its economy. This conclusion by itself would be enough to recommend Brazilian participation in the GNS. It is also important to recognize that a negative agenda (that is, participation on the basis of a "blockade" strategy) would tend to limit Brazil's influence on the design of an eventual code for services.[18]

Another important argument in favor of an active negotiating posture at the GNS follows from the simple fact that for a country like Brazil a "rules-oriented" world is preferable to a "power-oriented" international system (see Jackson 1978, pp. 98–101). Multilateralism is the best defense against aggressive bilateralism.

It would, however, be naive to expect major changes in Brazil's negotiating posture on the basis of the reasons provided here. The extensive array of regulations that apply to the Brazilian service sector has created strong vested interests against liberalization. And the prospects for any liberalization policy amid macroeconomic instability are dim at best. Awareness of the potential benefits of liberalization of trade in services may, nonetheless, foster a productive debate on the rationale of Brazilian trade policies for the sector.

Notes

1. For recent data on the performance of the Brazilian economy and its structure of production, see "As Contas Nacionais," *Conjuntura Econômica*, September 1988, pp. 38–50.

2. For a discussion of the role of services in economic development see Bell (1973), Riddle (1986), and Primo Braga (1989b). See also Bhagwati (1987c) for some important caveats concerning the stages approach to economic development.

3. Branford (1987, p. 73) points out that President Samey's declaration announcing Brazil's National Informatics Plan in 1986 explicitly mentions the threat of "scientific and cultural colonialism."

4. For the GATT mandate, see Roessler (1986). The U.S. approach was based on the proposition that for many services, tradability requires market presence (see Feketekuty 1988).

5. For example, service transactions such as technical assistance associated with capital equipment sales are often entangled with trade in goods; tourism expenditures do not cover the black market for foreign exchange; and workers remittances are not included in the services account. For further details see Ascher and Whichard (1987) and Gonçalves (1988).

6. This strategy was abandoned in 1986 with the Cruzado plan, but the ensuing foreign exchange crisis forced its reintroduction in 1987. For details see Martone and Primo Braga (1987, 1988).

7. Imports of specialized technical services, which are intimately associated with investment activities, fell from $284 million in 1980 to $93 million in 1988 according to Instituo Nacional da Propriedade Industrial (1989, p. 200). It is worth mentioning that gross capital formation as a share of GDP declined from 22.5 percent in 1980 to 17.1 percent in 1987 (*Conjuntura Economica*, September 1988, p. 49).

8. If both domestic and international flights are counted, Varig ranked twelfth; see Kasper (1988, table 2-12).

9. See Sauvant and Zimny (1987) and Balasubramanyan (1989). For additional data on worldwide foreign direct investment flows see GATT (1989).

10. For details on the history of foreign direct investment in Brazil see Baer (1989, ch. 10). Villela and Suzigan (1973) provide useful information on Brazil's policies toward foreign capital for 1889–1945.

11. For example, by 1929 the sectoral distribution of U.S. direct investment in Brazil was as follows: manufacturing, 23.7 percent; distribution of petroleum, 11.9 percent; public utilities, including transport, 50.0 percent; trade, 8.2 percent; and other activities, 6.2 percent. See Baer (1989, p. 216).

12. The rapid increase in foreign direct investment associated with consulting, representation, participation, property management, and advertising during the 1970s explained the relative growth in the share of service-related foreign direct investment reported in table 20-4 for that period.

13. The provision of services in telecommunications, for instance, has been reserved for state-owned enterprises since 1962; see Soares (1986, p. 55).

14. Transnational corporations were allowed to continue operating in the mainframe market. For details about Brazil's informatics policy

see Frischtak (1986), Cline (1987), Tigre (1987), and Inter-American Development Bank (1988).

15. Brazil was the country with the largest number of barriers to trade in services in the inventory conducted by the office of the U.S. Trade Representative in 1985, according to Berg (1987, p. 9).

16. Welch (1989) constructed "efficiency indices" for the financial sectors of Latin American countries using ratios between M2 (total credit extended) and sectoral value added. These ratios provide rough estimates of the productivity of each country's financial sector. It is important to point out, however, that these poor results are probably more closely related to macroeconomic distortions than to microeconomic inefficiencies.

17. For details see Verillo (1988, pp. 190–91). This experience may partially explain Brazil's lack of enthusiasm for a negotiation involving rights of establishment for firms and temporary right of abode for the provision of labor-intensive services.

18. For a discussion on the desired characteristics of this code see Jackson (1988).

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Annex 1

The Punta del Este Ministerial Declaration

Meeting in Punta del Este (Uruguay) from 15–20 September on the occasion of the special session of the GATT Contracting Parties, ministers of GATT member countries adopted a Declaration launching a new round of multilateral trade negotiations—the Uruguay Round. The Declaration falls into two parts.

As contracting parties, the ministers adopted Part I of the declaration regarding trade in goods. It establishes the objectives and principles of the negotiations, and the launch of issues on which negotiations will take place. The Declaration provides for a standstill and rollback on trade restrictive or trade distortive measures under which governments undertake not to phase out their existing breaches of GATT disciplines.

As representatives of governments meeting on the occasion of the Session, the ministers further decided to launch a negotiation on trade in services, and adopted Part II of the Declaration in that regard. It has been agreed that these negotiations will not be placed within the legal framework of GATT, but that GATT practices and procedures will nevertheless apply to them.

Ministers then adopted the Ministerial Declaration as a whole as a single policy commitment launching the Uruguay Round. The negotiations are to extend over four years.

Ministerial Declaration on the Uruguay Round

Ministers, meeting on the occasion of the Special Session of Contracting Parties at Punta del Este, have decided to launch Multilateral Trade Negotiations (The Uruguay Round). To this end, they have adopted the following Declaration. The Multilateral Trade Negotiations (MTN) will be open to the participation of countries as indicated in Parts I and II of this Declaration. A Trade Negotiations Committee shall hold its first meeting not later than 31 October 1986. It shall meet as appropriate at Ministerial level. The Multilateral Trade Negotiations will be concluded within four years.

Reprinted from GATT Focus, 8 October 1986

Part I—Negotiations on trade in goods

The Contracting Parties meeting at Ministerial level

Determined to halt and revise protectionism and to remove distortions to trade

Determined to preserve the basic principles and to further the objectives of the GATT

Determined also to develop a more open, viable and durable multilateral trading system

Convinced that such action would promote growth and development

Mindful of the negative effects of prolonged financial and monetary instability in the world economy, the indebtedness of a large number of less-developed contracting parties, and considering the linkage between trade, money, finance and development

Decide to enter into Multilateral Trade Negotiations on trade in goods within the framework and under the aegis of the General Agreement on Tariffs and Trade.

A. Objectives

Negotiations shall aim to

(i) bring about further liberalization and expansion of world trade to the benefit of all countries, especially less-developed contracting parties, including the improvement of access to markets by the reduction and elimination of tariffs, quantitative restrictions and other non-tariff measures and obstacles;

(ii) strengthen the role of GATT, improve the multilateral trading system based on the principles and rules of the GATT and bring about a wider coverage of world trade under agreed, effective and enforceable multilateral disciplines;

(iii) increase the responsiveness of the GATT system to the evolving international economic environment, through facilitating necessary structural adjustment, enhancing the relationship of the GATT with the relevant international organizations and taking account of changes in trade patterns and prospects, including the growing importance of trade in high technology products, serious difficulties in commodity markets and the importance of an improved trading environment providing, inter alia, for the ability of indebted countries to meet their financial obligations;

(iv) foster concurrent co-operative action at the national and international levels to strengthen the inter-relationship between trade policies and other economic policies affecting growth and development, and to contribute towards continued, effective and determined efforts to improve the functioning of the international monetary system and the flow of financial and real investment resources to developing countries.

B. General principles governing negotiations

(i) Negotiations shall be conducted in a transparent manner, and consistent with the objectives and commitments agreed in this Declaration and with the principles of the General Agreement in order to ensure mutual advantage and increased benefits to all participants.

(ii) The launching, the conduct and the implementation of the outcome of the negotiations shall be treated as parts of a single undertaking. However, agreements reached at an early stage may be implemented on a provisional or a definitive basis by agreement prior to the formal conclusion of the negotiations. Early agreements shall be taken into account in assessing the overall balance of the negotiations.

(iii) Balanced concessions should be sought within broad trading areas and subjects to be negotiated in order to avoid unwarranted cross-sectoral demands.

(iv) Contracting Parties agree that the principle of Differential and More Favourable Treatment embodied in Part IV and other relevant provisions of the General Agreement and in the Decision of the Contracting Parties of 28 November 1979 on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries applies to the negotiations. In the implementation of standstill and rollback, particular care should be given to avoiding disruptive effects on the trade of less-developed contracting parties.

(v) The developed countries do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of developing countries, i.e., the developed countries do not expect the developing countries, in the course of trade negotiations, to make contributions which are inconsistent with their individual development, financial and trade needs. Developed contracting parties shall therefore not seek, neither shall less-developed contracting parties be required to make, concessions that are inconsistent with the latter's development, financial, and trade needs.

(vi) Less-developed contracting parties expect that their capacity to make contributions or negotiated concessions or take other mutually agreed action under the provisions and procedures of the general agreement would improve with the progressive development of their economies and improvement in their trade situation and they would accordingly expect to participate more fully in the framework of rights and obligations under the General Agreement.

(vii) Special attention shall be given to the particular situation and problems of the least-developed countries and to the need to encourage positive measures to facilitate expansion of their trading opportunities. Expeditious implementation of the relevant provisions of the 1982 Ministerial Declaration concerning the least-developed countries shall also be given appropriate attention.

C. Standstill and rollback

Commencing immediately and continuing until the formal completion of the Negotiations, each participant agrees to apply the following commitments:

Standstill

(i) not to take any trade restrictive or distorting measure inconsistent with the provisions of the General Agreement or the Instruments negotiated within the framework of GATT or under its auspices;

(ii) not to take any trade restrictive or distorting measure in the legitimate exercise of its GATT rights, that would go beyond that which is necessary to remedy specific situations, as provided for in the General Agreement and the Instruments referred to in (i) above;

(iii) not to take any trade measures in such a manner as to improve its negotiating positions.

Rollback

(i) that all trade restrictive or distorting measures inconsistent with the provisions of the General Agreement or Instruments negotiated within the framework of GATT or under its auspices, shall be phased out or brought into conformity within an agreed timeframe not later than by the date of the formal completion of the negotiations, taking into account multilateral agreements, undertakings and understandings, including strengthened rules and disciplines, reached in pursuance of the Objectives of the Negotiations;

(ii) there shall be progressive implementation of this commitment on an equitable basis in consultations among participants concerned, including all affected participants. This commitment shall take account of the concerns expressed by any participant about measures directly affecting its trade interests;

(iii) there shall be no GATT concession requested for the elimination of these measures.

Surveillance of standstill and rollback

Each participant agrees that the implementation of these commitments on standstill and rollback shall be subject to multilateral surveillance so as to ensure that these commitments are being met. The Trade Negotiations Committee will decide on the appropriate mechanisms to carry out the surveillance, including periodic reviews and evaluations. Any participant may bring to the attention of the appropriate surveillance mechanism any actions or omissions it believes to be relevant to the fulfillment of these commitments. These notifications should be addressed to the GATT secretariat, which may also provide further relevant information.

D. Subjects for negotiations

Tariffs

Negotiations shall aim, by appropriate methods, to reduce or, as appropriate, eliminate tariffs, including the reduction or elimination of high tariff and tariff escalation. Emphasis shall be given to the expansion of the scope of tariff concessions among all participants.

Nontariff measures

Negotiations shall aim to reduce or eliminate non-tariff measures, including quantitative restrictions, without prejudice to any action to be taken in fulfillment of the rollback commitments.

Tropical products

Negotiations shall aim at the fullest liberalization of trade in tropical products, including in their processed and semi-processed forms and shall cover both tariff and all non-tariff measures affecting trade in these products.

Contracting Parties recognize the importance of trade in tropical products to a large number of less-developed contracting parties and agree that negotiations in this area shall receive special attention, including the timing of the negotiations and the implementation of the results as provided in B(ii).

Natural resource-based products

Negotiations shall aim to achieve the fullest liberalization of trade in natural resource-based products, including in their processed and semi-processed forms. The negotiations shall aim to reduce or eliminate tariff and non-tariff measures, including tariff escalation.

Textiles and clothing

Negotiations in the area of textiles and clothing shall aim to formulate modalities that would permit the eventual integration of this sector into GATT on the basis of strengthened GATT rules and disciplines, thereby also contributing to the objective of further liberalization of trade.

Agriculture

Contracting Parties agree that there is an urgent need to bring more discipline and predictability to world agricultural trade by correcting and preventing restrictions and distortions, including those related to structural surpluses so as to reduce the uncertainty, imbalances and instability in world agricultural markets. Negotiations shall aim to achieve greater liberalization of trade in agriculture and bring all measures affecting import access and export competition under strengthened and more operationally effective GATT rules and disciplines, taking into account the general principles governing the negotiations, by:

(i) improving market access through, inter alia, the reduction of import barriers;

(ii) improving the competitive environment by increasing discipline of the use of all direct and indirect subsidies and other measures affecting directly or indirectly agricultural trade, including the phased reduction of their negative effects and dealing with their cause;

(iii) minimizing the adverse effects that sanitary and phytosanitary regulations and barriers can have on trade in agriculture, taking into account the relevant international agreements.

In order to achieve the above objectives, the negotiating group having primary responsibility for all aspects of agriculture will use the Recommendations adopted by the Contracting Parties at their Fortieth Session, which were developed in accordance with the GATT 1982 Ministerial Programme and take account of the approaches suggested in the work of the Committee on Trade in Agriculture without prejudice to other alternatives that might achieve the objectives of the Negotiations.

GATT Articles

Participants shall review existing GATT articles, provisions and disciplines as requested by interested contracting parties and, as appropriate, undertake negotiations.

Safeguards

(i) A comprehensive agreement on safeguards is of particular importance to the strengthening of the GATT system and to progress in the MTNs.

(ii) The agreement on safeguards:

–shall be based on the basic principles of the General Agreement;

–shall contain, inter alia, the following elements; transparency, coverage, objective criteria for action including the concept of serious injury or threat thereof, temporary nature, degressivity, and structural adjustment, compensation and retaliation, notifications, consultation, multilateral surveillance and dispute settlement; and

–shall clarify and reinforce the disciplines of the General Agreement and should apply to all contracting parties.

MTN agreements and arrangements

Negotiations shall aim to improve, clarify, or expand, as appropriate, agreements and arrangements negotiated in the Tokyo Round of multilateral negotiations.

Subsidies and countervailing measures

Negotiations on subsidies and countervailing measures shall be based on a review of Articles VI and XVI and the MTN agreement on subsidies and countervailing measures with the objective of improving GATT disciplines relating to all subsidies and countervailing measures that affect international trade. A negotiating group will be established to deal with these issues.

Dispute settlement

In order to ensure prompt and effective resolution of disputes to the benefit of all contracting parties, negotiations shall aim to improve and strengthen the rules and then procedures of the dispute settlement process, while recognizing the contribution that would be made by more effective and enforceable GATT rules and disciplines. Negotiations shall include the development of adequate arrangements for overseeing and monitoring of the procedures that would facilitate compliance with adopted recommendations.

Trade-related aspects of intellectual property rights, including trade in counterfeit goods

In order to reduce the distortions and impediments to international trade, and taking into account the need to promote effective and adequate protection of intellectual property rights, and to ensure that measures and procedures to enforce intellectual property rights do not themselves become barriers to legitimate trade, the negotiations shall aim to clarify GATT provisions and elaborate as appropriate new rules and disciplines. Negotiations shall aim to develop a multilateral framework of principles, rules and disciplines dealing with international trade in counterfeit goods, taking into account work already undertaken in the GATT.

These negotiations shall be without prejudice to other complementary initiatives that may be taken in the World Intellectual Property Organization and elsewhere to deal with these matters.

Trade-related investment measures

Following an examination of the operation of GATT articles related to the trade restrictive and distorting effects of investment measures, negotiations should elaborate, as appropriate, further provisions that may be necessary to avoid such adverse effects on trade.

E. Functioning of the GATT system

Negotiations shall aim to develop understandings and arrangements:

(i) to enhance the surveillance in the GATT to enable regular monitoring of trade policies and practices of contracting parties and their impact on the functioning of the multilateral trading system;

(ii) to improve the overall effectiveness and decision-making of the GATT as an institution, including, inter alia, through involvement of Ministers;

(iii) to increase the contribution of the GATT to achieving greater coherence in global economic policy-making through strengthening its relationship with other international organizations responsible for monetary and financial matters.

F. Participation

(a) Negotiations will be open to:

(1) all contracting parties,

(2) countries having acceded provisionally,

(3) countries applying the GATT on a de facto basis having announced, not later than 30 April 1987, their intention to accede to GATT and to participate in the negotiations,

(4) countries that have already informed the Contracting Parties, at a regular meeting of the Council of Representatives of their intention to negotiate the terms of their membership as a contracting party, and

(5) developing countries that have, by 30 April 1987, initiated procedures for accession to the GATT, with the intention of negotiating the terms of their accession during the course of the negotiations.

(b) Participation in negotiations relating to the amendment or application of GATT provisions or the negotiations of new provisions will, however, be open only to contracting parties.

G. Organization of the negotiations

A Group of Negotiations on Goods (GNG) is established to carry out the programme of negotiations contained in this Part of the Declaration. The GNG shall, inter alia:

(i) elaborate and put into effect detailed trade negotiation plans prior to 19 December 1986;

(ii) designate the appropriate mechanism for surveillance of commitments to standstill and rollback;

(iii) establish negotiating groups as required. Because of the interrelationship of some issues and taking fully into account the general principles governing the negotiations as stated in B(iii) above it is recognized that aspects of one issue may be discussed in more than one negotiating group. Therefore each negotiating group should as required take into account relevant aspects emerging in other groups;

(iv) also decide upon inclusion of additional subject matters in the negotiations;

(v) coordinate the work of the negotiating groups and supervise the progress of the negotiations. As a guideline not more than two negotiating groups should meet at the same time;

(vi) the GNG shall report to the Trade Negotiations Committee.

In order to ensure effective application of differential and more favorable treatment the GNG shall, before the formal completion of the negotiations, conduct an evaluation of the results attained therein in terms of the Objectives and General Principles Governing Negotiations as set out in the Declaration, taking into account all issues of interest to less-developed contracting parties.

Part II—Negotiations on trade in services

Ministers also decided, as part of the Multilateral Trade Negotiations, to launch negotiations on trade in services. Negotiations in this area shall aim to establish a multilateral framework of principles and rules for trade in services, including elaboration of possible disciplines for individual sectors, with a view to expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting economic growth of all trading partners and the development of developing countries. Such framework shall respect the policy objectives of national laws and regulations applying to services and shall take into account the work of relevant international organizations.

GATT procedures and practices shall apply to these negotiations. A Group on Negotiations on Services is established to deal with these matters. Participation in the negotiations under this Part of the Declaration will be open to the same countries as under Part I. GATT secretariat support will be provided, with technical support from other organizations as decided by the Group of Negotiations on Services.

The Group of Negotiations on Services shall report to the Trade Negotiations Committee.

Implementation of results under Parts I and II

When the results of the Multilateral Trade Negotiations in all areas have been established, Ministers meeting also on the occasion of a Special Session of Contracting Parties shall decide regarding the international implementation of the respective results.

Annex 2

The Montreal Ministerial Declaration

Negotiations on Trade in Services

1. Ministers reaffirm the objectives for negotiations on trade in services agreed at Punta del Este. Ministers agree that substantial progress has been achieved in pursuit of these objectives.

2. Ministers take note of the report of the GNS to the TNC contained in MTN.GNS/21 which they consider an important basis for further work directed towards the achievement of these negotiating objectives. This work should proceed in a parallel and interrelated fashion.

3. Ministers note the understanding reached on statistics and on existing international arrangements and discipline as set out in paragraphs 7 and 8 of the GNS report.

4. Work on definition should proceed on the basis that the multilateral framework may include trade in services involving cross-border movement of services, cross-border movement of consumers, and cross-border movement of factors of production where such movement is essential to suppliers. However, this should be examined further in the light of, *inter alia,* the following:

(a) Cross-border movement of service and payment.
(b) Specificity of purpose.
(c) Discreteness of transactions.
(d) Limited duration.

5. Ministers agree that work should proceed, without excluding any sector of trade in services on an *a priori* basis, with a view to reaching agreement on the sectoral coverage under the multilateral framework in accordance, *inter alia,* with the considerations that coverage should permit a balance of interests for all participants, that sectors of export interest to developing countries should be included, that certain sectors could be excluded in whole or in part for certain overriding considerations, and that the framework should provide for the broadest possible coverage of sectors of interest to participants.

Reprinted from News of the Uruguay Round of Multilateral Trade Negotiations, NUR 023, 14 December 1988.

6. Ministers agree that, before the concepts, principles and rules which comprise a multilateral framework for trade in services are finally agreed, these concepts, principles and rules will have to be examined with regard to their applicability and the implications of their application to individual sectors and the types of transactions to be covered by the multilateral framework.

7. Ministers agree that negotiations on the elaboration of a multilateral framework of principles and rules for trade in services should proceed expeditiously. To this end, the following concepts, principles and rules are considered relevant:

(a) Transparency

Provisions should ensure information with respect to all laws, regulations and administrative guidelines as well as international agreements relating to services trade to which the signatories are parties through adequate provisions regarding their availability. Agreement should be reached with respect to any outstanding issues in this regard.

(b) Progressive Liberalization

The negotiations should establish rules, modalities and procedures in the multilateral framework agreement that provide for progressive liberalization of trade in services with due respect for national policy objectives including provisions that allow for the application of principles to sectors and measures. Provisions should also be established for further negotiations after the Uruguay Round. Specific procedures may be required for the liberalization of particular sectors.

The aim of these rules, modalities and procedures should be to achieve, in this round and future negotiations, a progressively higher level of liberalization taking due account of the level of development of individual signatories. To this end the adverse effects of all laws, regulations and administrative guidelines should be reduced as part of the process to provide effective market access, including national treatment.

The rules, modalities and procedures for progressive liberalization should provide appropriate flexibility for individual developing countries for opening fewer sectors or liberalizing fewer types of transactions or in progressively extending market access in line with their development situation.

(c) National Treatment

When accorded in conformity with other provisions of the multilateral framework, it is understood that national treatment means that the services exports and/or exporters of any signatory are accorded in the market of any other signatory, in respect of all laws, regulations and administrative practices, treatment "no less favourable" than that accorded domestic services or services providers in the same market.

(d) Most-Favoured-Nation/Non-Discrimination

The multilateral framework shall contain a provision on m.f.n./non-discrimination.

(e) Market Access

When market access is made available to signatories it should be on the basis that, consistent with the other provisions of the multilateral framework and in accordance with the definition of trade in services, foreign services may be supplied according to the preferred mode of delivery.

(f) Increasing Participation of Developing Countries

The framework should provide for the increasing participation of developing countries in world trade and for the expansion of their service exports, including *inter alia* through the strengthening of their domestic services capacity and its efficiency and competitiveness.

(g) Safeguards and Exceptions

Further negotiations will be necessary on provisions for safeguards, e.g., for balance-of-payments reasons, and exceptions, e.g., based on security and cultural policy objectives.

(h) Regulatory Situation

It is recognized that governments regulate services sectors, e.g., by granting exclusive rights in certain sectors, by attaching conditions to the operations of enterprises within their markets for consumer protection purposes and in pursuance of macro-economic policies. Asymmetries exist with respect to the degree of development of services regulations in different countries. Consequently, the right of countries, in particular of developing countries, to introduce new regulations is recognized. This should be consistent with commitments under the framework.

8. Other elements mentioned in MTN.GNS/21, as well as new ideas and concepts participants may wish to put forward, will also be considered.

9. It is understood that the acceptability of the multilateral framework will be dependent on the initial level of negotiated commitments of signatories.

Future Work

10. Future work should provide for:

(a) The compilation by the secretariat of a reference list of sectors by February 1989. This process could be assisted by submissions by participants.

(b) Invitation to participants to submit indicative lists of sectors of interest to them with a target date of May 1989.

(c) The process of examining the implications and applicability of concepts, principles and rules for particular sectors and specific transactions should begin as lists become available.

(d) Further work as necessary on the role of international disciplines and arrangements and on the question of definition and statistics.

11. The GNS should endeavour, by the end of 1989, to assemble the necessary elements for a draft which would permit negotiations to take place for the completion of all parts of the multilateral framework and its entry into force by the end of the Uruguay Round.

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The World Bank
The United Nations Centre on Transnational Corporations

The years 1986–90 may well enter the history of international economic relations as a period of rapid progress toward a more open world services economy with greater opportunities for trade and development. This volume, intended as a guide to the economics underlying the Uruguay Round negotiations on services, suggests three lessons.

First, contrary to widespread skepticism, developing countries do have comparative advantages in certain aspects of air transport, banking, insurance, tourism, shipping, construction, telecommunications, and professional services, including software development and health care. These advantages derive from the countries' relatively abundant resources of labor with the needed skills.

Second, comparative advantages in services do more than create potential tradeoffs between industrial and developing countries in multilateral negotiations on services. Certain goods exported by developing countries are essential inputs into services, and certain services (such as telecommunications) are essential inputs into manufactures. Liberalization will facilitate developing countries' exports of goods, and imports of less-expensive services will increase the efficiency of the developing economies. Both evolutions will boost development.

Third, in services as in goods, domestic and external measures cannot be isolated from each other. Domestic liberalization is rapidly choked if there is not an open regime, and trade liberalization without internal market-oriented reforms can be costly. The Uruguay Round comes at the right time to consolidate liberalizations and to encourage new ones.

Part I of this book looks at the validity and adequacy of basic economic tools for analyzing services trade issues within the familiar GATT tradition of trade negotiations. Part II presents, for each main group of services, the economic characteristics of their production, the modes of delivery, the impact of the current international environment, and the existing methods and extent of regulation and protection in industrial and developing countries. Part III, through case studies of selected countries, examines the basic questions that the delegations in Geneva will have in mind as they negotiate a framework agreement—in particular, the balance between the costs of adjusting to a more open environment and the gains from liberalization.

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