

## **CPB Discussion Paper**

**No 36**  
July, 2004

### **A different approach to WTO negotiations in services**

**Henk Kox, Arjan Lejour**

CPB Netherlands Bureau for Economic Policy Analysis  
Van Stolkweg 14  
P.O. Box 80510  
2508 GM The Hague, the Netherlands

Telephone	+31 70 338 33 80
Telefax	+31 70 338 33 50
Internet	<a href="http://www.cpb.nl">www.cpb.nl</a>

ISBN 90-5833-182-2

## Abstract in English

International negotiations on the liberalisation of service trade are concentrated at non-tariff barriers (NTBs). National government measures form important obstacles for service providers when they want to access foreign markets. International studies predict substantial welfare benefits from removing trade obstacles for services. Negotiations on lowering these obstacles are complicated because government regulations are seldom strictly oriented at keeping foreign firms out their domestic service markets. Some of them (e.g. quantity-based restrictions) are clearly at odds with WTO principles. We argue however that in most cases regulators primarily aimed at correcting domestic market failures with disregard for the potential repercussions for foreign providers of services. In negotiations this problem can be approached by introducing economic necessity tests, but that is a very long and tedious process. We propose a different negotiation approach based on lessons learned from WTO negotiations on agricultural support measures.

*Key words: WTO negotiations, GATS, services, NTB's, regulation*

## Abstract in Dutch

Internationale onderhandelingen over handelsliberalisatie van diensten spitsen zich toe op non-tariffaire belemmeringen (NTB's). Nationale overheidsmaatregelen zijn vaak belangrijke obstakels voor dienstenaanbieders, als zij op buitenlandse markten willen penetreren. Volgens internationale studies zijn er aanzienlijke welvaartswinsten mogelijk als deze barrières geslecht worden. Een probleem is dat veel van deze overheidsmaatregelen niet het primaire doel hebben om buitenlandse aanbieders te weren. Vaak zijn er binnenlandse motiveringen voor deze maatregelen om bijvoorbeeld binnenlands marktfalen te corrigeren. Hierbij worden de repercussies op buitenlandse dienstenaanbieders niet meegenomen. In de onderhandelingen kunnen deze effecten worden meegenomen door toetsen op economische noodzakelijkheid in te voeren. Dat is echter een tijdrovend proces. We stellen een andere onderhandelingsstrategie voor, gebaseerd op de WTO onderhandelingen over landbouwsteun.

*Steekwoorden: WTO onderhandelingen, GATS, diensten, NTB's, regulering*



# Contents

	Abstract in English and abstract in Dutch	3
	Summary	7
1	Introduction	9
2	Liberalisation of international trade in services	11
3	GATS outcomes in the Doha Round	17
4	Intrinsic difficulties in services trade negotiations	19
5	A possible way forward	23
6	Conclusions	27
	References	29



## Summary

Service industries typically account for 50 to 70 per cent of national product, both in developing countries and developed countries. However, international trade barely represents 7 per cent of world services production. Low levels of international service trade can be explained from technical matters, regulation-based trade barriers, and cultural differences like language.

During the Uruguay Round, the liberalisation of international trade in services for the first time formally entered the WTO negotiations, resulting in a *General Agreement on Trade in Services* (GATS). Renewal and extension of this agreement is scheduled to be one of the results of the Doha Round. Many empirical simulation studies find a significant welfare improvement of further liberalisation of international service markets. However, signals from the GATS negotiation table indicate that at best a modest lowering of market access barriers in services can be expected. For achieving the full welfare gains from liberalised international trade in services we probably will have to look beyond the horizon of the Doha Round.

The GATS negotiations are quite complex. Not only do the country proposals cover a range of 160 commercial service industries, but also four different modes of supplying service across national borders including cross-border trade, local activities by service multinationals, and temporary border-crossing by individual service providers.

In this article we argue that future GATS rounds are likely to increase in complexity. The reason is that at some moment the 'easy' liberalisation measures – like removing domestic regulations that unintentionally hamper international market access – will be exhausted. An increasing part of the remaining non-tariff barriers in national service markets is associated with national policy goals unrelated to trade, like for instance consumer protection or labour market regulation. Removal of such non-tariff barriers then requires domestic welfare trade-offs. Internationally co-ordinated liberalisation will have to face such issues. Our paper proposes a new negotiation approach that may keep future GATS rounds efficient, and make them more fruitful.

Some lessons can be learned from the way in which agricultural subsidies were brought into the WTO negotiation framework during the Uruguay Round. The basic idea is that countries review and classify the NTB character of measures that deal with market failures in their domestic service industries. The trade-distorting effects and the welfare aims at which the non-tariff measures originally aimed need to be disentangled. In our proposal member states classify their domestic regulations for services into four virtual coloured boxes.

The *red box* contains NTBs like quantitative trade restrictions or price differentiation for domestic and foreign providers of services. These measures are obviously at odds with the WTO principle of non-discrimination. The NTBs in the red box do not address domestic market failures and protectionist motives prevail. Such NTBs deserve priority in the negotiations.

Measures that do address domestic market failures, but have unintended and/or unnecessary trade-restricting impacts, belong in the *brown box*. In these cases, adaptation of the

measures is relatively easy and costless, if GATS creates an incentive for doing so. When considering positive domestic welfare effects of more foreign market access, the brown-box cases are potential win-win situations.

The *blue box* contains more complicated NTBs in services industries. These measures address real market failures at a national basis, while the market failure has broadly shared international dimensions. This market barrier is a side-effect of intervention for an internationally shared problem. GATS is not the proper negotiating forum to discuss the harmonisation of standards; there are better international forums for doing so. GATS negotiations do, however, offer the possibility for countries to lay down the commitment that their national standards for these services will be based on internationally agreed standards.

Finally, the *green box* includes those measures that repair domestic market failures, with unavoidable trade effects that a country wants to take for granted, because of strong national preferences in this particular policy domain. The green box in fact circumscribes the no-go area for GATS negotiations.

Our proposal will make future GATS negotiations processes more efficient by going straight to the most urgent and promising trade issues (the *red-box* and *brown-box*). Moreover, it could reduce potential strategic behaviour, and it creates a self-disciplinary behaviour for the member states.



# 1 Introduction<sup>1</sup>

Service industries typically account for 50 to 70 per cent of national product, both in developing countries and developed countries. However, international trade barely represents 7 per cent of world services production.<sup>2</sup> Developing countries tend to have rather closed service sectors. Most of the international trade in services is accounted for by developed countries, but even in these countries, service industries contribute only modestly to foreign trade. Low levels of international service trade can be explained from technical matters, regulation-based trade barriers, and cultural differences like language (OECD, 2003).

During the Uruguay Round, the liberalisation of international trade in services for the first time formally entered the WTO negotiations, resulting in a *General Agreement on Trade in Services* (GATS). Renewal and extension of this agreement is scheduled to be one of the results of the Doha Round. Any economist would blindly accept a bet that —considering Ricardo's comparative advantages— a welfare improvement must be possible by increasing international trade in services. Indeed, that is what many empirical simulation studies find. However, signals from the GATS negotiation table indicate that at best a modest lowering of market access barriers in services can be expected. For achieving the full welfare gains from liberalised international trade in services we probably will have to look beyond the horizon of the Doha Round.

In this article we argue that future GATS rounds are likely to increase in complexity. The reason is that at some moment the 'easy' liberalisation measures – like removing domestic regulations that unintentionally hamper international market access – will be exhausted. An increasing part of the remaining non-tariff barriers in national service markets is associated with national policy goals unrelated to trade, like for instance consumer protection or labour market regulation. Removal of such non-tariff barriers then requires domestic welfare trade-offs. Internationally co-ordinated liberalisation will have to face such issues. Our paper proposes a new negotiation approach that may keep future GATS rounds efficient, and make them more fruitful.

The basic idea is that countries review and classify the NTB character of measures that deal with market failures in their domestic service industries. Some lessons can be learned from the way in which agricultural subsidies were brought into the WTO negotiation framework during the Uruguay Round. A similar approach can be used to strike a better balance between liberalised service trade and the correction of domestic market failures. The trade-distorting effects and the welfare aims at which the non-tariff measures originally aimed need to be disentangled. Therefore we propose to discriminate four virtual boxes, based on four criteria.

<sup>1</sup> We thank Theo van de Klundert for useful comments.

<sup>2</sup> This reduces to 5.3 per cent if we disregard intra-EU services trade. This is calculated for the year 2000 on the basis of World Bank GDP data and WTO data on international service trade.

These criteria are the trade-restrictiveness of the measure, the necessity of the trade restrictiveness of the barrier, the motivation of correcting domestic market failures, and the international dimensions of the market failure. This classification scheme could structure the GATS negotiations and make them more fruitful and efficient.

This proposal is presented in section 5. Section 2 discusses the liberalisation of trade in services. Section 3 presents the current status of the negotiations in the Doha round, and section 4 discusses the relation between the trade-restrictiveness of regulation and the aim of correcting domestic market failures with the regulation measures. Section 6 concludes

## 2 Liberalisation of international trade in services

Only a small fraction of service products, like standard software packages, can be stored and shipped in boxes like traditional merchandise exports. In most other cases —think of your foreign holiday or your hairdresser— it is difficult to separate production and consumption of the service in time and space. It implies that for an international transaction to take place, either the producer or the consumer himself must go abroad. The producer can set up a production unit abroad or can have himself represented by an employee sent abroad on a temporary basis. While exporting and production abroad are optional supply forms for manufacturing firms, in some service industries the only feasible way for a firm to supply a foreign market is by setting up a local subsidiary (Sampson and Snape, 1985). The GATS treaty therefore identifies four modes of international service supply, as shown in Table 2.1. The table shows that international service deliveries in most cases occur through subsidiaries.

**Table 2.1 Modes of international service supply in the GATS treaty, and dominant types of trade barriers**

GATS supply modes	Type of international service transactions	Share in world service trade <sup>a)</sup>	Type of regulation-based trade barriers affecting this supply mode
Mode I	Service products cross the border	28 %	Quantitative restrictions, tariffs, discriminatory levies
Mode II	Consumers cross the border (mainly tourism, health and education services)	14 %	Discriminatory levies
Mode III	Service firms establish a production unit abroad (commercial presence)	57 %	Requirements for products and/or suppliers, network access restrictions, quantitative restrictions
Mode IV	Temporary migration of natural persons to deliver services abroad (business travel, contractual service providers).	1 %	Quantitative restrictions, visa procedures, discriminatory levies, requirements for products and suppliers

<sup>a)</sup> Supply mode shares for 2000 are taken from World Bank (2003).

Many governments regulate domestic service markets and put up impediments to the presence, operation and movement of foreign service providers. The table indicates which type of regulation-based trade barriers one typically finds in relation to the four supply modes. Some supply modes are affected more intensely than others by regulation-based trade barriers. The toughest regulation-based barriers are typically found for Mode IV, followed by Modes III and I. Market access for Mode II is relatively free.

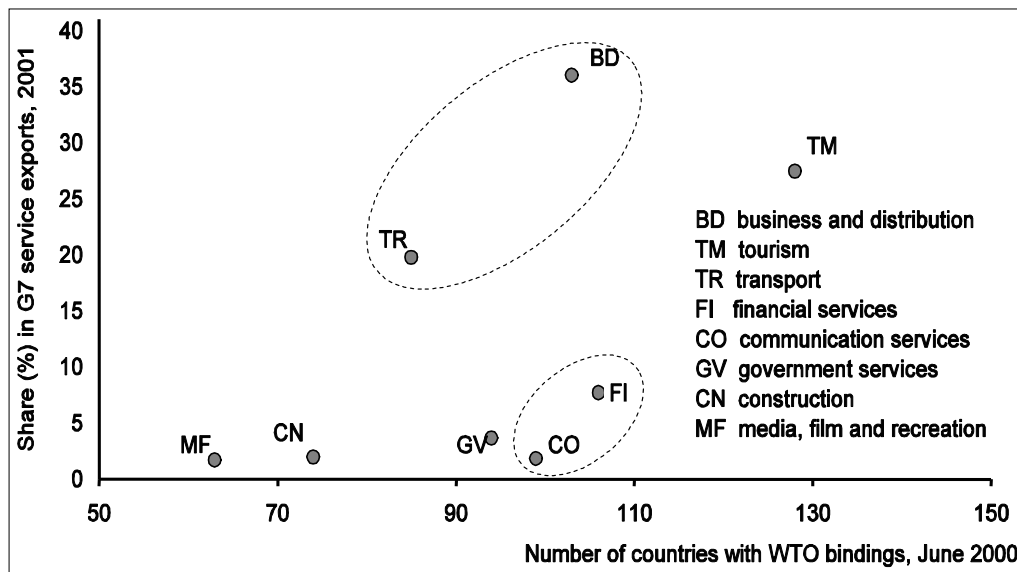
The 1995 GATS treaty was a historical achievement. For the first time WTO member countries laid down mutual obligations to lower market access barriers for foreign service providers, and to abstain from discrimination between domestic and foreign service providers. Figure 2.1 characterises in a nutshell the baseline situation at the beginning of the Doha Round. It shows the structure of service sector commitments and the relative size of these sectors in world service trade. The structure of the commitments is pretty much in line with some predictions from trade theory.

Burgess (1990) has shown that the international competitiveness of non-service industries can be improved by free trade in intermediate services, so that domestic non-service industries can use the best available intermediary inputs. Ethier (1982) argued that production inputs from different national origins can be complementary rather than competing. When domestic final goods firms appreciate greater variety in inputs, liberalisation of input trade is welfare-increasing. Markusen (1989) developed a model for trade in knowledge-intensive intermediary services, in which the crucial assumptions are that these services are differentiated products, and that they are produced under increasing returns to scale.<sup>3</sup> Product differentiation means that foreign products often are complementary rather than competing. Due to the scale effect, the extent of differentiation is limited by the size of the market. Hence, by liberalising trade in knowledge-intensive services, countries essentially confer a positive technological externality on their trading partners. Markusen predicts considerable welfare gains by opening up national markets for such production services.

If these authors —writing well before the end of the Uruguay Round— were right, we would expect that trade lobbies from inside and outside the service industries must easily be able to convince their governments that trade in these producer services should be liberalised (cf. Mitra 1999). Apparently it worked, judging from Figure 2.1. Without implying any causal relationship, this figure shows that liberalisation concessions were concentrated in service industries that also accounted for the largest share in service trade.

<sup>3</sup> The knowledge necessary for producing these services must be acquired at an initial learning cost, after which the services can be provided at relatively low marginal costs.

**Figure 2.1** The structure of WTO bindings by service industry at the start of the Doha round: number of participating countries and share in service exports<sup>4</sup>



Most trade concessions were done for tourism. This can be seen as a special case to the extent that opening up borders for tourism hardly bears any costs in terms of competing domestic supply. Apart from tourism, producer services account for most of the country bindings during the Uruguay Round. The two ellipses in the graph demarcate the positions of producer services within the GATS commitments. Business and financial services are the service sectors that come closest to Markusen's concept of knowledge-intensive producer services, and these services account for the highest number of mutual trade concessions. If the number of countries offering legally binding concessions is taken as a yardstick, we may conclude that WTO members tend to consider trade concessions for these industries a win-win strategy. Transport, although representing a large share in international service trade, is a somewhat mixed case. Of all producer services, it accounts for the lowest number of trade concessions. The number of countries with trade concessions is also rather low for the other service industries: construction, culture-related and government-related services. We argue later on that this may be due to the fact that trade liberalisation in these areas requires more complex domestic welfare trade-offs.

At the outset of the new Doha Round, a host of studies estimated through scenario simulations the magnitude of potential welfare gains that could result from further liberalisation of services (OECD 2003). Table 2.2 summarises some important studies, the type of simulation model used, the liberalisation scenarios, and the welfare results.

<sup>4</sup> The structure of the G7 exports is used as the best available approximation for the structure of world service trade. Source: Kox and Lejour (2004).

**Table 2.2 Summary results of main international studies on the effects of a new GATS round**

Study	Model used	Magnitude service trade barriers	Liberalisation scenario	Worldwide impact in % GDP (and /or bln. US \$)
<b>Mode I : border-crossing services</b>				
World Bank (2003)	Linkage: dynamic AGE model, constant returns to scale	Tariff equivalents 10%	Abandoning all tariffs. Cost reduction 10% in all services	Non-OECD GDP + 9.4% (880 bln. US\$). Impact service liberalisation 4x that of manufacturing
Chadka et al. (2000); Brown et al. (2001)	Michigan model with imperfect competition	Hoekman indices <sup>a</sup> 80% tariff equiv.	33% reduction of barriers	400 bln. US\$ OECD GDP +2% Non-OECD GDP +2,5%
Robinson et al. (1999)	Clone of GTAP model, constant returns to scale	variant Hoekman indices <sup>a</sup> 80% tariff equiv.	50% reduction, with and without additional productivity growth	World GDP + 1–3 %; impact service liberalisation 5x that of manufacturing
Francois et al. (2003)	GTAP model with imperfect competition	Tariff equivalents: OECD 5%; rest of the world 10%	50% reduction	World GDP + 25–50 bln. US\$
<b>Mode III: commercial presence</b>				
Verikios & Zhang (2001); Dee, Hanslow & Phamduc (2000)	FTAP= GTAP (constant returns to scale), with FDI (commercial presence )	about 10% (tariff equivalents)	Full market access and non-discrimination in 3 industries: telecom, financial and business services	Non-OECD GDP + 0.5% OECD GDP + 0.1 – 0.2%
<b>Mode VI: temporary movement of natural persons</b>				
Walmsley and Winters (2003)	GMig = GTAP (constant returns to scale), with temporary international labour migration	Quota restriction for temporary international labour migration	temporary international migration of schooled and unschooled labour up to 3% of employment <sup>b)</sup>	World GDP +0.6% (152 bln \$) OECD GDP + \$74 bln. non-OECD GDP + \$78 bln.

<sup>a)</sup> Hoekman indices are tariff equivalents constructed on the basis of country offers for market access (or the lack of offers) during the Uruguay Round. Tariff equivalents are expressed as a percentage of imports value.

<sup>b)</sup> Only simulation results for services are reported here.

Sources: the studies mentioned and OECD (2003).

Most studies use a static general equilibrium model, and solely focus on service supply through mode I, even though this supply mode represents a minority of international service transactions. The 'mode I' studies start from different views on the magnitude of trade barriers, varying between 5 and 80 per cent tariff equivalents.<sup>5</sup> Also their liberalisation scenarios differ. Nonetheless, they typically find welfare effects of several hundred billion US dollars. Because these studies do not take account to the dynamic effects of trade liberalisation, nor the other

<sup>5</sup> Only the FTAP studies are based on a systematic and detailed study of trade barriers for service industries (Findlay and Warren 2001); the other studies adopt a more rough estimating method like Hoekman indices. See Whalley (2003) and OECD (2003) for a review of recent analytical and empirical work on quantifying market access barriers in services.

service modes of supply, the total welfare gains are probably much higher. The FTAP studies from the Australian Productivity Commission pay specific attention to supply mode III, while one study investigates the impact of less restrictive regulations with regards to mode IV (Walmsley and Winters, 2003). Taking a meta view, four conclusions emerge from the simulation results:

- Both developing and developed countries stand to gain in welfare.
- Relative to GDP, non-OECD countries stand to gain most by lowering barriers to service trade.<sup>6</sup>
- Potential welfare results strongly depend on the assumed magnitude of trade barriers.
- The large differences between studies as to the size of market barriers marks the absence of a uniform yardstick for assessing whether and to what extent trade barriers hamper access to national service markets.

<sup>6</sup> The total welfare effect in developing countries suggested by some studies would dwarf the total amount of net official development aid originating from OECD countries (\$58 billion in 2002).





### 3 GATS outcomes in the Doha Round

Taken together, the scenario studies suggest that trade liberalisation in services is a potential win-win game for the world community. This begs the question whether this potential outcome will be 'cashed in' after the present GATS round. So far, country commitments for Mode III are more extensive than the commitments under Mode I (WTO 2001b). Hauser and Wunsch (2002) infer from this that the first GATS agreement emulates a foreign investment agreement rather than one allowing for cross-border trade. Taken at face value, this suggests that there is much scope for improving the existing GATS commitments for cross-border trade in services. What can we expect from the present round of GATS negotiations?

The first indications are not too promising. According to the initial schedule, the Doha Round should be concluded before 2005. The start of the negotiations can hardly be called dazzling. There was a slow start in tabling initial negotiation offers and requests with regard to services, especially on account of developing countries. The failure of the WTO ministerial conference in Cancún (September 2003) indicated that the Doha Round might not be finalised before 2005. The imminent change of major negotiating *dramatis personae* in 2004 — associated with US presidential elections and changes in the European Commission — will not contribute much towards keeping the GATS negotiations out of the doldrums. We can keep in mind that the Uruguay Round took nearly eight years, almost twice the original schedule.

A way to find out tentatively what results this round may yield, is to compare the offers that countries have put forward. Since the negotiations generally follow a path of reciprocity, we investigated the concordance between national offers in specific service industries. The idea is that service industries with a high density of national offers are more likely to see negotiation breakthroughs. Concordance between national offers at industry level can be regarded as a bottom-line condition for positive results. It does not rule out the possibility that some cross-issue compromises are accomplished in the final phase of negotiations. For instance, service concessions by developing countries tend to hinge on a breakthrough in agriculture negotiations. Save for last-minute concessions which countries tend to keep in their back pockets till the very last stage of negotiations, a concordance analysis yields an indication of probable GATS results during the Doha Round.

By the end of 2003, about 40 countries had deposited offers for improving market access and alleviating discriminatory measures. Most of these offers are rather modest, and in many cases they hardly go beyond committing domestic liberalisation measures that had already become actual practice since the Uruguay Round. Such concessions will not result in additional international trade in services. For a more industry-level perspective, we base ourselves on initial market access offers, which the 9 major OECD countries (together representing three-

quarters of international service trade) by the end of 2003 had tabled for services. Table 3.1 shows the industry level densities.

**Table 3.1 GATS market access offers by major OECD countries<sup>a)</sup> at the end of 2003**

Industry	Number of countries	Industry	Number of countries
Transport	9	Tourism	5
Business services	8	Education	4
Financial services	8	Energy	3
Communication and postal services	8	Media, recreation, cultural services	2
Environmental services	7	Health services	0
Construction	6	<u>PM</u>	
Distribution	5	Mode IV	5

Note: a) The European Union is regarded as one country; the other countries are: USA, Japan, Canada, Korea, Australia, New Zealand, Norway and Switzerland. Source: compiled for published negotiations offers.

Again we find most offers for trade concessions in the group of producer services. If reciprocity forms the basis for GATS results, we may expect positive liberalisation results for business services, communication and postal services, financial services, transport and environmental services. Environmental services still represents as small fraction of international services trade. Postal and courier services are relatively new at the GATS table. Completely new are energy-related services. Even a GATS classification scheme for reciprocal concessions in this area is still lacking, so that few results on energy can be anticipated in this round. All major countries except the USA have tabled offers for the maritime transport sector. A breakthrough crucially depends on the USA. During the Uruguay Round, the USA effectively blocked the accomplishment of a maritime agreement, and its market access offers are meagre once again. The prospects for results in other service sectors (education, health, media and culture) are bleak, if only because countries prefer to keep these issues in the public rather than the private domain. Mode IV is the area in which developing countries hope to achieve successes, especially for services that require much unskilled labour. While the admitted duration of stay for higher educated natural persons that deliver services abroad might be extended, the 2003 offers do not justify optimism that such concessions will also be reached for less educated service providers.

Summing up, the negotiation offers by major OECD countries at best offer the prospect of modest and fragmented negotiation result; the Doha Round will not have grand results for services. It will take future GATS negotiation rounds to accomplish most the welfare gains that are predicted by most of the liberalisation studies mentioned in Table 2.2. It is our opinion that real future negotiation progress requires a different approach.

## 4 Intrinsic difficulties in services trade negotiations

Service products and the relevant trade barriers in services tend to be more heterogeneous than in agriculture or manufacturing. Non-tariff measures rather than tariffs form the most important type of market barrier for services. Those tariffs hamper market access for foreign trade, and to what extent, can be assessed in a relatively straightforward way. On that basis, countries may negotiate mutual concession packages of more or less similar magnitude. This procedure is unfit for services. Often it cannot be assessed unequivocally whether—and to what extent— a domestic measure hampers market access for foreign service suppliers, and therefore, whether it is an effective non-tariff barrier (NTB). Many domestic regulations and measures with a NTB character were not introduced for protectionist purposes. Rather, they address purely domestic issues, mostly for correcting some forms of market failure.<sup>7</sup> The trade impact of the measure is a side-effect that was unintended, or thought of as unimportant.

**Table 4.1 Motivation of domestic measures with a NTB character**

Type of NTB <sup>a)</sup>	Examples	Intentional trade restriction?	'National treatment' principle applied?
Trade-related quantitative restrictions	Import ban, import quotas, export ban	yes	No
Price-based NTBs	Differentiated tariffs or levies for domestic and foreign service providers	yes	No
Quantitative restrictions unrelated to trade	Limitation market access through licenses, visa, domain monopolies, environmental or spatial restrictions	Often: not	Often implicit discrimination
Requirements for service product	Compulsory norms and standards for product	Often: not	Often implicit discrimination
Requirements for service providers	Qualification, obligatory membership of national professional organisations, operational requirements, juridical status	Often: not	Often implicit discrimination
Differentiated access to national distribution systems	Rules for fixed infrastructure (rail, water, energy, telecommunication networks)	Often: not	Often implicit discrimination

Note: a) we follow the classification that Hoekman and Braga (1997) introduced for NTBs in service markets.

<sup>7</sup> The existence of market failures implies that the free operation of a service market either results in too low or too high consumption of a certain service, compared to a welfare optimum. The market failures being mostly at stake in service markets are: structural uncertainty on the quality of the service (asymmetric information), positive or negative externalities conferred to the rest of the economy by production or consumption of the service, and the existence of setup costs in production (scale minimum).

Table 4.1 reviews the main types of NTBs in services, their trade-related intentions and their infringement on the 'national treatment' principle of WTO. Only for two types of NTBs, we can say unambiguously that the measure is a form of outright protectionism, and that it discriminates openly towards foreign providers of services. In all other cases, this is much more difficult to assess. Discrimination of foreign suppliers is often implicit, meaning that these suppliers need to do more effort and incur larger costs in order to comply with the requirements of a domestic regulation.

Once we accept that many NTBs were designed for repairing domestic market failures, this cannot but affect the way we deal with liberalisation in service trade. Let us follow the decision track that eventually leads to country *Y*'s GATS commitment to drop or alleviate a certain measure:

1. Domestic lobby parties in country *Y* seldom indicate or complain that a domestic measure functions as a NTB. The exceptions are situations where an organised group of domestic firms clearly feel themselves put at a competitive advantage by not having access to cheap or more varied foreign imports.<sup>8</sup> The general case is, however, that domestic action with regard to NTBs is lacking. Following Olson (1965), it can be explained from the structure of protection costs. International trade is unimportant in most service industries, so that the opportunity costs –i.e. the potential benefits of liberalisation– are also invisible. Moreover, the costs of protection are spread thinly over anonymous sections of the domestic economy. NTBs often resulted from government dialogue with domestic professional associations and incumbent firms, the same who gain most from the NTB protection.
2. Consequently, foreign action is normally required for even signalling the existence of NTB protection. Foreign firms in country *X* feeling that a government measure in country *Y* puts them artificially at a competitive disadvantage, complain to their own government. If this fits into the latter's policy priorities, country *X* will put up the issue as a GATS negotiation demand to country *Y*. The burden of proof rests with country *X*, and it may not be easy to substantiate claims that export or investment opportunities are negatively affected.
3. Nonetheless, the GATS demand raises domestic awareness in country *Y*. Its government now has to reconsider the domestic costs and benefits associated with the NTB, and evaluate its alternatives. Are the market failures that initially led to the NTB measure still valid? Can the measure be alleviated or substituted by less trade-restricting measures? What are the possible welfare gains from reciprocal GATS concessions that may be asked from country *X* in exchange for dropping the NTB? What magnitude has the overall domestic liberalisation benefits?

<sup>8</sup> The endogenous liberalisation lobby always has been strongest for producer services, which may explain why this part of service trade was liberalised already during the Uruguay Round. Domestic lobbies are also important in the case of acute labour market scarcities (e.g. ICT personnel).

The complexities and slowness of this decision process may explain why the GATS negotiations so far have achieved only modest successes in removing market access barriers in services. The 1995 GATS agreement (article VI:4) has created an opening for dealing with domestic regulations that have a negative impact on trade. According to this article, the WTO Council on Trade in Services (or its subsidiary bodies) should develop "disciplines" aimed at ensuring that qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services. So far, the WTO did not yet develop effective checks on, and necessity tests for national regulatory measures.<sup>9</sup> The proposal that we describe in the next section offers a method for its design and elaboration. If adopted, the proposal could make actual negotiations much more effective, by cutting-short the three aforementioned decision steps.

<sup>9</sup> The WTO Council for Trade in Services, nonetheless, has done some work to promote that national accountancy standards are based on internationally agreed standards. The GATS Working Party on Professional Services recognises that —with respect to accountancy— member governments may have legitimate regulatory objectives in the areas of "*inter alia the protection of consumers (...), the quality of the service, professional competence and the integrity of the profession*". Cf. WTO Council for Trade in Services (1999b).



## 5 A possible way forward

The basic idea is that countries review and classify the NTB character of measures that deal with market failures in their domestic service industries. The classification procedure itself is based upon guidelines from the WTO or another independent institute or commission. Some lessons can be learned from the way in which agricultural subsidies were brought into the WTO negotiation framework during the Uruguay Round.

Just like service-industry NTBs, agricultural subsidies are a multi-headed monster. It was felt that cutting off one "subsidy head" in the negotiations might just stimulate the growth of subsidies under a new heading.<sup>10</sup> WTO leadership therefore opted for an integral approach. The WTO agriculture negotiations got a strong push once member countries agreed to classify their own agricultural support measures in three virtual "coloured boxes". The amber box contained the most trade-distorting measures like guaranteed prices, export subsidies and import tariffs. The blue box held the somewhat less distorting measures like income support for farmers. Finally, the green box contained the measures with the smallest impact on agricultural trade like government support for agricultural education or agricultural research. Once governments themselves had classified their own support measures, the latter became more comparable. The operation resulted in a massive volume of technical and general information on agricultural protection, support and distortion and its consequences. This increase in information has made even opaque policy instruments more transparent. As a consequence, it became easier to structure the agricultural talks and achieve successes at that negotiation table.

A similar approach can be used to strike a better balance between liberalised service trade and the correction of domestic market failures. The trade-distorting effects and the welfare aims at which the non-tariff measures originally aimed, need to be disentangled. Table 5.1 offers a classification of NTBs in four virtual boxes, based on four criteria. The table also specifies the main direction of the negotiation solutions.

The *red box* contains NTBs like quantitative trade restrictions or price differentiation for domestic and foreign providers of services. These measures are obviously at odds with the WTO principle of non-discrimination. The NTBs in the red box do not address domestic market failures and protectionist motives prevail. Such NTBs deserve priority in the negotiations.

<sup>10</sup>Cf. Harvey (1994); Rayner et al. (1993).

<b>Table 5.1      Classification of non-tariff barriers in services for future GATS negotiations</b>					
	Aimed at trade-restriction?	Trade restriction inevitable?	Aimed at domestic market failure?	Has market failure international proportions?	Negotiation approach
Red box	Yes	Yes	No	Not applicable	Negotiate in GATS
Brown box	No	No	Yes	No	Discuss in GATS: establish principle of least trade-distorting measure, introduce limitation in time
Blue box	No	Yes	Yes	Yes	Establish in GATS that these NTBs have to conform with internationally harmonised standards or mutually recognized
Green box	No	Yes	Yes	No	Keep them outside GATS framework when positive domestic welfare effects dominate

Measures that do address domestic market failures, but have unintended and/or unnecessary trade-restricting impacts, belong in the *brown box*. In these cases, adaptation of the measures may be relatively easy and costless, if GATS creates an incentive for doing so. When considering positive domestic welfare effects of more foreign market access, the brown-box cases are potential win-win situations. The reciprocity incentive may suffice to tackle these cases in the GATS negotiations.

The *blue box* contains more complicated NTBs in services industries. These measures address real market failures, but do so at a national basis, while the market failure has broadly shared international dimensions. An example is the use of national accountancy standards and associated professional qualification. Having to re-qualify in each national market implies a market access barrier for internationally operating providers of accountancy services. National accountancy standards make it difficult or at least costly for firms to operate in foreign markets. This market barrier is a side-effect of intervention for an internationally shared problem.<sup>11</sup> GATS negotiations are not the proper negotiating forum to discuss the harmonisation of standards; there are better international forums for doing so. The same applies, *mutatis mutandis*, for standards in the areas of telecommunication, postal services or shipping standards. GATS negotiations do, however, offer the possibility for countries to lay down the commitment that their national standards for these services will be based on internationally agreed standards. Alternatively, they may agree on mutual recognition of national qualification standards and professional requirements in specified service industries.

<sup>11</sup> The trustworthiness, accuracy and reliability of accountancy reports are essential for the functioning of financial systems; hence, it is a source of positive externalities. The market failure is that such externalities tend to be in short supply due to free-riding behaviour.



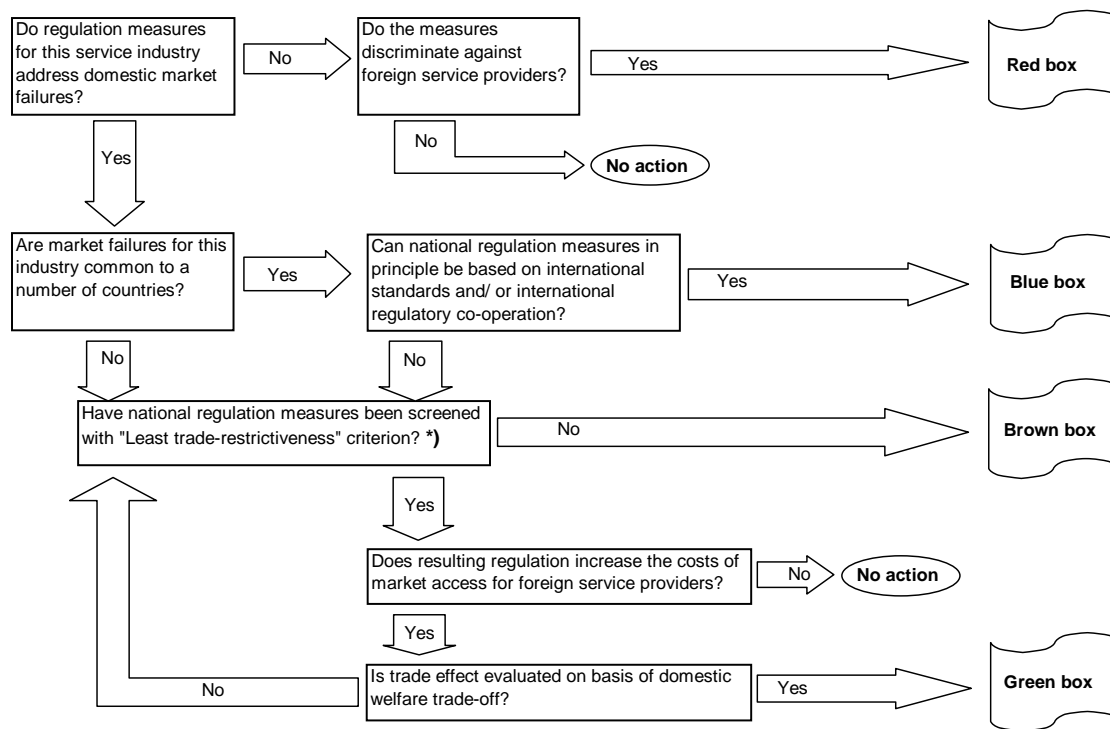
Finally, the *green box* includes those measures that repair domestic market failures, with unavoidable trade effects that a country wants to take for granted, because of strong national preferences. The *green box* in fact circumscribes the no-go area for GATS negotiations. Examples of green box measures are likely to be found in the areas of environmental and social policy, culture-related services, education, health, safety and security issues. Also the demarcation between public and private services could be brought into the green box.<sup>12</sup> An option would be to limit the applicability of the green box to domestic regulations in specific areas, like protection of non-business consumers and national security. For regulatory measures in the green box, GATS could require that the measures are transparent, and that they are notified to a public register administered by the GATS Secretariat.

This new negotiation approach requires preparatory work from the WTO/GATS secretariat. It should not be too difficult for them to prepare –as an example– a longlist of typical non-tariff measures that countries might consider per service industry and per supply mode. A new version of the GATS Negotiating Guidelines (WTO 2001a) would be required, with global consistency guidelines for classification of domestic NTBs by the member countries.<sup>13</sup>

<sup>12</sup> For government services like education and health the low level of mutual trade concessions in the Doha Round can be explained by the fact that most WTO members still prefer to keep these activities in the public services domain, and hence outside the GATS negotiations.

<sup>13</sup> Mattoo and Wunsch (2004, p. 28) propose a "prudential carve-out" clause for domestic regulation that can be useful for defining the *green box* domain, although the authors use the proposal in a different context.

**Figure 5.1 Classification framework for non-tariff barriers in service industries**



\*) Sub-criteria: transparency, objectiveness, not more burdensome than necessary to ensure quality, national treatment

Figure 5.1 offers the skeleton for a decision framework that may be translated into the preparatory guidelines for member countries. If such a scheme is to be applied in future negotiations, member countries should agree on procedural rules for the preparation of future negotiation rounds by the WTO/GATS Secretariat.

Prior to the start of the negotiations, countries submit their self-review report on the trade barriers to the GATS secretariat. They have to authorise the review on basis of a formal consistency check whether it has been prepared according to the negotiation guidelines. This process may prevent too bold dissimilarities in the way member states classify their NTBs. An arbitration committee of the impartial trade specialists may handle conflicts between countries and the GATS secretariat on the authorisation procedure.

## 6 Conclusions

Future GATS rounds are likely to increase in complexity. The reason is that at some moment the 'easy' liberalisation measures – like removing domestic regulations that unintendedly hamper international market access – will be exhausted. The remaining non-tariff measures that restrict access to national service markets will increasingly be associated with competing national policy goals like for instance consumer protection. Removing or changing such non-tariff measures will evoke more complex domestic welfare trade-offs, and international co-ordination will get more difficult. In view of the upcoming negotiation issues, our study proposes an analytical framework that could keep future GATS rounds manageable. Non-tariff barriers are classified into four categories, based on the degree of trade distortion, the desired degree of international coordination and the domestic motivation for regulation that resulted into the trade barrier.

Application of this approach might bring more focus in future GATS negotiations, by concentrating solely on the biggest distortions and the really negotiable cases. The current practice is that country X's demands to country Y are based on a broad-spectre approach, including issues that in country Y are covered by strong national preferences, and therefore non-negotiable (*green box*). Trade talks on such issues are frustrating and at best unproductive. Our proposal may strengthen the speed and efficiency of future GATS rounds along three lines.

In our approach, negotiations would go straight to the *red-box* and *brown-box* issues where the biggest and quickest results may be expected. This classification will most probably raise the efficiency and speed of the ensuing negotiations, because the trade talks can become much more focussed. Also the *blue-box* issues offer prospects for finding common grounds, although a different negotiation approach is required here. The structure of the 1995 GATS agreement offers a useful basis for starting the *blue-box* negotiations.<sup>14</sup>

Our proposal will possibly also raise the efficiency of GATS negotiations in another way, by cutting away part of the incentive for free riding behaviour that is now associated with WTO's most-favoured nation (MFN) principle. The present system operates on the basis of country offers and demands. Basically countries do trade concessions to other countries in order to receive a trade concession in exchange. The game is to "give away" as little as possible initially, to acquire as much as possible in exchange. Individual countries negotiate country by country, sector by sector with other GATS members: a wearying process. The MFN principle guarantees that a far-reaching concession done to one negotiation partner should also be available to other GATS partners. The mechanism creates an incentive for some players to "do" as little as possible early in the negotiations. Such 'wait and see' behaviour protracts the negotiation

<sup>14</sup> In particular, articles VI:4 and VI:5 of the GATS. Furthermore, WTO Council for Trade in Services (1999a) summarises the international regulatory initiatives in services, which can be used in the context of *blue-box* negotiations.

process. Our proposal will not completely get rid of such free riding, but the classification process forces member countries from early on to visualise the *red-box* and *brown-box* issues that are to become the object of mutual trade concessions. This in itself will probably speed up the negotiating process.

Finally the review process will raise the awareness of trade-distortive effects of national regulation. This could have a self-disciplinary impact even before negotiations start such that countries eradicate NTBs that belong in the *brown box* (unintended and unnecessary side effects).

## References

- Brown, D.K., A.V. Deardorff, and R.M. Stern, 2001, CGE modelling and analysis of multilateral and regional negotiation options, Discussion Paper No 468, University of Michigan.
- Burgess, D.F., 1990, Services as intermediate goods: the issue of trade liberalisation, in: R.W. Jones and A.D. Krueger (eds.), *The political economy of international trade*, Basil Blackwell, Cambridge, pp. 122-139.
- Chadra, R., D. Brown, A. Deardorff and R. Stern, 2000, Computational Analysis of the Impact on India of the Uruguay Round and the Forthcoming WTO Trade Negotiations, Discussion paper 459, School of Public Policy University of Michigan, Ann Arbor, Michigan.
- Dee, Ph., K. Hanslow and T. Phamduc, 2000, Measuring the cost of barriers to trade in services, paper presented at 11th Annual NBER East Asian Seminar (22-24 June 2000), Australian Productivity Commission., Canberra.
- Ethier, W.J., 1982, National and international returns to scale in the modern theory of international trade, *American Economic Review*, vol. 72 (3), pp. 389-405.
- Findlay, C and T. Warren (editors), 2000, *Impediments to trade in services: measurement and policy implications*, Routledge, London.
- Francois, J, H. van Meijl en F. van Tongeren, (2003) *Economic Benefits of the Doha round for The Netherlands*, Report submitted to the Ministry of Economic affairs, LEI
- Harvey, D., 1994, Agricultural policy reform after the Uruguay Round, in: K. Ingersent, A. Rayner and R. Hine, eds., *Agriculture in the Uruguay Round*, MacMillan 1994.
- Hauser, H. and S. Wunsch, 2002, *Der Grenzüberschreitende Handel mit elektronischen Dienstleistungen - die Rolle der WTO und die Anforderungn an die nationale Politik*, Report to the German Parliament, Swiss Institute for International Economics and Applied Economic Research, St. Gallen.
- Hoekman, B. and C. Primo Braga, 1997, Protection and trade in services: a survey, Policy Research Working Paper # 1747, World Bank, Washington.
- Kox, H., 2001, Exposure of business services to international competition, CPB Document 10, The Hague.

Kox, H., and A. Lejour, 2004, Een nieuwe WTO-ronde voor diensten. Mogelijke gevolgen voor Nederland, CPB document 51, The Hague (in Dutch).

Markusen, J.R., 1989, Trade in producer services and in other specialised intermediate inputs, *American Economic Review*, vol. 79 (1), pp. 85-95.

Mattoo, A. and S. Wunsch, 2004, Securing openness of cross-border trade in services: a possible approach, <http://www.cid.harvard.edu/cidtrade/Papers/mattoo-wunsch.pdf>.

Mitra, D., 1999, Endogenous lobby formation and endogenous protection: a long-run model of trade policy determination, *American Economic review*, 89(5), pp. 1116-1134.

OECD, 2003, *Services liberalisation: identifying opportunities and gains part two: modelling the economic benefits of services trade liberalisation*, Trade directorate TD/TC/WP(2003)23/PART2, OECD, Paris.

Olson, M., 1965, *The logic of collective action*, Harvard University Press.

Rayner, A., K. Ingersent and R. Hine, 1993, Agriculture in the Uruguay Round: an assessment, *The Economic Journal*, vol. 103, pp. 1513-1527.

Robinson, S., Z. Wang, and W. Martin, 1999, Capturing the Implications of Services Trade Liberalisation, paper presented at the Second Annual conference on Global Economic analysis, Denmark, June.

Sampson, G. and R. Snape, 1985, Identifying the issues in trade in services, *The World Economy*, vol. 8, pp. 171-181.

Verikios, G. and X. Zhang, 2001, Global Gains from Liberalising Trade in Telecommunications and Financial Services, Paper presented to the Fourth Annual Conference on Global Economic Analysis, Productivity Commission Staff Research Paper, Canberra.

Walmsley, T.L. and L.A. Winters, 2003, Relaxing the restrictions on the temporary movement of natural persons: a simulation analysis, CEPR Discussion Paper No. 3719, CEPR, London.

Whalley, J., 2003, Assessing the benefits to developing countries of liberalisation in services trade, NBER Working paper No. 10181, NBER, Washington.

World Bank, 2002, *Global Economic Prospects for Developing countries 2003*, Washington

World Bank, 2003, *Global Economic Prospects for Developing countries 2004*, Washington

WTO, 2001a, *Guidelines and procedures for the negotiations on trade in services*, S/L/93, Adopted by Special Session of the Council for Trade in Services, 28 March 2001, WTO, Geneva.

WTO, 2001b, *Market access: unfinished business post-Uruguay Round inventory and issues*, Special Studies 6, Geneva.

WTO Council for Trade in Services, 1999a, International regulatory initiatives in services, Document S/C/W/97, WTO, Geneva.

WTO Council for Trade in Services, 1999b, Article VI:4 of the GATS: Disciplines on domestic regulation applicable to all services, Document S/C/W/96, WTO, Geneva.

