

Services trade negotiations — what's in it for East Asia?

Philippa Dee

Asia-Pacific School of Economics and Government

Australian National University

philippa.dee@anu.edu.au

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1 Introduction

In the current Doha Round of trade negotiations, East Asia is being asked to contemplate significant liberalisation of services trade. Yet many countries are cautious. They perceive themselves as having relatively few ‘offensive’ interests outside tourism and the movement of natural persons, and fear that concessions in ‘defensive’ areas would see their services sectors overrun with foreign multinationals, to the detriment of indigenous firms. East Asian economies have been strongly in favour of developing an emergency safeguard mechanism in services to protect against this outcome, and are reluctant to make any concessions in advance of that development.

Recent empirical research undertaken for the World Bank and elsewhere has examined the extent to which these fears are warranted. It has highlighted that there is more to services trade liberalisation than the traditional ‘offensive’ (read export) and ‘defensive’ (read import) interests that dominate negotiations in goods trade. Also up for negotiation are non-discriminatory trade barriers that impede the performance of indigenous firms as well as multinationals. This changes the game in important ways. The research has identified situations in which East Asia’s policy caution might be warranted. But it has also pointed to where win-win outcomes might occur.

This note first summarises what the research shows about the economic effects of full services trade liberalisation — both its gains and its adjustment costs. It then discusses an example of what can be achieved in multilateral negotiations, by looking at the effects of Vietnam’s WTO accession offer in services. Finally, it looks at the likely outcome of services trade negotiations in the context of preferential trade agreements.

2 Potential gains from full services trade reform

There are three potential sources of gain from full services trade reform.

There are potential benefits from greater foreign participation in the local economy. For example, research suggests that Malaysia’s tight controls on foreign entry and operations in banking are inflating the cost of banking services. Loosening these and other restrictions could reduce banking charges in Malaysia by over 30 per cent (Dee 2004a). Similarly, loosening the remaining foreign equity limits in ports and local shipping in Vietnam would do much to improve the quality of its poor infrastructure base in this area.

Second, there are benefits from removing general regulatory impediments that impede the operations of locally-owned businesses as well as foreign operators. For example, research suggest that the numerous restrictions on private sector participation in wholesale and retail trade in Vietnam could have raised real resource costs in the sector by about 9 per cent (Dee, Duc and Hiep 2005). Given the size of the distribution sector, and its key role in facilitating the exchange of goods and services throughout the economy, these restrictions would impose a significant economy-wide cost.

Third, there are benefits from regulatory reforms that promote competition among both locally-owned and foreign businesses, especially where such competition can encourage market participants to find new, lower cost ways of doing business. For example, experience elsewhere suggests that there are significant cost savings to be had from finding ways to encourage genuine market competition among electricity generators. Reforms to Thailand's regulatory regime in electricity generation that would encourage such competition could reduce the costs of electricity generation by up to 11 per cent (Dee 2004b).

The gains to Malaysia and Thailand from unilateral services trade reform are projected to far exceed those from unilateral reform in agriculture or manufacturing (Dee 2004a, 2004b). This is despite the measured tax equivalents of the barriers to trade in services being lower than some of the average tariff rates in agriculture and manufacturing in these countries.

The research shows the sources of the greater gains from removing barriers to services trade (figure 1). Some services trade barriers are tariff-like. They raise prices because they allow markups to be inflated, creating rents for incumbent firms. Removing these rent-creating barriers is like removing tariffs. It tends to generate a relatively large transfer from producers to consumers, and a relatively small net gain in allocative efficiency to the economy as a whole. Other services trade barriers raise prices because they raise the real resource cost of doing business. Removing these cost-escalating barriers frees real resources for use elsewhere, generating a relatively large net gain all round. As shown in figure 1, the economy-wide gains from productivity improvements are significant, far exceeding those from better allocative efficiency.

Further, services trade reform often yields a terms of trade gain rather than a terms of trade loss. This is a secondary effect, since services trade reform has its first round effect primarily on domestic prices and costs. But the resulting increase in demand by other countries for imports can sometimes give a country a significant indirect terms of trade gain.

Services trade reform generates a positive endowment effect, like tariff reform, because it encourages inward FDI and generates higher capital stocks. Somewhat surprisingly, Malaysia also has a very small positive welfare contribution from international rent and interest payments. Here there are two offsetting affects. Greater FDI entails greater profit repatriation overseas by foreign multinationals operating in Malaysia. But the profits that are repatriated overseas no longer contain a super-normal rent component, so Malaysia gains in relative terms on this score.

Overall, therefore, full unilateral reform of services trade raises more of the contributors to welfare than does unilateral liberalisation of agricultural or manufacturing protection. Removing barriers to services trade would seem to be a higher priority than removing barriers to agriculture or manufacturing, although this conclusion does not yet take into account the possible adjustment costs associated with the different types of reform.

Negotiating priorities in services

The research also suggests that the gains to removing non-discriminatory barriers to market access are at least 75 per cent of the total gains from services trade reform in these countries, while the gains to removing derogations from national treatment are at most 25 per cent of the total gains. Part of the reason is that some of the greatest barriers are market access barriers. But part of the reason is that removing national treatment barriers alone can produce second best economic welfare losses in some sectors.

Thus the gains from removing non-discriminatory market access restrictions dominate, especially in the less trade-oriented economies. This is an important finding, since trade negotiators trained in the field of goods trade typically put highest priority on derogations from national treatment.

Sectoral priorities in services

The research examines services trade reform in seven different services sectors — air passenger transport, banking, distribution, electricity generation, maritime (reform of port services), the professions, and telecommunications. Among the sectors examined, the policy priorities would appear to be in distribution and the professions (part of business services nec), both because these sectors are large, and because there is at least some evidence that the trade barriers in these sectors are cost-escalating, at least in part. Reform of the professions may also appear to

be a priority because the barriers in that sector were seen as affecting both commercial presence and cross-border trade.

These conclusions follow from figures 2 and 3, which show the *percentage* contribution of each sector to the overall gain from removing services trade barriers, relative to the *percentage* contribution of each sector to the total value added generated in the seven sectors.

Reform in air passenger transport and electricity generation could also yield significant welfare gains, not because these sectors are large, but because the barriers tend to be cost-escalating, generating a bigger ‘bang for the buck’.

The projected gains from services trade reform in banking and telecommunications are small, partly because these sectors are small, and partly because the barriers are primarily rent-creating. The gains to removing barriers in sea transport are generally small, partly because the sector is small, and partly because the barriers in port services are small.

Adjustment costs

A positive overall welfare gain from services trade reform means that, *if the gainers were to compensate the losers*, none would be made worse off, and at least some would be made better off. In these circumstances, one would expect a consensus in favour of reform.

However, political processes do not always operate to ensure that the gainers compensate the losers, and even if such compensation takes place, it may occur only at a considerable political cost. Thus it is important, not just to identify sources of overall welfare gains, but also to identify where losses do occur, and to identify strategies to minimise the losses to particular groups while maximising the gains overall.

The research shows that in one sense, the political economy of services trade reform is distinctly different to that of tariff reform — when tariffs are removed, the liberalised sector is smaller than otherwise; when services trade barriers are removed, the liberalised sector can often be larger than otherwise. This is a function of two things. First, non-discriminatory barriers to market access tend to be more important than the discriminatory derogations from national treatment, so the main effect of reform is an expansion in overall supply, rather than a switch from domestic to foreign suppliers. Second, while reform of cross-border trade

might be a factor moving activity offshore, there is simply not much cross-border trade in many services sectors that is heavily impeded.

The research also suggest that when a services sector expands, it may be from the expansion of both domestically-owned firms and foreign multinationals. This is despite trade barriers in some services sectors that discriminate heavily against foreign multinationals relative to domestically-owned firms, and provision in the modelling work for consumers and users to switch towards foreign multinationals as the margin of discrimination against them is removed. Nevertheless, non-discriminatory trade barriers also penalise domestically-owned firms, and under the total reform scenarios, many are projected to gain.

The single most important feature accounting for the direction of movement of downstream using industries is the presence of economy-wide resource constraints. The downstream using industries benefit from cheaper services, but lose out to the services sector itself in the competition for skilled and unskilled labour. To some extent, the availability of more capital through greater capital accumulation can alleviate this constraint, but not entirely. The overall outcome is that the non-services sectors tend to lose in *relative* terms from the removal of barriers to services trade.

The resulting adjustment costs depend primarily on whether those *relative* moves in output translate into *absolute* expansions or contractions over time. A simple comparison of the modelling results with historical growth rates suggests that after full services trade reform, the worst affected industries would simply be growing more slowly than otherwise, rather than contracting in absolute terms. The adjustment costs are likely to be limited accordingly.

The employment effects mostly follow from the output effects, except where reform of cost-escalating trade barriers leads to significant productivity gains, freeing resources for use elsewhere. The downside cost of this is a significant additional reallocation (in relative terms) of skilled and unskilled labour.

But again, the research suggests that at least some of these adjustment pressures could be absorbed by maintaining healthy rates of overall economic growth. In Thailand, for example, a growth rate of just 2.6 per cent a year would be sufficient to ensure that the employment pressures translated into a slower rate of employment growth in the worst affected sectors, rather than an absolute contraction in employment. The comparable figures are 2.0 per cent in Vietnam, and less than half a percent in Malaysia.

3 What do multilateral trade forums deliver?

The research suggests there are significant gains from full services trade reform, and that associated adjustment pressures could be relatively easily managed with healthy underlying rates of economic growth. But what do multilateral trade forums deliver? One recent example is Vietnam's recent WTO accession negotiations in services (Dee, Duc and Hiep 2004).

Vietnam's recent WTO accession offer in services largely involves multilateralising the measures it took under the US-Vietnam Bilateral Trade Agreement a few years earlier. In order to protect perceived Vietnamese interests in the professions, Vietnam has also instituted new measures, such as requiring at least five trained professionals in each accounting firm. This will limit the way in which newly-trained professionals, whether Vietnamese or foreign, can establish and grow their business.

Vietnam's recent offer is largely restricted to liberalising measures that limit foreign participation. Examples are the lifting of limits on foreign equity participation in banking, distribution, legal services and telecommunications, allowing foreign banks to accept Vietnamese currency deposits and issue credit cards, allowing foreign distribution firms to establish a first outlet as of right (without an economic needs test), and allowing foreign auditing companies to provide auditing services to State-owned enterprises.

Many of these restrictions, especially in banking and telecommunications, appear to have had the effect of creating rents for incumbent firms, rather than raising real resource costs. So the main result of liberalising these measures is projected to be reallocation of rents from incumbents to new foreign entrants, with relatively small benefits in terms of lower service prices to Vietnamese consumers, and trivial net benefits to the Vietnamese economy as a whole. Further, the liberalisation is projected to very slightly penalise Vietnamese-owned businesses, relative to the situation had no liberalisation occurred.

Nevertheless, the accession offer is significant because its commitments would be *bound* — Vietnam would be making a legally binding commitment not to renege on these commitments in the future. Such bindings have value, over and above the benefits of any actual liberalisation, in part because they reduce the uncertainty faced by Vietnam's trade and investment partners.

However, the accession offer could readily be made much more valuable, first by removing elements in it that appear to be backward steps relative to the status quo,

and secondly by combining it with additional commitments to attack some of the non-discriminatory measures that impede both Vietnamese-owned and foreign operators.

There are two apparently backward steps in the recent accession offer. As noted, the first is a requirement for accounting firms to have at least five people with professional qualifications. Another is a requirement that, for two years after their establishment, foreign architecture and engineering firms can only serve foreign clients. An amended WTO accession offer that excluded these provisions would yield slightly bigger gains.

The research also examines the effects of combining this amended WTO offer with additional unilateral regulatory reforms. These include regulatory reforms that would encourage competition among both locally-owned and foreign operators in air passenger transport and electricity generation. Such pro-competitive reforms could encourage better performance throughout these two sectors. Further, they would do so at least in part by lowering the real resource cost of doing business. As such, they would generate significant economy-wide gains.

Additional unilateral measures that are quantified included further land reform, which could allow a wider range of services to be offered in banking and more investment certainty in distribution services, and an improvement in organised crime and corruption on the waterfront. Additional measures that are not quantified, but would likely yield significant gains, are the lifting of remaining foreign equity restrictions in port and regional shipping services, as a way of upgrading the quality of Vietnam's infrastructure in these areas.

Even on the basis of the gains that are quantified, the benefits to the Vietnamese economy from combining the amended WTO offer with further unilateral reforms would be substantial. It is projected that, after an adjustment period of about ten years, Vietnamese residents would be better off than otherwise by around \$US 240 million per year as a result of undertaking these reforms, compared to the situation at the same point in time if the reforms were not undertaken. This would be over half the gains from complete liberalisation in the seven sectors considered.

The pro-competitive reform of regulations governing electricity generation would contribute almost 40 per cent of this total gain. This reflects the strong economy-wide gains to reforms that would reduce real resource costs, and the downstream benefits of lower electricity prices to manufacturing and other sectors.

Reform in wholesale and retail trade would account for another 40 per cent of the total gain. This sector is large, so even quite modest reforms that reduce cost-raising trade barriers on a non-discriminatory basis (so that the reforms benefit Vietnamese-owned as well as foreign-owned businesses) can have pervasive effects.

When the reforms are sufficiently widespread (as when the amended WTO accession offer is combined with additional unilateral reform), the modelling suggests that they can benefit Vietnamese-owned firms as well as foreign affiliates. This is consistent with Vietnamese-owned businesses being able to largely retain their niche markets in the face of further foreign entry. Thus, while foreign banks may specialise in serving foreign affiliates in manufacturing, Vietnamese banks can continue to dominate in providing loans to Vietnamese-owned businesses, and increasingly, in providing consumer products to Vietnamese families. The modelling results confirm that when reforms are sufficiently widespread, and aimed sufficiently at measures that affect Vietnamese-owned businesses as well as foreign operators, then no special additional measures are required to protect Vietnamese interests.

The reforms considered do not appear to jeopardise overall employment levels. On the contrary, because many of the reforms encourage additional foreign investment, they raise the productive capacity of the economy and increase the demand for both skilled and unskilled labour. This confirms the relatively orderly nature of services trade reforms.

4 *What do preferential trade agreements deliver?*

Almost by definition, preferential trade agreements (PTAs) are typically restricted to liberalising measures that discriminate against foreign service providers.

Firstly, regional trade agreements tend to be preferential. Even though many services trade barriers could be liberalised on a non-preferential basis, in practice recent PTAs have tended to do one of two things in services and other ‘new age’ areas — either bind the status quo, or make concessions on a preferential basis, even when logic suggests they could sensibly be made non-preferentially. One very clear reason for this outcome is that countries that have strong ‘offensive’ interests in the Doha round are unlikely to give away negotiating coin by making defensive concessions on a non-preferential basis within a PTA, prior to a Doha Round settlement.

Partly as a corollary, recent PTAs have tended to target only those provisions that explicitly discriminate against foreigners. This is because, in many cases, the only provisions that can feasibly be liberalised on a preferential basis are those that discriminate against foreigners.

But even without this feasibility constraint, there are economic and political economy forces that tend to limit concessions within PTAs to those that explicitly discriminate against foreigners. One is the request-and-offer negotiating modality typically used in services negotiations (in the Doha Round, as well as in PTAs). Under this modality, countries are asked to contemplate, not just reforms that are in their own best interests, but reforms that are in their trading partners' best interests. It will tend to be in a trading partner's best interests to target only those provisions that explicitly discriminate against foreigners — in this way, the foreign market share is maximised.

Further, the only WTO discipline on the services provisions of PTAs is that they remove substantially all discrimination. There is no WTO requirement that they target the non-discriminatory measures that affect domestic as well as foreign firms.

A final consideration is one of visibility. Regulatory regimes are always complex, and often not very transparent to insiders, let alone outsiders. The regulations that will tend to be visible to *potential* new entrants (the source of additional competitive pressures) are those that discriminate against foreigners.

Recent research has confirmed that if an East Asian PTA targeted regulations that explicitly discriminated against foreigners, and the reforms were undertaken on a preferential basis, this would add only trivially to the gains from preferential liberalisation of tariffs on merchandise trade (Dee 2005). The estimated total gains to the PTA partners are US \$1.7 billion per year from this limited regulatory reform, compared with gains of US \$16.6 billion from preferential tariff reform.

The East Asian region would benefit more from the slower but more widespread reform that might accompany a Doha round settlement. An indicative Doha settlement could deliver income gains to the region of US \$32.6 billion per year, almost double those achievable from an East Asian PTA.

Of even greater benefit would be comprehensive unilateral regulatory reform in the East Asian region, targeting non-discriminatory restrictions. In part because these tend to add to real resource costs, such a reform package would yield gains to the region of more than more than US \$100 billion per year — more than five times an East Asian PTA.

5 Conclusion

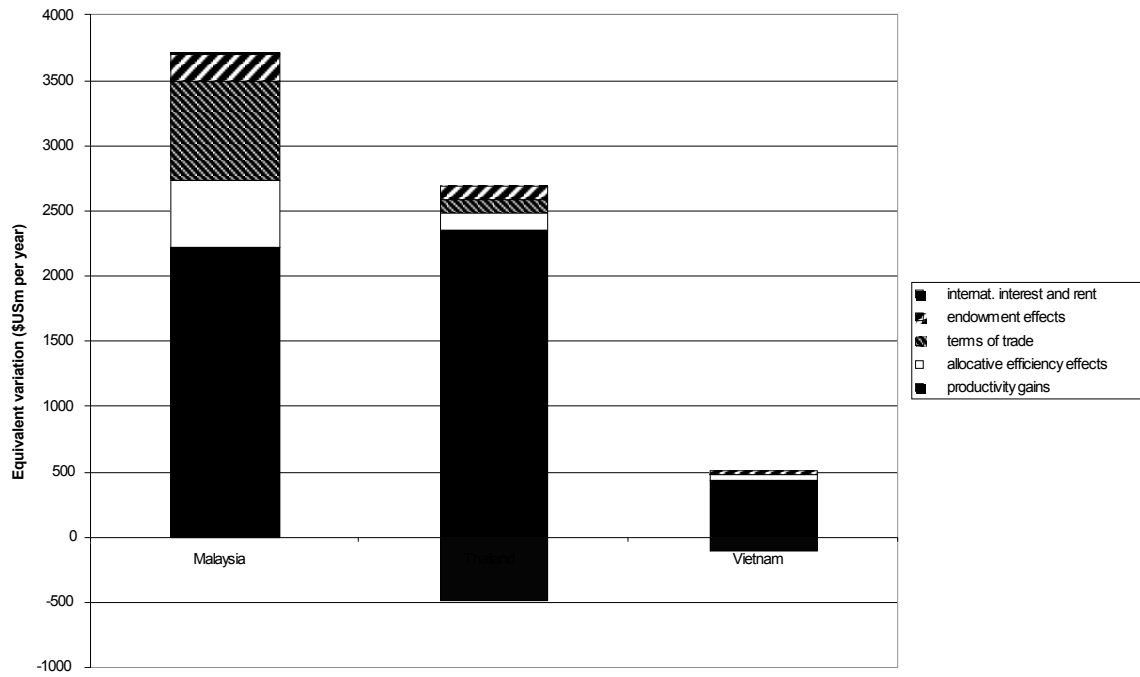
Services trade reform is not to be feared. But it needs to encompass those non-discriminatory measures that impede indigenous service suppliers, not just those measures that explicitly discriminate against foreigners. If it does so, emergency safeguard measures are unlikely to be needed. Importantly from a political economy perspective, such reforms would tend to target measures that have raised real resource costs. As such they could even benefit incumbent service providers.

Such reforms are unlikely to be delivered via PTAs. Instead, each East Asian economy needs to consider the services trade reforms that are in its own best interests. This may require comprehensive reviews of domestic regulatory regimes. The gains from binding these reforms in the WTO are twofold — significant economic gains at home, and significant negotiating credit to be used in the non-services areas of the WTO negotiations.

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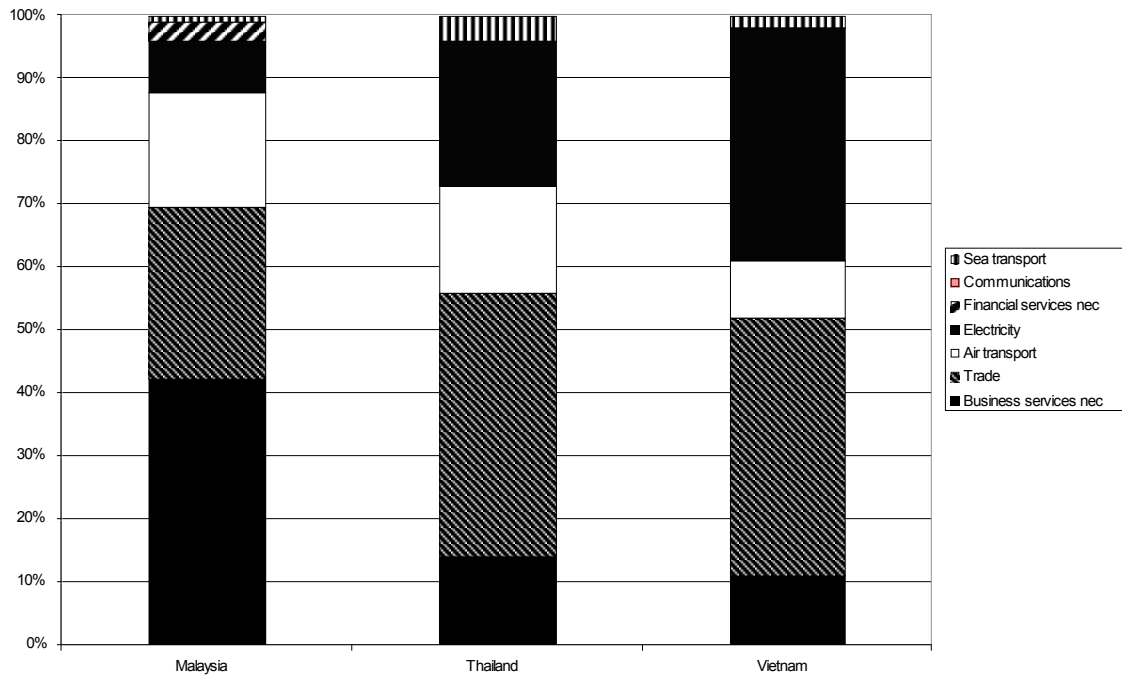
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Figure 1 Welfare implications of full unilateral services trade reform



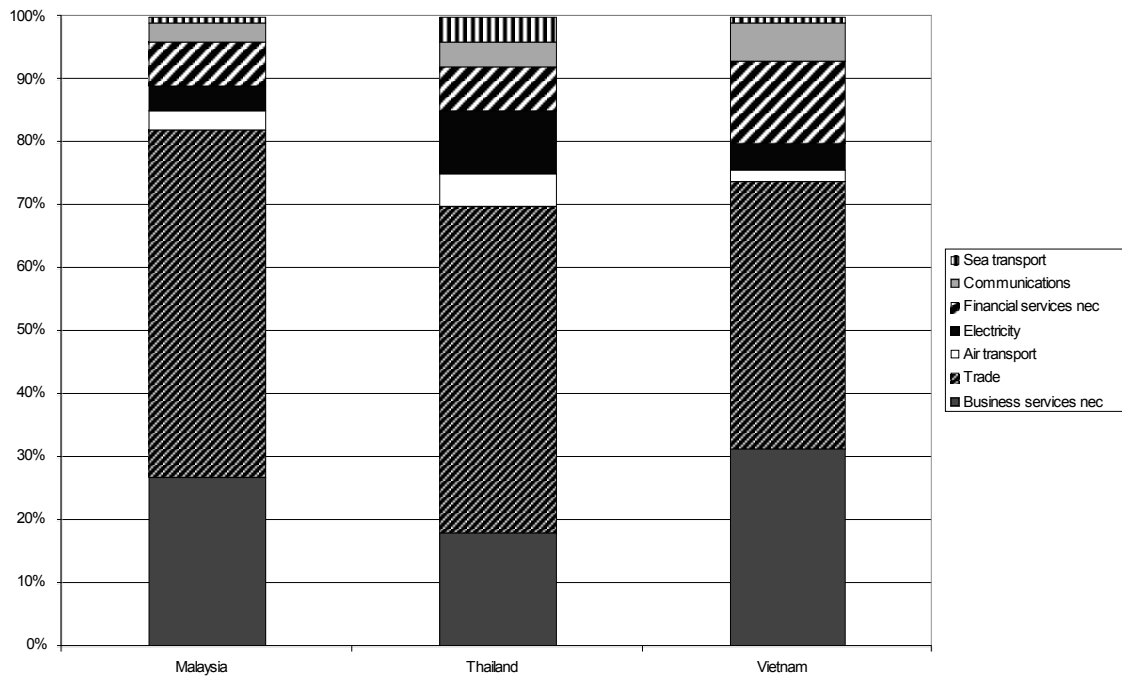
Source: Dee (2004a), (2004b), Dee, Duc and Hiep (2005).

Figure 2 Sectoral contribution to welfare gains from full unilateral services trade reform



Source: Dee (2004a), (2004b), Dee, Duc and Hiep (2005).

Figure 3 Sectoral contribution to value added



Source: Dee (2004a), (2004b), Dee, Duc and Hiep (2005).