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Shaping Future Rules for Trade in Services
Lessons from the GATS

Aaditya Mattoo

2.1 Introduction

The new round of services negotiations has begun, not with passionate intensity, but with a rather mechanical sense of "since we said we would, therefore we must." Although the lack of attention from those opposed to freer trade is cause for relief, the lack of conviction in supporters of new negotiations merits concern. The reason for both, however, is the limited impact so far of the General Agreement on Trade in Services (GATS). Creating a framework of rules in this difficult area was certainly an achievement, but the GATS has so far failed to deliver meaningful liberalization, and it has invariably been a step behind technological and regulatory developments in services. The agreement is generally perceived, not as a scourge of protection, but as a rather stodgy reaper of liberalization accomplished elsewhere.

In highlighting the limitations of the GATS, which is the main purpose of this paper, it is easy to understate what it has accomplished. In recognition of the fact that many services require proximity between consumers and suppliers, the agreement went beyond the traditional notion of trade (including only cross-border delivery) to encompass supply through the move-

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ment of both capital and labor.[1] The agreement also created a framework to deal with forms of protection more complex and less visible than tariffs. These include, first, a variety of quantitative restrictions, ranging from cargo sharing in transport services and limits on the number of (foreign) suppliers in telecommunications and banking to restrictions on the movement of service-providing personnel that affect trade in all services. Then there are numerous forms of discrimination against foreign providers, through taxes and subsidies as well as by allowing less favorable access to essential facilities such as ports, airports, or telecommunications networks. Finally, there is a subtle class of measures that are neither quotas nor explicitly discriminatory but nevertheless have a profound effect on services trade, that is, domestic regulations such as qualification and licensing requirements.

Gandhi said that it was pointless to dream of systems so perfect that human beings no longer need to be good. It is perhaps equally utopian to wish for international trade rules that can deliver liberalization without the willingness of governments. No doubt liberalization of services is primarily a challenge for domestic policy. Still, multilateral negotiations and agreements can help in four ways, by helping to achieve deeper liberalization through reciprocity-based market access negotiations; efficient protection and regulation through rules that favor the choice of superior instruments; credibility of policy through legally binding commitments; and a guarantee against discrimination through the most-favored nation (MFN) principle. How much has the GATS already delivered in these respects?

- The GATS has created an adequate framework to deal with explicit protection, but neither the negotiating momentum to reduce such protection nor the rules to ensure that it takes a desirable form.
- In dealing with the trade-impeding impact of domestic regulations, an admittedly difficult area, the agreement has achieved even less: the Uruguay Round provisions were weak, and only limited progress has been made in the last five years.
- More positively, many countries have taken advantage of the GATS to create a more secure trading environment by legally binding current levels of openness, and some have even precommitted to greater levels of future openness. However, the coverage of commitments for developing countries is limited, and in some cases commitments serve to protect the privileged position of incumbents rather than enhancing the contestability of markets.
- As befits a multilateral agreement, the GATS in principle prohibits a country from discriminating between its trading partners. The explicit

1. Developed country proponents of the GATS initially envisaged an inclusion only of capital movements, but developing country negotiators successfully pressed for the inclusion of labor movements also.

departures from this obligation, such as the exceptions for regional integration agreements and the exemptions listed by members, are well known. However, the difficulties in preventing implicit discrimination through domestic regulations and through the allocation of quotas have not been adequately appreciated.

- Finally, the GATS has so far done little to address the problem of private anticompetitive practices that fall outside the jurisdiction of national competition law, for example, in sectors like maritime and air transport. It has thus failed to reassure small countries that the gains from liberalization will not be appropriated by international cartels.

The rest of this paper develops the arguments presented above and provides suggestions on possible improvements not only in the rules of the agreement but also in the specific commitments made by countries and the negotiating methodology.[2] Where relevant, the paper draws upon the experience of the East Asian countries with the GATS. A basic tenet of the paper is that it is possible to make improvements in the GATS, and to make it a more effective instrument of liberalization, without fundamental structural changes, which are, in any case, of doubtful political feasibility.

2.2 Efficient Protection

The domestic political economic forces that lead to protection may also dictate that it is obtained through inefficient instruments. In goods trade, negotiations helped reduce protection, but ensuring that the efficient instruments of protection were chosen was the role of rules. Thus, General Agreement on Tariffs and Trade (GATT) rules broadly reflect the ranking of instruments suggested by economic theory: quotas are prohibited, tariffs are allowed but progressively negotiated down and bound, and production subsidies are permitted but subject to countervailing action under certain circumstances. The GATS rules on market access do not create a similar hierarchy. There are two basic rules: the market access provision (Article XVI) simply lists a set of measures, mostly different types of quotas, that cannot be maintained in scheduled sectors *unless prespecified*;[3] and the national treatment provision (Article XVII) prohibits any form of discrimination (including through subsidies) against foreign services and foreign ser-

2. The paper draws upon other research by the author, in particular Mattoo (2000a).

3. Article XVI stipulates that measures restrictive of market access that a WTO member cannot maintain or adopt, unless specified in its schedule, include limitations on (a) the number of service suppliers; (b) the total value of services transactions or assets; (c) the total number of services operations or the total quantity of service output; (d) the total number of natural persons that may be employed in a particular sector; (e) specific types of legal entity through which a service can be supplied; and (f) foreign equity participation (e.g., maximum equity participation). With the exception of (e), the measures covered by Article XVI all take the form of quantitative restrictions.

vice suppliers, again, *unless prespecified*.[4] Thus, in the services context, both the *level* and the *form* of protection are the outcome of negotiations between World Trade Organization (WTO) members.

2.2.1 Ranking Alternative Instruments

The question is: does economic theory in its current state suggest a hierarchy of instruments affecting services trade, and is it possible to create rules that favor a choice of superior instruments? The superiority of subsidies over trade restrictions is as valid for services as it is for goods,[5] and, in principle, tariffs are to be preferred to quotas for much the same reason as in the case of goods. However, there are at least three reasons that differences may arise. First, in some instances tariffs may not be easy to impose, and so the substitution of a more desirable policy instrument for a less desirable one may not be feasible. Second, some of the instruments that have a tariff-like effect in terms of inflicting costs on foreign providers (such as overly burdensome standards) are not, however, tariff-like in generating revenue. Finally, there are the numerous restrictions imposed on foreign direct investment and the movement of personnel that directly affect the market structure.

Consider each issue in turn. First, the difficulty of switching to fiscal instruments of protection has probably been exaggerated. As far as cross-border trade is concerned, the imposition of duties is probably most difficult—perhaps impossible, given the current state of technology—when a service is delivered electronically. In this case, however, other barriers to trade are also likely to be infeasible. Where quotas are feasible and maintained, as on cross-border trade in transport services, it is easy to conceive of tariff-type instruments: for example, a tax per passenger or unit of cargo carried by a foreign company. Moreover, the auction of a quota is analogous in economic effect to the imposition of a tariff. In the case of commercial presence, a number of fiscal instruments are possible, including entry taxes (or auctions of entry licenses), output taxes, and profit taxes. Ironically, the legal systems of many countries allow discrimination against foreigners through outright bans and entry quotas but make it difficult to impose discriminatory taxes.

4. Article XVII:1 states the basic national treatment obligation: "In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers." Unlike Article XVI, Article XVII provides no exhaustive list of measures inconsistent with national treatment. Nevertheless, Article XVII:2 makes it clear that limitations on national treatment cover cases of both de jure and de facto discrimination.

5. Both instruments encourage national production, the former by reducing the private costs of national producers and the latter by imposing a cost on foreign service providers. The latter is an inferior instrument because it leads to a deterioration in the price-quality mix that foreigners are able to provide local consumers. See also Hindley and Smith (1984), Hindley (1988), and UNCTAD and World Bank (1994) for a discussion of the economics of services trade.

Consider now the consequences of restrictive measures that increase foreign costs without generating revenue. In this case, part of the loss in consumer surplus is not offset by an increase in tariff revenue, so the loss in national and global welfare is much greater. Similarly, when quotas are imposed, their consequences for (national) welfare could be alleviated if the rents generated accrued domestically to importers or the government rather than to foreign exporters. However, the difficulties of intermediation in services suggest that quota-rents are more likely to be appropriated by exporters—or, more likely, quotas are likely to lead to socially wasteful administration costs and rent-seeking. Hence, one general conclusion is that if complete liberalization is not feasible, a shift from both quotas and non–revenue-generating measures to fiscal measures would lead to an increase in both national and global welfare.

A prohibition of quotas is unlikely to be politically feasible today. An intermediate step would be to build into GATS rules a legal presumption in favor of fiscal measures (see Deardoff 1994, 2000; Snape 1994; Hoekman 1996). The Uruguay Round Understanding on the Balance-of-Payments Provisions of the GATT 1994 provides a useful model. This understanding requires members to give preference to price-based measures and to use quotas only if price-based measures are inadequate, and the choice must be justified. In the GATS context, we would wish to see a shift from both quotas and wasteful discriminatory regulations to fiscal measures. Inducing a shift away from the former would require making the market access provision more stringent. Inducing a shift from latter has not been anticipated in the structure of the agreement and may be worth considering. In any case, greater flexibility in the national treatment provision (which prohibits all forms of discrimination) is not necessary, for, even if a country had committed to providing national treatment, then it is allowed to modify its commitments (under Article XXI) and switch instruments of protection—as long as the extent of protection does not increase.

2.2.2 Restrictions on Foreign Direct Investment

Restrictions on foreign investment assume particular significance in the case of services for which cross-border delivery is not possible, so that the price and quality of the service depend completely on the domestic market structure. Many developing countries, including some of those in East Asia, have been reluctant to allow unimpeded entry; instead, market access has been conceded either by allowing limited foreign entry or by increased foreign ownership of existing firms. Malaysia, the Philippines, and Thailand are among the countries that impose equity restrictions and restrictions on entry in key sectors like telecommunications and financial services, and many other East Asian countries have imposed one or the other type of restriction (see tables 2.1–2.3).

A central conclusion of the literature on privatization is that larger wel-

Table 2.1 **East Asia Foreign Equity Participation, Degree of Competition, and Nature of Precommitment in Fixed Telecom Networks**

Country	Limitations on FDI	Degree of Competition in Fixed Networks	Precommitment
Hong Kong	None	Oligopoly of 5 in domestic, monopoly in international	Will consider issuing more than the existing four licences for local fixed network services in June 1998.
Indonesia	GATS: 35%	Regional monopolies with scope for joint operating schemes	Policy review upon the expiry of the exclusive rights: exclusivity expires in 2011 for local service, in 2006 for long distance services, and in 2005 for international service.
Japan	20% in NTT and KDD	Full competition	
Korea	Variable: Facilities-based: 33%; KoreaTelecom: 20%; Resale-based: 0%	Full competition, phased in over several years	Will increase foreign equity limits: Facilities-based: 49% in 2001; Korea Telecom: 33% in 2001; Resale-based: 49% in 1999, 100% in 2001
Malaysia	GATS: 30%	Increasing competition; discretionary licensing	
The Philippines	GATS: 40%	Full competition; discretionary licensing	
Singapore	GATS: 73.99% (direct: 49%, indirect: 24.99%)	Monopoly	Oligopoly of 3 or more after April 2000
Thailand	Limited, in BTO arrangements	Monopoly, with some BTO arrangements	Will introduce revised commitments in 2006 when new law comes into force.

Source: Compiled by the author from GATS Schedules of Commitments.

fare gains arise from an increase in competition than from simply a change in ownership from public to private hands. Does the conclusion change when the change of ownership is from national to foreign hands? Foreign investment clearly brings benefits even in situations in which it does not lead to enhanced competition (e.g., there are entry restrictions). Foreign equity may relax a capital constraint, can help ensure that weak domestic firms are bolstered (e.g., via recapitalizing financial institutions), and can serve as a vehicle for transferring technology and know-how, including improved management. However, if foreign direct investment (FDI) comes simply because the returns to investment are artificially raised by restrictions on competition, the net returns to the host country may be negative (returns to the

Table 2.2 **Market Access Commitments in Insurance in East Asia (direct includes life and nonlife)**

Member	Limitations on Cross-Border Supply	Limitations on Consumption Abroad	Limitations on Commercial Presence			
			Legal Form	No. of Suppliers	Equity	Other
Brunei Darussalam	U	None excl. statutory ins.	Local registration	U (h)	U (h)	
Hong Kong	U	None excl. statutory ms.	S, B, or association of underwriters			
Indonesia	U	DL			100% of listed companies (G)	
Japan	Life: U Nonlife: for limited class; only with mode 3 for some services					
Korea	U except marine cargo and aviation insurance	U	S, B, joint ventures (but not with Korean licenses)		Restrictions on acquisition of existing firms; foreign portfolio invt only for listed stocks, ≤ 23% (h) LSO	
Malaysia	Life: U Nonlife: DL	Life: U Nonlife: DL	I	New: U	On incorporation of existing branches and for original owners: 51%; new participation in existing 30% (DLSO)	No branches for foreign > 50% (G)
The Philippines	U except for marine hull and marine cargo	U		DL	Acquisition or new: 51% (G)	

(*continued*)

Table 2.2 (continued)

Member	Limitations on Cross-Border Supply	Limitations on Consumption Abroad	Limitations on Commercial Presence			
			Legal Form	No. of Suppliers	Equity	Other
Singapore	U	None, excluding statutory insurance		New: U	Existing: 49% provided no foreign party is largest shareholder	
Thailand	U except for internal marine, aviation, and transit	None		DL	25%	
	Nonlife for limited class	Nonlife: none for limited class				

Source: Compiled by the author from GATS Schedules of Commitments.

Notes: B = branches; S = subsidiaries; h = restrictions in horizontal commitments; I = local incorporation required; None = commitment to impose no restrictions; No text = no restrictions, but reference to some regulations; U = unbound (no commitment); R = reciprocity condition or MFN exemption; DL = discretionary licensing or economic needs test; (D) LSO = (discretionary) limits on single ownership; G = grandfathering provisions.

Table 2.3 **Market Access Commitments in Banking in East Asia (acceptance of deposits and lending)**

Member	Limitations on Cross-Border Supply	Limitations on Consumption Abroad	Limitations on Commercial Presence					
			Legal Form	No. of Suppliers	Equity	Number of Operations (branches)	Value of Transactions or Assets	Other
Hong Kong	U	None	Deposits: S or B	DL for acquisition of locally inc bank		For banks, including overseas, max offices = 3 (G)		For S, 10 years as authorized institution
					Lending: none			
Indonesia	None	None	New: I, joint venture (G of old B)	New: U	Acquisition of existing: 49% (G)	2 B/auxiliary office		
Japan	U	None						
Korea	U	U		Only branches of top 500 banks; unclear on S	Restrictions on acquisition of existing firms; foreign portfolio investment only for listed stocks, and $\leq$ 23% (h) LSO		Ceilings on foreign currency loans	
Malaysia	Deposits: U	None		New: U	Existing: 30% (G) DLSO	U for B and ATMs of commercial banks		
	Lending $\geq$ RM25m only with mode 3							
PNG (o)	None	None	None					

(*continued*)

Table 2.3 (continued)

Member	Limitations on Cross-Border Supply	Limitations on Consumption Abroad	Limitations on Commercial Presence					
			Legal Form	No. of Suppliers	Equity	Number of Operations (branches)	Value of Transactions or Assets	Other
The Philippines	U	None	Single form of presence + local incorporation: DL	DL, R	Acquisition or new: 51% (G)	10 new B (1995–2000), individual max = 6	30% max foreign share of total assets	
Singapore	U	None		Deposits new: U	Deposits: 40% LSO	Deposits: 1 office (incl. ATM)		
				Lending: none	Lending: none	Lending: off Premise ATM: U	Lending local currency to non-residents: DL	
Thailand	U	U	I or B	S: U B: DL	Acquisition of existing: 25% (limitations on individual ownership) DL on > 25%	Existing banks with a B before 1995: 2 additional BS (G); new Bs: DL		

Source: Compiled by the author from GATS Schedules of Commitments.
Notes: See table 2.2.

investor may exceed the true social productivity of the investment). To some extent the rent appropriation may be prevented by profit taxation or by holding competitive auctions of licenses or equity, but the benefits of competition would still not be obtained.[6]

Entry restrictions are becoming harder to justify in the face of growing evidence of the benefits of competition.[7] Why then do we observe such widespread restrictions on entry? While it is possible to construct special models of market and/or regulatory failure where entry barriers enhance welfare (Laffont 1998), there are usually more prosaic reasons for the barriers. First, restrictions generally aim to protect the incumbent suppliers from immediate competition for infant industry–type reasons, to facilitate "orderly exit," or simply due to political economy pressures. The result is protection not only of national firms but also of foreign incumbents—as in the case of foreign telecom monopolies in Hong Kong, foreign insurance companies in Malaysia, and, most strikingly, the bilateral agreements in air transport. Other instruments, such as discriminatory subsidies or taxes, could be better targeted. Monopolistic or oligopolistic rents are also sometimes seen as a means to help firms to fulfill universal service obligations through cross-subsidization. However, governments are increasingly devising means of achieving these objectives without sacrificing the benefits of competition: for example, by imposing universal services obligations on new entrants or asking for competitive bids for subsidies to serve unprofitable areas. In some cases, a form of "investment pessimism" exists, leading to the belief that promises of oligopoly rents are necessary to attract new investment. However, it is not clear why the market structure needs to be determined by policy, unless there are some initial investments the benefits of which may be appropriated by rivals. Finally, governments may seek to raise revenue (or rents for politicians and bureaucrats) by auctioning monopoly or oligopoly rights. This amounts to indirect appropriation of consumers' surplus. However, the static and dynamic inefficiencies consequent upon lack of competition would still exist.

Ideally, multilateral rules should make it difficult for governments to resort to trade restrictions to pursue objectives that are better achieved through other means. In each of the cases mentioned above, entry restric-

6. It is also difficult to provide an economic rationale for foreign equity restrictions. The incentive to transfer technology or otherwise to improve performance is bound to be less for foreign investors if they will only receive a fraction of the gain. It would, therefore, be optimal to allow full foreign ownership to prevent dilution of incentives and extract potential rents through the initial sale price. However, political concerns about foreign control probably account for the broad ownership restrictions in countries like Malaysia and the Philippines and in the incumbent firm in the telecom sector in Japan.

7. In Latin America, for example, countries that granted monopoly privileges to telecom operators of six to ten years to the privatized state enterprises saw connections grow at 1.5 times the rate achieved under state monopolies but only half the rate in Chile, where the government retained the right to issue competing licenses at any time.

tions are at best a second- or third-best instrument to achieve the objective in question, but they are chosen because of constraints such as the inability to raise revenue without economic or political cost. It will probably be difficult and not necessarily desirable to outlaw completely barriers to entry. However, it may be possible to create a legal presumption against such barriers by requiring that a country that imposes them demonstrate that they are necessary—in the sense that more appropriate instruments are not feasible. This idea is developed below.

2.3 Credibility through GATS Commitments

It is well known that the freedom to change one's mind can be a nuisance. The GATS offers a valuable mechanism to make credible commitments to policy. Failure to honor these commitments would create an obligation to compensate those who are deprived of benefits, making the commitment more credible than a mere announcement of liberalizing intent in the national context. Governments can bind current policy or commit themselves to implement liberalization at a future date.

Unfortunately, with some exceptions, not much was made of this opportunity. In general, countries made limited commitments, excluding many sectors and many modes (see Hoekman 1996; Adlung 2000). The larger East Asian economies did bind a certain level of access in segments of major services sectors like business, communication, finance, transport, and tourism, but few countries made commitments in sectors like distribution, education, and environmental and health services. Several countries in the region bound at less than the status quo, at least with respect to some aspects of their regimes. The Philippines, for example, did so with respect to foreign equity participation in commercial banks, binding at 51 percent when domestic law allows 60 percent. Korea also stopped short of reflecting in its GATS offer all the present and future liberalization commitments made at the Organization for Economic Cooperation and Development (OECD).[8]

2.3.1 Precommitment

One reason governments may be reluctant to liberalize immediately is a perceived need to protect the incumbent suppliers from competition—either because of infant industry–type arguments or to facilitate "orderly exit." The failure of infant industry policies in the past, and the innumerable examples of perpetual infancy, is attributable in part to the inability of a

8. Furthermore, under the terms of the International Monetary Fund agreement, the de facto regime with respect to foreign capital is already more liberal than the GATS offer. For instance, president Kim Dae-Jung was quoted as saying that "from now on there is no need for discrimination between indigenous and foreign capital. We are living in an era where foreign investment is more important than foreign trade" (*Financial Times,* 29 December 1997).

government to commit itself to liberalize at some future date and hence to confront incumbents with a credible deadline. One way of overcoming the credibility problem is for governments to make binding commitments under the GATS to provide market access at a precise future date.

In general, the use of the GATS as a mechanism for lending credibility to future liberalization programs has been disappointing. The telecommunications sector is an exception, however. In this sector, several East Asian governments are among those who have taken advantage of the GATS to strike a balance between their reluctance to unleash competition immediately on protected national suppliers and their desire not to be held hostage in perpetuity either to the weakness of domestic industry or to pressure from vested interests (table 2.1). Singapore and Korea have bound themselves to introduce competition at precise future dates. Indonesia and Thailand are among the countries that have made weaker commitments. Greater use needs to be made of the GATS in this respect, for there is growing evidence that reform programs that are believed are more likely to succeed.

2.3.2 Grandfather Provisions

A particularly perverse use of commitment from an economic point of view is the inclusion of grandfather provisions in the financial services schedules of some countries under negotiating pressure. The issue arose because domestic law, pertaining to foreign ownership, branching, and other rights, had changed since foreign firms first established commercial presence. For instance, Malaysia began to implement its indigenization policy after several fully foreign-owned firms were already operating in its market. The home countries of the firms were unwilling to see a dilution of what they saw as "acquired rights," whereas Malaysia was unwilling to grant the same rights to new entrants. The negotiated solution was for Malaysia to commit to preserve the rights of incumbents while offering inferior terms to new investors (see table 2.4). Where differences in ownership and legal form affect firm performance, new entrants have been placed at a competitive disadvantage. Thus, the triumph of moral over economic reasoning has meant that the GATS was used to make markets less contestable.

2.4 Regulatory Disciplines

Most of the key regulatory challenges must necessarily be addressed at the national level, and, even more than in the case of other policies, there are limits to what should and can be addressed at the multilateral level. Still, there are likely to be benefits from strengthened multilateral disciplines on domestic regulations. First of all, such disciplines are needed to enable exporters to address regulatory barriers to their exports in foreign markets. For instance, unless disciplines are developed to deal with licensing and

Table 2.4 Grandfather Provisions in GATS Schedules on Banking and Insurance Services in East Asia

Country	Provision
	Foreign Equity-Related
Indonesia	Banking and insurance: Share ownership of foreign services suppliers is bound at the prevailing laws and regulations. The conditions of ownership and the percentage share of ownership as stipulated in the respective shareholder agreement establishing the existing individual joint venture shall be respected. No transfer of ownership shall take place without the consent of all parties in the joint venture concerned.
Malaysia	Banking: Entry is limited to equity participation by foreign banks in Malaysian-owned or controlled commercial and merchant banks with aggregate foreign shareholding not to exceed 30 per cent, but the thirteen wholly-foreign owned commercial banks are permitted to remain wholly-owned by their existing shareholders. Insurance: New entry is limited to equity participation by foreign insurance companies in locally incorporated insurance companies with aggregate foreign shareholding not to exceed 30%. Foreign shareholding not exceeding 51% is also permitted when (i) existing branches of foreign insurance companies are locally incorporated, which they are required to be by 30 June 1998, and (ii) for the existing foreign shareholders of locally incorporated insurance companies which were the original owners of these companies.
The Philippines	Insurance and banking: New investments of up to 51% of the voting stock, but existing investments of foreign banks will be maintained at their existing levels.
	Legal Form-Related
Hong Kong	Banking: The condition that branches of foreign banks are allowed to maintain offices in one main building and no more than two additional offices in separate buildings, does not apply to banks incorporated outside HKSAR licensed before May 1978 in respect of fully licensed banks and before April 1990 in respect of restricted licence banks.
Indonesia	Banking: Existing branches of foreign banks are exempted from the requirement imposed on new entrants to be in the form of locally incorporated joint venture banks.
Malaysia	Insurance: Branching is only permitted for direct insurance companies with aggregate foreign shareholding of less than 50 per cent but companies are permitted to maintain their existing network of branches. (See also foreign equity-related provision above.)
Thailand	Banking: While the establishment of new branches is subject to discretionary licensing, existing foreign banks which already had the first branch office in Thailand prior to July 1995 will each be permitted to open no more than two additional branches.
	General
The Philippines	Insurance: Limitations in market access listed in the specific insurance sub-sectors do not apply to existing wholly or majority foreign-owned authorized insurance/reinsurance companies as of the entry into force of the WTO Financial Services agreement.

Source: Compiled by the author from GATS Schedules of Commitments.

qualification requirements, market access commitments in areas like financial and professional services will have only notional value. Furthermore, the development of such disciplines can play a significant role in promoting and consolidating domestic regulatory reform. The telecommunications negotiations, which led to the early institution of independent regulators in many countries, provide an example of this possibility. Finally, there is a class of problems that must necessarily be addressed at the multilateral level: the problem of international cartels in sectors like maritime transport.

2.4.1 The Case for a Horizontal Approach

One of the ironies of the GATS is that among its weakest general provisions are those dealing with domestic regulations.[9] The reason is not difficult to see: it is extremely difficult to develop effective multilateral disciplines in this area without seeming to encroach upon national sovereignty and unduly limiting regulatory freedom. Nevertheless, it is desirable and feasible to develop horizontal disciplines for domestic regulations (see also Feketekuty 2000). Such a generic approach is to be preferred to a purely sectoral approach for at least three reasons: it economizes on negotiating effort, leads to the creation of disciplines for all services sectors rather than only the politically important ones, and reduces the likelihood of negotiations' being captured by sectoral interest groups. It is now widely recognized that the most dramatic progress in the European Union single-market program came from willingness to take certain broad cross-sectoral initiatives. In the World Trade Organization (WTO) context, the experience of the accountancy negotiations shows the propensity for single-sectoral negotiations on domestic regulations to produce a weak outcome: although a valuable "necessity test" was instituted, the elaboration of disciplines on measures such as qualification requirements was disappointing.

Even if a horizontal approach is desirable, is it feasible? The diversity of services sectors, and the difficulty in making certain policy-relevant generalizations, would seem to favor a sector-specific approach. However, even though services sectors differ greatly, they have much in common in terms of the underlying economic and social reasons for regulations. Focusing on these reasons provides the basis for the creation of meaningful horizontal disciplines. The economic case for regulation in all services sectors arises essentially from market failure attributable primarily to three kinds of problems: natural monopoly or oligopoly, asymmetric information, and externalities (see table 2.5).

9. The relevant provision (Article VI) requires members not to apply licensing and qualification requirements and technical standards so as to undermine market access commitments in a manner that "could not reasonably have been expected" when the specific commitments were made. This provision may provide a defense against new restrictions but could be interpreted to mean that old regulations whose persistence could reasonably have been expected cannot be challenged.

Table 2.5 **A Multilateral Approach to Dealing with Domestic Regulations**

Market Failures	Services sectors	Multilateral Approach
Monopoly/oligopoly	Network services: transport (terminals and infrastructure), environmental services (sewage) and energy services (distribution networks)	Generalize key disciplines in telecom reference paper to ensure cost-based access to essential facilities, be they roads, rail tracks, terminals, sewers or pipelines
Asymmetric information	Intermediation and knowledge based services: financial services, professional services, etc.	Nondiscrimination and generalization of the "necessity" test. Use the test to create a presumption in favor of economically efficient choice of policy in remedying market failure.
Externalities	Transport, tourism, etc.	
Social objectives		
Universal service	Transport, telecommunications, financial, education, health	

2.4.2 Dealing with Domestic Monopolies

Market failure due to natural monopoly or oligopoly may create trade problems because incumbents can impede access to markets in the absence of appropriate regulation. Because of its direct impact on trade, this is the only form of market failure that may need to be addressed directly by multilateral disciplines. The relevant GATS provision—Article VIII, dealing with monopolies—is limited in scope. As a consequence, in the context of the telecom negotiations, the reference paper with its competition principles was developed in order to ensure that monopolistic suppliers would not undermine market access commitments (Tuthill 1997). It might be possible to generalize these principles to a variety of other network services, including transport (terminals and infrastructure) and energy services (distribution networks), by ensuring that any major supplier of essential facilities provides access to all suppliers, national and foreign, at cost-based rates.[10]

2.4.3 Other Sources of Domestic Market Failure

In all other cases of market failure, multilateral disciplines do not need to address the problem *per se*, but rather to ensure that domestic measures to deal with the problem do not serve unduly to restrict trade. (The same is true for measures designed to achieve social objectives.) Such trade-restrictive effects can arise from a variety of technical standards, prudential regulations, and qualification requirements in professional, financial, and numerous other services, as well as from the granting of monopoly rights to complement universal service obligations in services like transport and

10. Even though it would be extremely difficult to determine what cost-based rates are, the provision should at least make it possible to challenge the more egregious departures.

telecommunications. The trade-inhibiting effect of this entire class of regulations is best disciplined by complementing the national treatment obligation with a generalization of the so-called "necessity" test. This test leaves governments free to deal with economic and social problems provided that any measures taken are not more trade restrictive than necessary to achieve the relevant objective. The test is already applied to technical barriers to trade in goods and is part of the recently established "pilot" disciplines for the accountancy sector. It might make sense to go beyond the GATT precedent and to use the test to create a presumption in favor of economically efficient choice of policy in remedying market failure and in pursuing noneconomic objectives (Mattoo and Subramanian 1998). For instance, in the case of professionals like doctors, a requirement to requalify would be judged unnecessary, because the basic problem, inadequate information about whether they possess the required skills, could be remedied by a less burdensome test of competence.

The necessity test is generally seen as an additional discipline on nondiscriminatory measures. It has not been recognized that without some such test it would be difficult to apply even the fundamental disciplines of national treatment (Article XVII) and MFN (Article II), for it would be impossible to determine if a measure is in effect nondiscriminatory.[11] Both articles prohibit discrimination between *like* services and *like* service suppliers, but likeness itself is not easy to establish. If a doctor is a doctor, a regulation that imposed any additional burden on a doctor trained in Country A (abroad) than on a doctor trained in Country B (at home) would violate Article II (Article XVII). If a doctor trained in one country is deemed not to be "like" a doctor trained in another country, then the disciplines contained in the articles would simply not apply. The former interpretation may be unduly stringent and politically unsustainable; the latter is unduly permissive and would open the door to all manner of regulatory protection. The necessity test would seem to be the perfect solution. Countries are not prevented from imposing additional qualification and training requirements, but these should not be more burdensome than necessary, in the sense described above.

To conclude, the arguments in this section must not be taken to mean that there is no need for sector-specific work. Such work is necessary and should involve consumers, industry, and regulators, to help determine how best to deal with asymmetric information and differences in standards between countries in particular sectors. However, the application of a necessity test is necessary today because harmonization and mutual recognition are not meaningful alternatives—even though they can play a role at the regional or plurilateral level. The pessimism with regard to harmonization is based

11. There is no explicit mention of the necessity test in the national treatment and MFN provisions.

on the absence of widely accepted international standards in services. Where such standards exist, as in banking or maritime transport, meeting them is seen as a first step toward acceptability rather than as a sufficient condition for market access. With regard to mutual recognition agreements (MRAs), it would seem that even in strongly integrationist Europe, despite a significant level of prior harmonization, the effect of MRAs may have been limited by the unwillingness of host country regulators to concede complete control (Nicolaidis and Trachtman 2000).

2.4.4 Competition Policy: The International Dimension

The procompetitive rules developed for the basic telecommunications sector were designed to protect the rights of foreign suppliers. Is there a need for broader competition policy disciplines in the GATS to protect the interests of consumers more directly? Article IX of the GATS deals with "certain business practices of service suppliers, other than those falling under Article VIII, [that] may restrain competition and thereby restrict trade in services." However, its disciplines are weak and require little more than consultation and information sharing.

There may be a need to strengthen these disciplines. Consider one particularly important example. Maritime transport costs have a profound influence on international trade. Their persistent high level has been attributed not only to restrictive trade policies but also to private anticompetitive practices such as rate-binding agreements, primarily but not exclusively of the maritime conferences (Hummels 1999). The high incidence of such agreements is due to the fact that the United States, the European Union, and many other countries exempt shipping conferences from antitrust regulation on the grounds that they provide price stability and limit uncertainty regarding available tonnage. In the case of routes serving the United States, the exemption from antitrust law is compounded by the Federal Maritime Commission's (FMC) role in helping to police price-fixing arrangements.[12]

A recent econometric analysis suggested that although public restrictions adversely affect maritime transport costs, private anticompetitive practices have an even stronger impact.[13] Thus, it would seem that even though there has been an erosion in the power of conferences due to the entrance

12. The 1984 U.S. Shipping Act required all ocean carriers to file their rates with the FMC and publish their rate and schedule information. Secret discounting on filed rates was until recently considered illegal. The FMC was authorized to ensure, through the imposition of fines, that the filed rates were actually charged. The rationale for these measures was ostensibly to protect small shippers from being disadvantaged by their inability to extract discounts from shipping companies. Certain other aspects of U.S. maritime policy are discussed in section 2.5.

13. Fink, Mattoo, and Neagu (2000) estimate that the breakup of conference and other price-setting agreements leads to a more dramatic reduction in transport prices (38 percent) than restrictive cargo allocation policies (11 percent). The estimated potential savings from the elimination of both could be as high as one billion U.S. dollars on goods carried to the United States alone. Francois et al. (1996) and Francois and Wooton (1999) also find significant costs of public and private restrictions on trade in maritime transport services.

in the market of efficient outsider shipping companies and of a certain tightening in the law, collusive arrangements have not disappeared.[14] As recently as May 2000, the European Commission imposed fines on shipping lines serving the East Asian and U.S. routes and on those serving the transatlantic route for collusive pricing that went beyond the scope of the exemptions that had been granted.

What are the implications for policy? The negotiations on maritime transport were the only post–Uruguay Round services negotiations that completely failed. This failure implied an unfortunate loss of political momentum for reform of domestic policies and, less obviously, a lost opportunity to develop procompetitive rules. To some extent, an effort was made to develop rules that would ensure nondiscriminatory access to port services.[15] However, these rules, concerned primarily with ensuring market access, did little to protect consumers from the anticompetitive practices of international cartels. An international initiative is needed, because these practices cannot be adequately addressed only through national competition policy, given the weak enforcement capacity of small states. A further reason for developing a first best international response to these practices is to prevent recourse to an inferior national response: recall that the costly cargo-sharing schemes imposed by many developing countries were primarily a reaction to the perceived power of conferences.

One approach would be to deal with the problem by creating sector-specific competition rules, as has been attempted in basic telecommunications services under the GATS. However, if there is sufficient evidence that anticompetitive practices also affect other services sectors, such as air transport and communications, there may a need to strengthen the general GATS disciplines, that is, Article IX, dealing with anticompetitive business practices.[16] This would serve to reassure small countries in particular that the gains from liberalization will not be eroded by collusive pricing.

2.5 The Most-Favored Nation Principle

The GATS and its MFN obligation came into effect before WTO members were willing to eliminate completely discriminatory measures in services trade. The agreement therefore had to strike a difficult balance between creating meaningful multilateral disciplines and accommodating discrimi-

14. A recent change in U.S. regulation regarding international shipping, notably the Ocean Shipping Reform Act (OSRA) of 1998, allows for the confidentiality of key terms (prices are included in this category) in contracts between shippers and carriers but preserves the antitrust immunity of the rate-setting conference system.

15. In some respects, the approach to port services, which can be seen as "essential facilities" often controlled by "major" or monopoly suppliers, was analogous to the approach to basic telecommunications networks established in the regulatory principles referred to above.

16. It is also conceivable that these issues could be addressed as part of broader competition policy disciplines in the WTO.

natory trade practices. The challenge to multilateral disciplines posed by the explicit departures from the MFN obligation, such as the exceptions for regional integration agreements and the MFN exemptions listed by members, are widely recognized. However, the difficulties arising from less visible, implicit discrimination have not been adequately appreciated.

2.5.1 The Scope and Significance of Explicit Departures from Most-Favored Nation

Consider the explicit exemptions first. Around 380 MFN exemptions have been listed by some seventy members, with many members listing several exemptions in the same sector (see Mattoo 2000b, table 1). Nearly two-thirds of the exempted measures are to be found in communication services and in transport services. One reason specified for these measures is the existence of sector-specific preferential regional agreements, or other bilateral or plurilateral agreements. For instance, in audiovisual services, more than half of the exemptions mention promotion of common (regional) culture as a motive for limiting access to joint programs to finance and diffuse audiovisual works; and in maritime transport, nearly half the exemptions are by developing countries for measures implementing the provisions of the United Nations Convention on a Code of Conduct for Liner Conferences.[17] The other reason cited for exemptions is a unilaterally imposed reciprocity condition, which specifies that a member is willing to guarantee access to its market only to those members who provide it with access to their markets. These are particularly significant in air transport services and financial services.[18]

In cases in which the exemptions coexist with specific commitments (as in financial services)[19] or legitimize preferences that do not greatly affect the pattern of trade (as in cross-border supply of land transport services), there is probably not much cause for concern. Most-favored nation exemptions would seem to matter most, and be most difficult to eliminate, in sectors like audiovisual services and maritime transport, where few specific commitments have been made and discriminatory practices seem to be empirically important.

Perhaps even more important than the MFN exemptions that have been listed are those that did not need to be. The Annex on Air Transport specif-

17. These provisions, in principle, divide 80 percent of the liner trade on a traffic route between the shipping companies of the two states at each end, leaving only 20 percent for shipping companies of other nationalities. Full implementation of this rule is apparently rare, and third-country ships usually have access to a larger share of the market. Many members chose to maintain MFN exemptions despite the suspension of the obligation for the sector.

18. The exemptions listed for air transport services pertain to the services falling within the scope of the GATS, that is, repair and maintenance, selling and marketing of air transport services, and computer reservation system (CRS) services.

19. Market access guaranteed under specific commitments must be extended on a nondiscriminatory basis to all trading partners, even if an MFN exemption has been sought. The MFN exemption can provide legal cover only for better treatment for some trading partners than provided for in the specific commitments.

ically excludes the complex network of bilateral agreements on air traffic rights from GATS rules.[20] Thus, a sector that is in urgent need of liberalization remains fragmented into cozy duopolies, and prospects for progress at the multilateral level are dim. One source of hope is the increasing agreement among WTO members to push for the liberalization of a cluster of services related to tourism. Excluding air transport from this initiative would be like leaving the Prince of Denmark out of a certain play.

The U.S. exemption in maritime transport was more like Banquo's ghost: it was not explicitly listed—because the MFN obligation was suspended for the sector—but had a completely disruptive effect on the negotiations.[21] The United States did not believe that the quality of its trading partners' market-opening commitments justified giving up its right to take retaliatory action against foreign restrictive practices. One way of making progress in the current round is to bundle transport negotiations together and focus on the liberalization of multimodal transport, a central concern of U.S. industry. Also, the development of competition disciplines, along the lines suggested above, would help to address the anticompetitive practices that the United States believes impede access to foreign markets.

The other main departure from MFN is the provision (Article V) for economic integration agreements, which allows any subset of WTO members to liberalize trade in services among themselves under certain conditions. This provision is broadly modeled on the corresponding provision in the GATT. The agreements that have been notified so far include those establishing the North American Free Trade Agreement (NAFTA), the European Communities, and their member states; their agreements with the Slovak Republic, Hungary, Poland, the Czech Republic, Romania, Norway, Iceland, Liechtenstein, and Bulgaria; and agreements between Canada and Chile and between Australia and New Zealand.[22]

There is an important question of whether regional and other preferential agreements are capable of achieving deeper and more effective liberalization of services, and whether they would contribute to or impede further multilateral liberalization. A discussion of the role of these agreements and the possible reform of the relevant GATS rules is beyond the scope of this paper (see Stephenson 2000). The paper concentrates on

20. International air transport services are for the most part governed by arrangements negotiated under the Chicago Convention (i.e., the International Air Services Transit Agreement, done at Chicago, 7 December 1944).

21. The original U.S. MFN exemption for maritime transport services reserved the "right to investigate and take action against foreign carriers to address adverse or unfavourable actions affecting United States shipping or United States carriers in United States oceanborne commerce and the cross trades between foreign ports."

22. A related exception from the MFN rule, for the movement of natural persons, is permitted by Article V bis of the GATS. This allows countries to take part in agreements that establish full integration of labor markets. The only such agreement notified so far is the one involving Denmark, Finland, Iceland, Norway, and Sweden.

the narrower issue of the economic and legal implications of discrimination in services, where the instruments of protection are domestic regulations and quotas.

2.5.2 Discrimination through Domestic Regulations and Quotas: Economic Considerations

The consequences of discrimination between trading partners through taxation (or duties) are well understood. Does discrimination through domestic regulations and quotas raise new analytical issues from the economic and legal point of view?

When tariffs are the instruments of protection, the costs of trade diversion for the importing country may be an important deterrent to preferential liberalization agreements. Despite the increase in consumers' surplus from any liberalization, governments may nevertheless be averse to such agreements because the displacement of high-tariff imports from third countries by low or no-tariff imports from preferential sources implies lost revenue. The same reasoning also applies to other regulations that imply a transfer from foreign suppliers to domestic interest groups. However, the situation is different when the protectionist instrument is a regulatory barrier that imposes a cost on the exporter without yielding a corresponding revenue for the importing government or other interest group. There is then no cost to the country granting preferential access because there is no revenue to lose. The same is true in the case of quotas when the rents were either dissipated or appropriated by foreign suppliers. Therefore, in these cases, preferential liberalization is necessarily welfare enhancing for the importing country—as well as for the exporting country that obtains improved access.[23]

However, if third countries supply the market in question, they lose because prices decline due to increased sales from the preferred source. The impact on global welfare depends on the nature of regulatory measure. If it generates no revenues or rents, then global welfare will increase. In effect, exempting some suppliers from the measure reduces their costs and leads to a reduction in price in the importing country. The gain to consumers from any decline in price is necessarily greater than the loss to a subset of suppliers. This suggests that multilateral rules should take a more tolerant view of preferential arrangements like recognition agreements that help eliminate wasteful duplication (e.g., of training) and are therefore global welfare–enhancing. However, we must not lose sight of the fact that nonpreferential liberalization would enhance welfare even more because the service would be supplied by the most efficient locations.

23. This reasoning does not take account of the fact that there may be greater spillover benefits (e.g., relating to technology) arising from trade with certain partners than with others.

2.5.3 Legal considerations

Recognition Agreements

Recognition agreements are like sector-specific preferential arrangements and can have similar trade-creating trade-diverting effects. Their result may well be to create trade according to patterns of mutual trust rather than the pattern of comparative advantage. The interpretation of the GATS provision on recognition (Article VII) is, therefore, likely to be of considerable importance. The provision attempts to strike a difficult balance. On the one hand, it is permissive and allows a member at any point of time to recognize the standards of one or more members and not of others. On the other hand, it seeks to ensure that this freedom is not abused by prohibiting the use of recognition as a means of discrimination and requiring a member who enters into a recognition agreement (RA) to afford adequate opportunity to other members to negotiate their accession to such an agreement or to negotiate comparable ones. In this respect, Article VII mandates an openness vis-à-vis third countries in a way that Article V, dealing with economic integration agreements, does not.[24]

How can it be established whether acceptance of some standards and not others is discriminatory? The approach discussed with regard to domestic regulations is also applicable here. Making distinctions between services and service suppliers in the pursuit of certain domestic policy objectives, such as to ensure the quality of professional services, financial stability, and competitive market conditions, is economically sensible. It would, therefore, be desirable to allow members the legal freedom to pursue such objectives but to discipline the exercise of such freedom by ensuring that the choice and level of instruments is not more burdensome than necessary—with economic efficiency considerations playing a role in this assessment. The text of Article VII does not contain an explicit necessity test, but, as in the case of the MFN and national treatment obligations, it is difficult to see how the provision can be given meaningful content without the inclusion of such a test.

Nondiscriminatory Allocation of Quotas

One central legal issue in the GATS, which has received surprisingly little attention, is how quotas are to be allocated in a manner consistent with the

24. Article V on integration agreements does not explicitly preclude RAs, and several countries (such as Australia and New Zealand) have chosen to notify their RAs under this provision. It would seem desirable to establish that Article VII, with its desirable nondiscriminatory and open-ended nature, overrides Article V of the GATS as far as RAs are concerned. This interpretation would help to generalize the liberalizing impact of RAs, for although an RA amounts to an acceptance of likeness vis-à-vis suppliers from a particular country, it also defines the appropriate standard of treatment vis-à-vis suppliers from other countries.

nondiscrimination obligation. In the past, this was not a major issue because commitments reflected the status quo, and the quotas, particularly with regard to service suppliers, were descriptions of the existing market structure.[25] In the future, however, as genuine liberalizing commitments are made, the nondiscriminatory allocation of quotas is bound to be an important issue. For instance, it has been reported that China, as part of its accession negotiations, promised the European Union that its firms would be granted a specific number of licenses in the insurance sector. How is this assurance to be reconciled with the MFN obligation?

The goods precedent offers limited guidance. General Agreement on Tariffs and Trade Article XIII, on the "nondiscriminatory administration of quantitative restrictions," requires aiming at a distribution of trade approximating the shares that countries might be expected to have in the absence of such restrictions or supplied during a previous representative period. In the services context, the requirement to replicate historical shares may have no relevance if there was no previous foreign presence, or it may perpetuate historical discrimination if previous quotas were allocated to favored suppliers.[26]

More appropriate candidates for a nondiscriminatory allocation of quotas would seem to be first-come, first-served rule (e.g., a large number of work permits are being issued) or a system of auctions to the highest bidder (e.g., a few telecom licenses are being issued). Neither rule would necessary lead to distributions that "might be expected to obtain in the absence of such restrictions."[27] It would seem, therefore, that the rules for ensuring nondiscriminatory allocation of quotas under GATS would need to look beyond the GATT precedent. It is possible that a less elaborate variant of the disciplines in the Agreement on Government Procurement, designed to ensure competitive tendering on a nondiscriminatory basis, will need to be considered.

2.6 Reviving Reciprocity?

Reciprocity has been a central principle governing GATT/WTO negotiations: one country reduces its level of protection in return for a reciprocal

25. Thus, when Bangladesh committed to "four licenses issued" in cellular telephony, the ambiguity in the choice of tense was not an accident: the licenses in question had already been issued.

26. In the Bananas Case, the European Union's method of allocating import licenses for bananas from certain sources was found to be inconsistent with Article II because it reallocated quotas and quota rents away from the importers who traditionally imported from these sources (see paragraphs 7.350–7.353 of the Panel Report). In a sense, the panel's reasoning followed the logic of GATT Article XIII.

27. It is obvious that first-come, first-served favors the proximate. Auctions would give the relatively efficient producers larger shares than they would have obtained in the absence of quotas (when quotas are set at below unrestricted trade levels). Jackson (1997, p. 140), however, notes that first-come, first-served and auctions would seem to fulfill the MFN obligation, and refers to the Article XIII reliance on historical patterns as a "quasi" MFN principle.

reduction by its trading partner.[28] While reciprocity-based negotiations are widely credited with the substantial reduction in levels of protection achieved in goods trade, it is surprising that the limited application of the principle has not conversely been seen as the reason for the disappointing results in services trade.

The GATS had a deliberately symmetric structure. In principle, there was scope for developed and developing countries to exploit their modal comparative advantage: improved access for capital from developed countries being exchanged for improved temporary access for individual service providers from developing countries. In practice, there was little political will to improve access for foreign individuals (except for the limited class of skilled intracorporate transferees), and a trade-off between modes of delivery simply did not take place. Moreover, even the negotiating links across services sectors and between services and goods sectors do not seem to have been particularly fruitful. Thus, the GATS commitments reflect for the most part the existing levels of unilaterally determined policy rather than liberalization achieved through a reciprocal exchange of "concessions."

It might well be that reciprocity cannot and will not play a major role in services trade. Services liberalization could for the most part be undertaken unilaterally, and the GATS would be important only in preventing its reversal—that is, in its credibility role (see Hoekman and Messerlin 2000). Indeed, for countries that are either determined to liberalize or determined to protect, negotiations are not important. However, for countries in the middle ground, who are open to reform but whose ability to implement reform is constrained by domestic opposition, multilateral negotiations can be useful. Many developing countries are today in this situation, and a wider application of the principle of reciprocity may deliver greater liberalization and more balanced outcomes.

2.6.1 Facilitating Reciprocity across Modes

A collective commitment to the use of appropriately designed formulas offers the best chance of linking different modes of delivery.[29] Such formulas can also help overcome concerns about free-riding that arise in an MFN-based system. But is it technically feasible to link concessions across

28. This emphasis on achieving a "balance of (liberalizing) concessions" has led to the perception of WTO negotiations as a mercantilist process driven by political forces that nevertheless leads to the desirable outcome of reduced levels of protection. In effect, reciprocity serves to mobilize the support of export interests to counterbalance the protectionist interests of import-competing firms and workers. In an important recent paper, Bagwell and Staiger (1999) show that reciprocity can be seen as neutralizing the adverse terms of trade effects associated with unilateral reductions in protection, and it therefore leads to greater liberalization.

29. Developing countries have resisted this option, preferring the use of a request-and-offer approach. Their reluctance stems from defensive considerations and a belief that they would be obliged to concede excessively high levels of openness if a formula approach were adopted.

modes (see Sapir 1998 and Thompson 2000)? One simple option is to take advantage of the current political pressure for accelerated liberalization in selected sectors, such as environmental services. This approach could be accepted on the condition that there was no gerrymandering: that is, all countries would liberalize access in all modes, including the movement of individuals. Environmentalists and environmental service exporters could then be relied on to counter the opposition of employees and individual suppliers in the domestic environmental industry. Furthermore, with severe shortages of skilled labor in the United States and Europe and the powerful constituency of high-technology companies lobbying for relaxation of visa limits, the prospects for serious intermodal trade-offs—such as obtaining labor movement in return for allowing greater commercial presence for foreign service providers—are now greater.

An alternative way of creating a link between modes is by requiring each country to provide increased "foreign labor content entitlements" to its domestic firms in relation to the country's increased exports of services (Mattoo and Olarreaga 2000a). Entitlements would be global rather than bilateral, and the extent and pattern of use would be determined by sound economic considerations of modal comparative advantage. Some of the social and political difficulties could be overcome by clarifying that liberalization is only with respect to temporary movement of service suppliers and does not imply migration. Establishing clear links between increased exports and increased foreign labor content entitlements may also help make the political case. The presence of foreign workers would be seen as a direct consequence of increased opportunities for export abroad, and also as contributing to the increased competitiveness that makes it possible to exploit these opportunities.

2.6.2 Reciprocity within Modes across Sectors

It would be wrong to suggest that reciprocity must necessarily take an intermodal form. There may, for instance, be scope for cross-sectoral reciprocity in the same mode. Trade in electronically delivered products—falling within the scope of cross-border supply—is of growing importance and offers an increasingly viable alternative to the movement of individuals. If the United States can supply financial and audiovisual services to the Philippines electronically, the Philippines in turn can supply software development and data processing services to the United States. Fortunately, most electronic commerce is already free of barriers, and so the main concern should be preventing the introduction of new barriers if they ever become technically feasible. Members of the WTO have so far focused on prohibiting the imposition of customs duties on electronically delivered products. Because the bulk of such commerce concerns services, open trading conditions are more effectively secured through deeper and wider commitments under the GATS on cross-border trade regarding market access

(which would preclude quantitative restrictions) and national treatment (which would preclude all forms of discriminatory taxation).[30] One possible formula would be for all members to agree that no restrictions would be imposed on cross-border delivery, either of all services or of a bundle whose composition could be negotiated.

2.6.3 Remedying the Hold-Back Problem through a Credit Rule

One undesirable aspect of an emphasis on reciprocity is that it creates the temptation to hold back from unilateral liberalization. This is why most economists view reciprocity with suspicion. This hold-back problem can be overcome, however, by rules which create an *ex ante* assurance (at the end of a round of negotiations) that credit would be given in future rounds of negotiations for unilateral liberalization undertaken between rounds. The impulse to liberalize unilaterally then need not be inhibited by the fear of loss of negotiating coinage. The proposed rule is different from the demands for credit that are typically made at the *beginning* of a new round of negotiations. The acceptance of such demands would have only a distributional effect, favoring those who have already undertaken liberalization, and the granting of such credit relies on the unlikely generosity of those who have not liberalized. The proposed *ex ante* assurance of credit rule has three virtues:[31] it would help induce or enhance liberalization in some countries between negotiating rounds; more striking, it could also lead to deeper levels of multilateral liberalization and force other countries to go further than in the absence of a rule; and, most important, such a rule does not rely on altruism to be generally acceptable.

Article XIX:3 of the GATS requires that in each future round "modalities shall be established" for the treatment of liberalization undertaken autonomously by members since previous negotiations. In principle, this is precisely the type of *ex ante* assurance of credit that would be desirable. However, the nebulousness of the provision and the postponement of the establishment of modalities suggest that in practice the provision may provide little more than a basis for *ex post* demands for credit. One way of giving the rule operational content is by establishing that any agreed liberalizing formula would be applied not to current actual levels of protection but to the levels bound in the previous round of negotiations.[32]

30. There is considerable scope for an improvement in commitments. For instance, in software implementation and data processing, of the total WTO membership of over 130, only 56 and 54 members, respectively, have made commitments; only around half of these commitments guarantee unrestricted market access, and a similar proportion guarantees unqualified national treatment. It is particularly striking that in the core banking services in which around 75 WTO members have made commitments, about one-third of the developing countries guarantee unrestricted cross-border supply, whereas only one out of the ten developed countries does so.

31. The alternative rules are discussed more fully in Mattoo and Olarreaga (2000b).

32. This suggestion was in fact contained in a proposal from Brazil submitted just before the Seattle Ministerial.

2.7 Conclusions

"Reveal and bind all trade-restricting measures." "Make national treatment a general obligation." It would be tempting to make such clear and powerful proposals, but it would not be realistic or useful. The GATS is here to stay in its present form, and radical reform will not occur in this round of negotiations—nor, probably, in the next. Those who think that this is unduly conservative need only take a closer look at the negotiations in the Working Party on GATS rules. The results of five years' work on subjects such as safeguards, subsidies, and government procurement are no more tangible than the emperor's new clothes. In defense of the GATS, however, it must be recognized that it took about a half century to reduce goods barriers, and there is still a distance to go. Additionally, of course, agriculture was exempted from the GATT negotiations until the Uruguay Round and continues to pose special problems. Thus, a fairly long time horizon is probably needed to achieve meaningful liberalization in services because of the difficulty in overcoming resistance by deep-rooted vested interest in many countries.

It seemed more constructive, therefore, to take a close look at the existing provisions of the agreement and make precise proposals on how they can be improved. The main conclusions are the following:

- Wasteful regulations and entry restrictions pervade services trade. Unlike the GATT, the GATS has created no hierarchy of instruments of protection, although the analysis here suggests that the ranking of instruments in the case of both goods and services is similar. Although it may not yet be politically feasible to impose the same hierarchy as in goods, an attempt should nevertheless be made to create a legal presumption in favor of instruments (such as fiscal measures) that provide protection more efficiently.
- Greater advantage must be taken of the valuable opportunity offered by the GATS to lend credibility to reform programs by committing to maintain current levels of openness or by precommitting to greater levels of future openness.
- Multilateral rules on domestic regulations can play an important role in promoting and consolidating domestic regulatory reform, even when they are primarily designed to prevent the erosion of market access commitments. It would be desirable to generalize the application of procompetitive principles developed for basic telecommunications to other network-based services sectors and the application of the "necessity test" instituted for accountancy services to regulatory instruments in all sectors.
- Anticompetitive practices could be important in sectors like maritime, air transport, and communication services. Because these practices

cannot be adequately addressed through national competition policy, given the weak enforcement capacity of small states, GATS rules in this area must be strengthened.

- Explicit departures from the MFN rule matter most in sectors like maritime transport, audiovisual services, and air transport services—which have been excluded from GATS disciplines. Progress will not be easy, but bundling sectoral negotiations together (e.g., in transport) may help. It is also necessary to develop rules to ensure the nondiscriminatory allocation of quotas and to maintain the desirable openness of the GATS provision covering mutual recognition agreements.
- If the GATS is to advance the process of services liberalization beyond levels undertaken independently and lead to more balanced outcomes from the developing country point of view, then reciprocity must play a greater role in negotiations. This may be facilitated by devising negotiating formulas that establish credible links across sectors (both goods and services) and across modes of delivery. To overcome a possible hold-back problem, it is necessary to provide credible *ex ante* assurance of negotiating credit for unilateral liberalization.

Finally, three sets of issues have been neglected by this paper: How can the provisions of the GATS and the schedules of commitments be made clearer and more accessible? What rules should be developed for safeguards, subsidies, and government procurement? What form do preferential agreements in services take, and how can GATS rules for such agreements be improved? Some work has been done in each of these areas, but there is need for much more research (see Sauvé and Stern 2000).

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Comment Anne O. Krueger

This is an excellent paper and well worth careful reading. It addresses the issues and challenges that confront successful multilateral negotiations to liberalization of trade in services, yet neither gives way to despair nor insists upon politically infeasible solutions (such as national treatment with no barriers to foreign services or services providers).

Efforts to liberalize trade in services are increasingly important as services trade increases even more rapidly than trade in goods, paralleling the increasing share of modern services in the economies of the industrialized countries. However, the difficulties of negotiating liberalization are formidable: whereas barriers to trade in goods were traditionally border measures (tariffs, quotas, etc.) that were reasonably comparable across goods (one could always estimate the tariff equivalent of quotas and surcharges on imports), trade in services is restricted through a variety of measures—licensing of financial intermediaries, imposition of quality and standards regulation of services providers, regulations governing foreign direct investment in service sectors in which domestic presence is essential to trade, and restrictions on access (as with airplane landing rights and control over port access).

As Mattoo points out, there is good reason to believe that a global multilateral deal could be struck between capital-exporting industrialized countries who want access to developing country markets for their capital-intensive services and labor-abundant developing countries, who could profitably export unskilled labor–intensive services if temporary entry were granted to foreign workers for work on such services as construction.

A key issue, as Mattoo recognizes, is how much can be achieved by cross-sectoral negotiations. Some observers, noting the different types of barriers to entry in different service sectors, have concluded that sector-specific negotiation (such as happened in telecoms) is the only way forward. However, the difficulties with this are well known and deserve repetition here. The genius of the General Agreement on Tariffs and Trade and the World Trade Organization has been in achieving cross-sectoral tying in such a way that countries were willing to give up protection of some items in return for re-

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duced trade barriers (tariffs) in other sectors. Clearly, there are some activities in which liberalization is desirable, with or without a quid pro quo, that will take place unilaterally. In other cases, protection has such strong political backing that it will not be removed even with multilateral bargaining. In between, however, lie a host of protectionist measures that would or could be reduced given sufficient incentives (in the form of reciprocal reduction of other services barriers to the country's exports). Most of these in-between cases—which is what the multilateral tariff negotiations enabled for trade in goods—can be traded off only against reduced protection in other sectors.

Hence the need for cross-sectoral negotiations. Some things, Mattoo notes, can be done. Finding a least-cost way to achieve domestic objectives and showing the necessity of a barrier can help. However, Mattoo seems to despair of finding any uniform metric to enable formula-based negotiations (such as was finally possible in agriculture with the development of the producer-subsidy-equivalent measure). This, it seems to me, is too pessimistic. To be sure, we do not have such a metric yet, but the tariff equivalent of existing protection on maritime services, barriers to entry of insurance or legal firms, and others may be estimable. Surely, as economists, we should keep trying to find acceptable ways of quantifying these barriers.

Finally, I wonder whether things are quite as bleak for services as Mattoo paints them. We do have the General Agreement on Trade in Services, and some barriers are listed and therefore bound. Perhaps in a next round countries could agree to list all remaining service barriers and to bind them to those (or even lower) levels. Further, there might be an agreement to eschew imposing barriers on new services. Perhaps we could even begin to develop a regime for some temporary movement of workers to provide services in exchange for removal or relaxation of ceilings on the percentage ownership of foreigners in some or all service industries.

That said, there are a great many constructive suggestions in Mattoo's paper. Let us hope that they, at least, can influence the next round of multilateral trade negotiations.