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TRADE IN SERVICES – MARKET ACCESS OPPORTUNITIES AND THE BENEFITS OF LIBERALIZATION FOR DEVELOPING ECONOMIES

by

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ABSTRACT

The service sector is the most important sector for most developing economies. It is the largest contributor to gross domestic product, production and employment. Since it is such an important sector, developing economies need to identify their comparative advantage in services and potential export markets.

Developing economies have a comparative advantage in labour services. They have an abundance of low and semi-skilled labour that is a major input into tourism, construction and transport services. New potential export opportunities are also emerging in communications and computer services. However, the export of many of these services is limited by many restrictions on the temporary movement of labour imposed by their trading partners through domestic regulation. Developing economies can improve their export revenues by specifically identifying these restrictions and, where a movement of labour is required, promote the benefits to potential export markets of services trade liberalization.

Developing economies are projected to be better off by US$ 130 billion from services trade liberalization. Consistent with similar modelling exercises for trade in goods, while there are some benefits from improving market access to foreign markets, most of the benefits come for liberalizing one's own market. As developing economies remove their restrictions, their service sectors develop, primarily funded by foreign direct investment, and they become major exporters of services. The main restrictions on service suppliers that are preventing developing economies from realizing these benefits are limits on foreign direct investment, stringent licensing requirements and restrictions on expanding operations.

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The paper draws heavily on the work of the Australian Productivity Commission who, in recent years, have been at the forefront in measuring and modelling the benefits of services trade liberalization.

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INTRODUCTION

The economic and trade performance of an economy is dependent on the efficiency of its service sector. Not only do economies derive the bulk of their employment and income from the service sector, but also many services — financial, telecommunications and transport — are vital intermediate inputs for other sectors. The international competitiveness of traditional sectors of developing economies is heavily dependent on access to services at world prices. The best guarantee that services will be supplied at world prices is to open an economy to the pressures and opportunities of international competition or trade and investment liberalization.

Developing economies benefit from liberalization by gaining market access and exporting those services in which they have a relative strength or comparative advantage. Access to foreign services markets is important for developing countries to enable them to improve their export earnings and the employment opportunities of their nationals, as well as increase the efficiency in their own economies so as to mobilize resources for development. Global economic integration and technological developments have increased international trade in services and are providing many export opportunities for developing economies.

Developing economies have the potential to reap greater benefits from liberalization than developed economies, primarily by liberalizing their own service sector. Domestic liberalization permits resources to be allocated to their most efficient uses. A more efficient allocation of resources improves the price, choice and quality of services, and overall economic capacity, which facilitates trade in agriculture and manufacturing — a traditional export earner for developing economies. Central to building economic capacity and progressing development is an efficient financial services sector. Liberal and appropriately regulated financial services sectors efficiently mobilize savings for investment, provide payment mechanisms for business transactions and improve the stability of financial institutions.

Sophisticated general equilibrium modelling of liberalizing trade in services provide insights into the projected real-income gains from a more efficient allocation of resources for development. The results establish a framework for negotiating priorities when the gains from liberalizing trade in services are compared with those for agriculture and manufacturing. They also provide valuable information to negotiators and policy makers on the potential gains from improved market access as well as on approaches to liberalization.

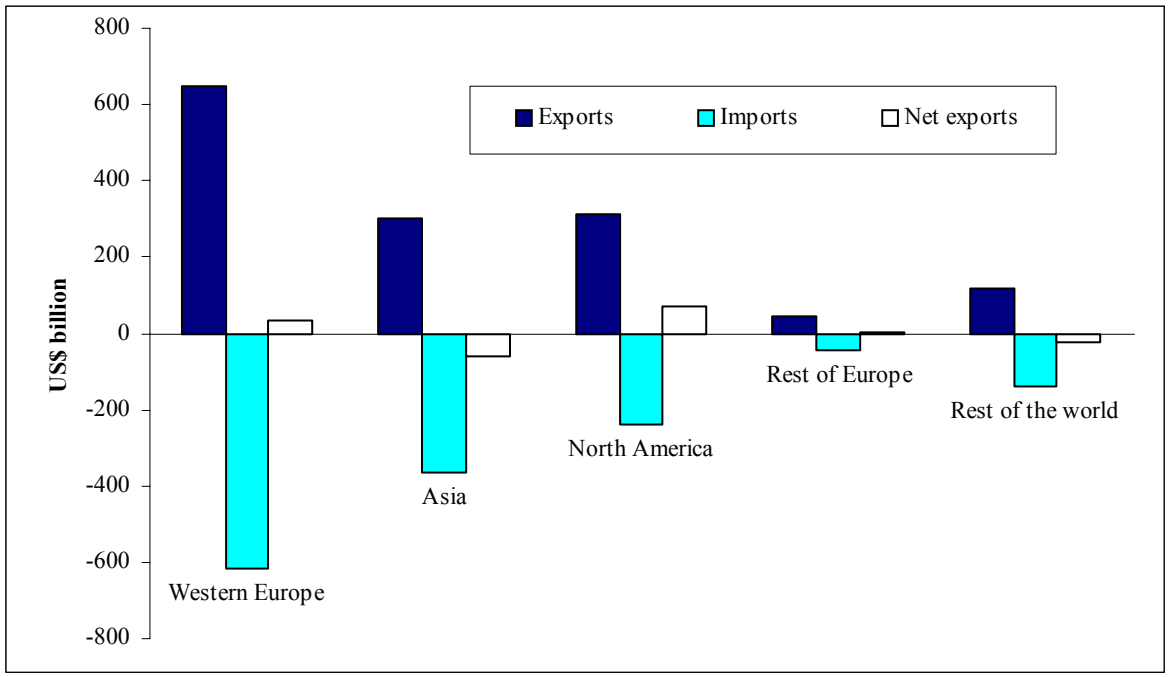
The greatest benefits will come from liberalizing all services markets – domestic and foreign. Politically, this is extremely difficult, but a multilateral framework that achieves market access in foreign markets can be an impetus for liberalizing one's own market. While this paper covers market access in foreign markets, results from empirical research indicate that most of the gains are from domestic liberalization — what you do for yourself is more important than what others do for you.

I. AN OVERVIEW OF INTERNATIONAL TRADE IN SERVICES

In 2000, world exports of services were US$ 1,435 billion, or approximately 20 per cent of total world exports (WTO, 2001a). As would be expected, the flow of exports and imports of services is the greatest for Asia, North America and Western Europe (see figure 1). These three regions account for more than 88 per cent of service exports — the European Union (45 per cent), North America (22 per cent) and Asia (21 per cent). Asia and the "Rest of the world" are the largest net importers of services.

The production of services typically accounts for the largest share of gross domestic product (GDP) and employment in developed and developing economies. The service sector is about 40 to 60 per cent of GDP and employment for developing economies and 60 to 80 per cent for developed economies (Hardin and Holmes, 1997). While the proportion of GDP attributable to services is generally lower in developing than in developed economies, the rate of growth of service sectors in developing economies

Figure 1. World exports and imports of services for selected regions,[a,b,c] 2000



Source: WTO (2001a).

[a] Comprehensive data on trade in services are only available for the cross-border mode of supply (see box 1). Data cover commercial services, defined as all services other than government services. Commercial services are subdivided into transport, travel and other commercial services.

[b] North America comprises Canada and the United States. Western Europe comprises Croatia, the European Union member States, Iceland, Malta, Norway, Slovenia, Switzerland, Turkey and the former Yugoslavia. The rest of Europe comprises Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States. The rest of the world comprises Africa, Latin America and the Middle East.

[c] Data for some economies are not available.

Box 1. How are services traded?

The major distinction between international trade in goods and international trade in services lies in the movement of the factors of production – mainly, labour and capital. For trade in goods, the factors of production are typically fixed in a specific location and the product is transported to the foreign market. For example, a motor vehicle manufacturing plant is usually located in the domestic market and motor vehicles are transported to the foreign market.

For trade in services, the factors of production move such that services can be supplied in four ways. The World Trade Organization's General Agreement on Trade in Services (GATS) describes the four ways or modes of supply for trade in services – cross-border, consumption abroad, commercial presence and the movement of people.

Mode 1: Cross-border
In the same way as goods are traded, services can be traded across borders. There is thus a clear geographical separation between the buyer and the seller. For example, a United States stockbroking firm may buy or sell shares for a Japanese resident over the Internet. The United States is exporting financial services across the border to Japan and Japan is importing financial services from the United States.

Mode 2: Consumption abroad
Services can be traded by the consumer moving or travelling to the foreign market. For example, a United States fee-paying student may travel to Japan to study at a Japanese university. Japan is exporting its education services to the United States and the United States is importing education services from Japan.

Mode 3: Commercial presence
Services can be traded by the capital of the exporter moving to the foreign market. For example, a United States telecommunications company may establish a company in Japan. The sale of telecommunications services in Japan is an export from the United States to Japan and Japan is importing telecommunications services from the United States. Most services are traded in this way.

Mode 4: Presence of natural persons (or movement of people)
Services can be traded by the producer or service supplier moving to the foreign market. For example, an accountant who is a United States citizen may temporarily work for a Japanese company in Japan. The United States accountant is exporting professional services to Japan and Japan is importing professional services from the United States.

is faster than that in developed economies (OECD, 1999).

The importance of services to an economy is even greater than that reflected in direct sectoral shares of GDP and employment because services are important inputs for all aspects of processing and production. The growth of an economy's service sector is strongly associated with product specialization, income growth and economic modernization. Services provide much of the necessary infrastructure for investment and economic growth, ensuring that their efficient delivery is an important means of improving an economy's overall productivity.

Global economic integration and technological developments have led to a continual expansion of a range of traded services which are defined as including both transactions between residents and non-residents, and transactions across geographical borders. International transactions, which in earlier times would have been impossible or prohibitively expensive, have now become commonplace because of the ease with which people can move and communicate across international borders. For example, the fall in the cost of international air services in recent decades has made many tourist services tradable. These services were previously available only to domestic consumers. Box 1 outlines how services are traded.

II. MARKET ACCESS FOR DEVELOPING ECONOMIES

Market access in services is inherently more complex than market access for trade in goods. For trade in goods, market access is about reducing mainly border measures such as tariffs that are imposed on goods as they enter a market. For trade in services, market access is about reducing government policy interventions which are less visible and may be applied after a service supplier has entered the market. These measures take the form of government regulations that are usually aimed at domestic policy objectives rather than trade policy objectives. There is usually little consideration of the effects of such measures on trade and market access for foreign service suppliers.

Exploiting market access in services, as for trade in goods, requires identification of the relative strength or comparative advantage and specialization in the production and export of those services. Developing economies can assess comparative advantage independently of others, but maximizing their export revenues requires identification of restrictions in foreign markets and skillful negotiation of their reduction or removal.

A. Developing economies and comparative advantage

The modern economy fundamentally depends on specialization and trade between economies. The principle of comparative advantage is the fundamental analytical explanation of the "gains from trade". The theory states that an economy should specialize in the production and export of services in which it has a relative advantage and import services in which it has a relative disadvantage. International trade on this basis will mean that services will be produced by the relatively least cost world producer and the quantity of services consumed will be optimal.

The determinants of an economy's comparative advantage are the endowments of the factors of production and technology. Factor endowment is the amount of resources — land, labour or capital — held by an economy that can be used for production. Technology entails the productive use of resources. An economy may have abundant factor endowments of unskilled labour and a comparative advantage in labour-intensive services — construction and tourism services. On the other hand, an economy may have a small quantity of highly skilled labour such that it has a comparative advantage in legal services.

Developing economies clearly have a comparative advantage in labour services or services where labour is a major input, such as tourism. Some developing economies also have a comparative advantage in construction and transport services, although this is more variable between economies. New export opportunities are also emerging for developing economies in communications and computer services.

B. Market access and the movement of natural persons

Developing economies' comparative advantage and the export potential of their services predominantly lie in the movement of low- and semi-skilled labour services or

the movement of people. Statistics on the movement of people, although imperfect, suggest that developing economies are net exporters and developed economies are net importers of labour services (WTO, 2001b).

Trade conditions for the movement of people tend to be more restrictive than for any other mode of supply (Drabek and Laird, 2001). Many developed economies are capital-intensive and permit the entry of highly skilled labour, but not the entry of low-skilled workers from labour-abundant developing economies. Developed economies permit the entry of highly skilled personnel and professionals for a limited duration but not the entry of unskilled and low-skilled workers such as construction workers (Stewart, 1993).

The restrictiveness of this mode of supply is also reflected in GATS commitments. Market access conditions tend to be significantly more restrictive for the movement of natural persons mode of supply than for any other mode (WTO, 2001b). Most of the commitments apply to all service sectors; and, rather than aiming to expand market access, commitments are usually less than the status quo. Commitments also specify the type of person that can enter a market – executive, manager or specialist – and the purpose of the entry – business networking, negotiating sales or establishing a commercial presence.

There are many constraints on the temporary migration of labour that are imposed through domestic regulations, and are mainly administrative in nature. There are four main types of restrictions on the movement of natural persons:

- *Immigration regulation on the entry.* These restrictions include eligibility conditions for the granting of work permits, cumbersome application procedures, and limitations on the length of stay and transferability of employment.

- *Regulation on the recognition of qualifications, work experience and training.* Recognition requirements prevent market access for foreign service suppliers or limit the scope of work that can be performed. There is also some discretion in granting recognition for certification or licensing of foreign persons.

- *Differential treatment of domestic and foreign service personnel.* There are usually stringent qualification and eligibility conditions – citizenship or residency requirements – imposed on foreign service suppliers.

- *Entry conditional on commercial presence.* The entry of foreign personnel is usually conditional on some form of establishment. Developing economies usually have limited resources to enter through commercial presence and are thus, unable to provide labour services.

Improved market access for developing economies will increase export earnings and improve employment opportunities for their nationals. The temporary nature of trade in the movement of people also improves domestic human capital. People returning from a foreign services market have acquired a new range of skills and knowledge that can be used to build capacity in the domestic economy.

In gaining market access, primarily from developed economies, developing economies need to promote the benefits and address the concerns of such trade for developing economies. Developed economies can acquire similar skills and knowledge from less expensive foreign personnel, which can alleviate pressures on inflation through demands from nationals for higher wages. Wages are around 80 per cent of the cost of production and lower labour costs provide developed economy firms with larger profit margins, which in a competitive market could be reinvested in research and development to produce more innovative products.

Economies often have many, mainly political, concerns about the liberalization of their labour services markets. It is difficult for Governments to embrace the benefits of importing less expensive labour in the face of vocal domestic lobby groups describing such a policy as a "threat" to domestic jobs. The fears of a few from the importing Government need to be weighed against the substantial benefits for the overall economy. Governments and lobby groups may need to be educated about the benefits. As in the case of any liberalization, short-term adjustment costs will also occur as resources in a previously protected labour market are reallocated, but in the long term substantial benefits will accrue to the economies importing (and exporting) labour services.

Governments and lobby groups also raise concerns about employment and permanent migration. Measures affecting natural persons seeking access to the employment market or measures regarding citizenship, residence or employment on a permanent basis are not covered under the GATS. The latter aims to promote liberalization of labour services but at the same time gives WTO Members the freedom to regulate the entry and temporary stay of natural persons, which includes the implementation of measures necessary to protect the integrity and ensure the orderly movement of natural persons across their borders.

Restrictions on the movement of people in some economies may prohibit the entry of foreign persons. However, market access can still be achieved by switching to the next best alternative, and usually less efficient, mode of supply. In recent years, India has developed a growing software services industry that delivers services over the Internet or via the cross-border mode of supply. The industry competes internationally even though developed economies continue to impose restrictions on the movement of Indian nationals (Chadha, 2001). Developed economies may also be more amenable with labour being embodied in a service supplied to the domestic market rather than labour entering directly and supplying a service within the domestic market.

The GATS also provides provisions aimed at enhancing market access for developing economies (see box 2).

C. Market access and tourism services

Tourism generates the largest export revenues for developing economies. It is one of the largest and fastest-growing service sectors, accounting for over 35 per cent of world services exports (WTO, 2001b). It is highly labour-intensive and is an important employer in developing economies.

Natural attractions and inexpensive destinations are the determinants of comparative advantage in tourism for developing economies. Foreigners are drawn to developing economies by their differences in terms of natural attractions and culture. Most of the largest exporters of tourist services are small island nations. Foreigners from developed economies also find visiting a developing economy relatively inexpensive and a "value for money" holiday.

Market access for tourist services is primarily the responsibility of a developing economy. Tourists travel to the foreign (or export) market to consume such services. Market access for tourist services is about permitting foreign persons' access to the country. Measures imposed by developing economies that limit their ability to maximize their export revenues from tourism are restrictions on the issuing and length of visas and currency movements for individual tourists.

Maximizing export revenues from tourism is very dependent on the necessary and efficient infrastructure being in place. Tourists rely on efficiently operating trans-

Box 2. Developing economies, market access and the GATS

The General Agreement on Trade in Services (GATS) is the first multilateral legally enforceable agreement on international trade in services. Its objective is progressive liberalization of international trade in services through successive rounds of negotiations. Generally, the GATS covers all services (except those provided by a governmental authority), services delivered through the four modes of supply (see box 1) and all measures affecting trade in services. The important principles in the GATS, as in other WTO agreements, are most-favoured-nation, transparency, market access and national treatment.

Developing economies can use the GATS to help them gain market access. Under Article IV, the GATS aims to increase the participation of developing economies in the world trading system. Developing economies can request developed economies to provide them with opportunities for their service exports. Article IV requires WTO Members to increase the participation of developing economies in the world trade by:

- Strengthening the domestic services capacity of developing economies and its efficiency and competitiveness through access to technology on a commercial basis;
- Improving their access to distribution channels and information networks; and
- Liberalizing market access in services that are of export interest to developing economies.

WTO Members were also requested to establish contact points for service suppliers from developing economies in order to facilitate access to information about supplying services in developed economies. Special priority is to be given to market access and information requests from least developed economies.

port, telecommunications and financial services. The domestic economy requires reliable transport services for tours and sightseeing, telecommunications services for organizing tours and financial services for currency exchange. Many developing economies need to develop these essential input services for the benefit of tourism and other sectors.

D. Market access and new export opportunities

Developing economies also have an opportunity to expand their service export bases. These include semi-skilled knowledge-based services in a range of communication and computer services. Advances in information technology and electronic commerce have created these opportunities. For example, India has in recent years developed a high-quality and low-cost software development industry (Chadha, 2001).

Potential comparative advantage for developing economies lies in a number of business services. These include a wide range of:

- Computer services, including software programming, database management, online support services, and Internet site design and management;
- Professional services, including low-cost architecture, consulting engineering, legal research and market research services;
- Technical assistance for other developing economies, including low-tech and medium-tech production processes, industrial engineering, industrial design, and research and development; and
- Cultural or linguistic services, including multilingual offshore call centre services (UNCTAD, 1998, 2001).

Developing economies have a potential comparative advantage in these services — as in many other services — because of their low-cost labour services, and thus market access is dependent on the movement of people. These new opportunities are also substantial generators of new employment. There are worldwide labour shortages in some of these services, in particular software development. Restrictions on work permits and visas limit the ability of the shortages to be addressed via the importation of labour from developing economies (WTO, 1998). As mentioned above, developing economies can take advantage, to a lesser extent, of some of these opportunities by supplying these services via a mode of supply other than the movement of people.

III. WHAT'S AT STAKE FOR DEVELOPING ECONOMIES?

Measuring the economy-wide impact of trade liberalization requires a global general equilibrium framework, which captures intersectoral effects for an economy and links between economies. This enables an assessment to be made of the impact of sector-specific policies on an economy as a whole.

Numerous general equilibrium studies analyse the economic impacts of policies affecting trade in goods, but relatively little work has been completed on assessing the potential gains from alternative liberalization scenarios in services. The past difficulties arise from inadequate information about international service transactions and a lack of comprehensive measures of restrictions on trade in services. Modelling of services trade also requires the development of a different modelling structure from that used for goods trade in order to incorporate the various modes through which services are supplied, that is, to account for the movement of factors of production (OECD, 2000a, 2000b).

A significant amount of methodological thinking is still required on modelling services trade liberalization, but a number of studies have analyzed the effects (Benjamin and Diao, 1998, 2000; Brown et al., 1996; Chadha, 2001; Chadha et al., 2000; Dee and Hanslow, 2000; DFAT, 1999; Hertel et al., 1999; and Robinson et al., 1999). The results are similar in a number of respects:

- There are always substantial global real-income gains from services liberalization. In many studies, the gains in terms of real income are similar to or greater than those derived from liberalization of trade in agriculture and manufacturing combined.
- Developing economies gain more than developed economies. Economies with greater restrictions or, mainly, developing economies reap the greatest benefits from liberalization.
- Liberalization of trade in services has powerful impacts on agriculture and manufacturing through intersectoral linkages in an economy. Services are essential inputs to other sectors, and substantial productivity gains accrue to other sectors when liberalization improves the efficiency of the service sector.

Dee and Hanslow (2000) use one of the most sophisticated general equilibrium models to analyse the effects of liberalizing trade in services. The model simulates the benefits of liberalizing restrictions on all services and indirectly incorporates the benefits from liberalizing restrictions on the movement of natural persons. It also has the capability to simulate the effect of removing certain types of restrictions. It can examine the impact of full and partial multilateral liberalization of services trade. It is a 19-region (covering Asia, North and South America and the European Union) by 3-sector (agriculture, manufacturing and services) computable general equilibrium model of the world economy known as the FTAP model. It was developed from the Global Trade Analysis Project (GTAP) model (Hertel, 1997), with the addition of the structure necessary to support the analysis of services liberalization.

One of the distinguishing features of FTAP is the inclusion of foreign direct investment (FDI). The treatment of FDI allows for examination of the comprehensive removal of restrictions on all modes of service

supply, including restrictions on services delivered via FDI. Hanslow et al. (1999) fully documents the structure of the FTAP model.

Dee and Hanslow used FTAP to find that the world as a whole is projected to be better off by more than US$ 260 billion annually as a result of eliminating all post-Uruguay Round trade restrictions. About US$ 133 billion would come from liberalizing services trade, US$ 51 billion from agricultural liberalization, and US$ 83 billion from liberalization of manufactures (see table 1). These are the projected gains in real income about 10 years after liberalization has occurred and the associated resource adjustments have taken place.

Developing economies are projected to be better off by US$ 130 billion. The services sectors in most developing economies are projected to expand. As their relatively

Table 1. Effects of liberalizing trade in services[a,b]
(Percentage and US$ millions)

	Change in real income					
	Percentage change			Absolute change in US dollars		
	Primary and secondary	Tertiary	Total	Primary and secondary	Tertiary	Total
Developing economies						
Chile	0.7	0.4	1.1	45	330	375
China	3.4	14.6	18.0	14 088	90 869	104 957
Indonesia	0.7	5.1	5.9	1 451	2 470	3 921
Malaysia	3.7	0.7	4.5	3 532	1 015	4 547
Mexico	0.3	0.1	0.4	-83	357	274
Philippines	5.1	0.4	5.5	1 601	1 236	2 837
Republic of Korea	1.5	0.1	1.6	8 784	1 886	10 670
Taiwan Province of China	2.7	0.2	3.0	11 659	-142	11 517
Thailand	2.6	0.2	2.8	4 063	1 698	5 762
Rest of the Cairns Group	1.2	0.1	1.3	12 766	6 970	19 736
Rest of the world	1.1	0.8	1.9	11 324	23 039	34 363
Total				**69 230**	**129 728**	**198 959**
Developed economies						
Australia	0.2	0.0	0.2	1 994	2 098	4 092
Canada	0.1	-0.1	0.0	-539	-499	-1 038
European Union	0.1	0.0	0.1	6 394	-6 169	225
Hong Kong (China)	-0.2	1.0	0.9	916	5 896	6 812
Japan	0.3	0.0	0.3	20 964	4 130	25 094
New Zealand	1.2	-0.1	1.1	4 400	257	4 657
Singapore	-0.3	-1.3	-1.5	7 421	-247	7 174
United States	0.2	-0.1	0.1	22 734	-1 809	20 925
Total				**64 284**	**3 657**	**67 941**
World				**133 514**	**133 385**	**266 900**

Source: Dee and Hanslow (2000).

[a] Figures may not add up to total because of rounding.
[b] These are the projected gains in real income about 10 years after liberalization has occurred and the associated resource adjustments have taken place.

high restrictions on entry are removed, their services sectors develop, primarily funded by FDI, and they become major exporters of services. China is expected to benefit by US$ 91 billion from the removal of particularly stringent restrictions.

While developing economies will receive a greater share of the expanding global services market, services sectors in economies with moderate restrictions will expand but their share of the global services markets in the long run will be smaller. Australia, New Zealand, Canada and the United States, as well as the European Union, are expected to gain but relatively less than developing economies. In part, this is because of increased competition via cross-border trade from the newly expanded Asian service sectors.

For some economies — the European Union, the United States, Canada, Singapore and the Taiwan Province of China — the contribution of multilateral services trade liberalization is expected to be negative (Dee and Hanslow, 2000). There are a number of reasons that contribute to this result, but one of the more interesting insights is the effects of liberalization on foreign direct investment (Productivity Commission and the Australian National University, 2000). FDI can lead to an expansion or contraction in the capital stock located within a region, leading to a positive or negative contribution to income generated within a region from this change in national endowments. For many countries, after the restrictions on FDI in foreign economies are removed, the owners of the foreign capital receive a lower return.

Dee and Hanslow also projected the benefits of *partially* liberalizing services trade. The results show that the greatest global benefits will come from liberalizing *non-discriminatory* or, mainly, *market access* restrictions rather than *discriminatory* or, mainly, *national treatment* restrictions (see table 2). Removing all restrictions on *establishment* would be better than removing all restrictions on *ongoing operations*.

The results show, however, that it is difficult to find an outcome where at least some economies gain and none lose from partial liberalization, when it involves removing only one class of restriction (*non-discriminatory, discriminatory, national treatment, establishment* or *ongoing operations*).

This suggests that the best strategy for liberalization may be to negotiate gradual reductions in *all* types of restrictions simul-

Table 2. Effects of partial liberalization on world real income[a]
(US$ billion)

	Removal of non-discriminatory restrictions	***Removal of discriminatory restrictions***	***Both***[b]
Removal of restrictions on establishment	56.8	3.7	64.2
Removal of restrictions on ongoing operations	25.6	12.9	39.3
Both[b]	98.8	19.3	133.4

Source: Dee and Hanslow (2000).

[a] Figures may not add up to total because of rounding. These are the projected gains in real income about 10 years after liberalization has occurred and the associated resource adjustments have taken place.

[b] Because of interaction effects between types of partial liberalization, the figures for "Both" are not additive.

taneously. *Non-discriminatory* restrictions on all service suppliers should be reduced or eliminated before the removal of *discriminatory* restrictions on foreign service suppliers. Dee et al. (2000) argue that reducing *non-discriminatory* restrictions on all service suppliers is a better approach than only reducing *discriminatory* restrictions on foreign service suppliers. Reducing *discriminatory* restrictions on foreigners alone can have a negative impact on the level of services supplied by domestic firms. This will result in lower prices and higher total sales, but domestic service suppliers will end up with a smaller share of the service sector. However, if restrictions that affect foreign and domestic service suppliers equally are reduced, all service suppliers will have the same opportunities to increase the amount of services they supply in an expanding market.

Verikios and Zhang (2001) also used the FTAP model to analyse the sectoral impacts of removing all restrictions on trade in financial and communications services. They found that the total gain in world income from liberalizing both sectors is US$ 48 billion. About US$ 24 billion of this would come from liberalizing communications services, with most of the gains coming from removing *non-discriminatory* restrictions. US$ 24 billion is likely to accrue to financial services, with almost all the gains coming from removing *discriminatory* restrictions. However, the gains from most regions are the highest when all restrictions are removed.

IV. WHAT ARE THE RESTRICTIONS AND THEIR EFFECTS?

The modelling results show greater benefits from liberalization for developing economies than for developed economies. Most of these gains arise from liberalizing the domestic service sector, not from seeking better market access to foreign services markets. This raises the question of the nature and extent of restrictions on trade in services that are preventing developing economies from achieving these gains.

Identifying and measuring restrictions shows the extent of restrictiveness of different economies and which economies, potentially, have the most to gain. Converting qualitative information on restrictions to a quantitative index measure of trade restrictiveness, based on coverage and some initial judgements about the relative stringency of the different sorts of restrictions, provides for ease of comparison for economies. These results can then be used to estimate the effect of restrictions on the prices and costs of services.

Measuring the effects of restrictions on trade in services has, until recently, been considered too difficult. This has mainly been because of the difficulty in identifying restrictions on services. Restrictions on trade in goods usually take the form of a tariff, while restrictions on trade in services usually take the form of government regulation and a certain level of regulation is usually justified for meeting regulatory objectives. These difficulties have, to a certain extent, been overcome with advances in economic thinking and the collection of information on restrictions. In recent years, researchers have developed a methodology that generally involves:

- Measuring how restrictive a service sector is in an economy by using a trade restrictiveness index; and
- Estimating the effect of restrictions, as measured by the trade restrictiveness index, on the economic performance — price, cost and/or price-cost margins — of service suppliers (McGuire, 2000).

These estimates of the effects on restrictions can be used to project the economy-wide and global benefits of removing restrictions on services using a computable general equilibrium model. Dee and Hanslow (2000) used some of these measures to model the benefits of liberalizing trade in services.

A. Measuring restrictions on trade in services

Restrictions on trade in services can be measured using a trade restrictiveness index. This index is a sophisticated frequency measure that estimates the restrictiveness of an economy's trading regime for services on the basis of the number and severity of restrictions.

Information on restrictions is first gathered and then classified. The information on restrictions is drawn from a number of sources, including material produced by Asia-Pacific Economic Cooperation (APEC), the OECD, the WTO and the United States Trade Representative. A comprehensive database of restrictions can be compiled from these sources, but it is possible that some service sector regulation and developments are not captured. That said, the information

compiled on restrictions is significantly more comprehensive than that provided in the GATS schedules of WTO Members. The process also highlights the types of restrictions that are imposed on services which is very helpful for negotiators.

Restrictions can be classified in two ways. The first is by whether a restriction applies to:

- *Establishment* — the ability of service suppliers to establish physical outlets in an economy and supply services through those outlets; or

- *Ongoing operations* — the operations of a service supplier after it has entered the market.

Restrictions on *establishment* often include licensing requirements for service suppliers or firms, restrictions on direct investment in existing firms and restrictions on the permanent movement of people. Restrictions on ongoing operations often include restrictions on firms conducting their core business, the pricing of services and the temporary movement of people.

The second way a restriction can be classified is by whether it is:

- *Non-discriminatory* — restricting domestic and foreign service suppliers equally; or

- *Discriminatory* — restricting only foreign service suppliers.

This two-by-two classification is similar to that used in the GATS schedules of commitments (WTO, 1994). Restrictions on *establishment* (or commercial presence) include those affecting services delivered via FDI. Restrictions on *ongoing operations* can affect services delivered by cross-border supply, consumption abroad or the presence of natural persons (other modes of supply recognized under the GATS). *Non-discriminatory* restrictions are similar to the GATS limitations on *market access* and *discriminatory* restrictions are similar to limitations on national treatment. Table 3 provides an example of how trade restrictions on banking services are classified.

The trade restrictiveness index score is calculated for each economy using a methodology of weights and scores (McGuire et al., 2000). Scores are assigned for each restriction on the basis of a judgement about how stringent it is. The more stringent the restriction, the higher the score. For example, an economy that restricts the number of

Table 3. An example of classifying trade restrictions on banking services

	Establishment (commercial presence mode of supply)	***Ongoing operations (cross-border, consumption abroad and movement of natural persons modes of supply)***
Non-discriminatory	The number of banking licences is restricted.	Banks are restricted regarding the manner in which they can raise funds.
Discriminatory	The number of foreign bank licenses is restricted.	Foreign banks are restricted regarding the manner in which they can raise funds.

Source: McGuire (2000).

banking licences is assigned a higher score than an economy that issues new banking licences with only prudential requirements.

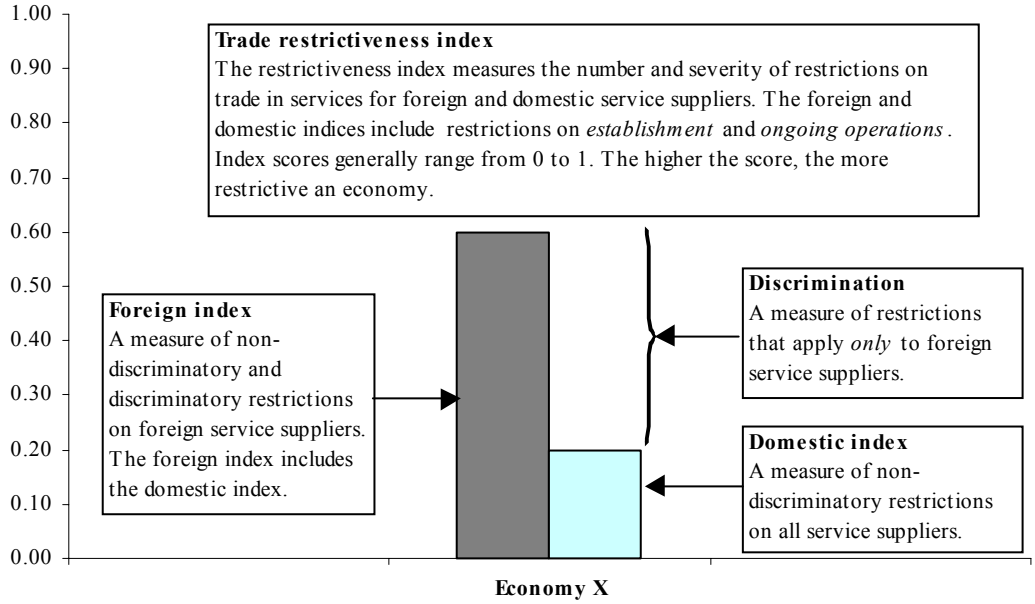
The restriction categories are then weighted together according to a judgement about their relative economic cost subject to reasonably available information. For example, restrictions on banking licences are weighted more heavily than restrictions on the temporary movement of people. The weights are generally chosen so that the total restrictiveness index score ranges from 0 to 1.

In calculating an overall economy score, it is not determined which restrictions might be justified for enhancing the efficiency of a service sector and which might not. In general, trade restrictions, by reducing competition in a services market, will reduce the efficiency of that market. However, sometimes regulation which limits competition is necessary to deal with "market failure" and to meet particular social objectives. No assessment is made of the merits or otherwise of the restrictions covered by the trade restrictiveness index. It is extremely difficult to make an assessment about the merits of regulation for economies with different regulatory objectives and structures. Furthermore, multilateral trading agreements, such as the GATS, aim to reduce restrictions while recognizing the freedom of trading agreement members to regulate to meet national policy objectives. Governments generally set their own regulation objectives — efficiency, transparency, stability and adequate disclosure.

An index score is calculated separately for domestic and foreign service suppliers. A *foreign index* is calculated in order to measure all restrictions that hinder foreign firms from entering and operating in an economy. It covers both *discriminatory* and *non-discriminatory* restrictions. A *domestic index* represents restrictions that are applied to domestic firms and it covers *non-discriminatory* restrictions. The *difference* between the foreign and domestic index scores is a measure of discrimination against foreigners. Figure 2 provides an illustration of the results from the trade restrictiveness index.

Figure 2. An illustration of the results from the trade restrictiveness index

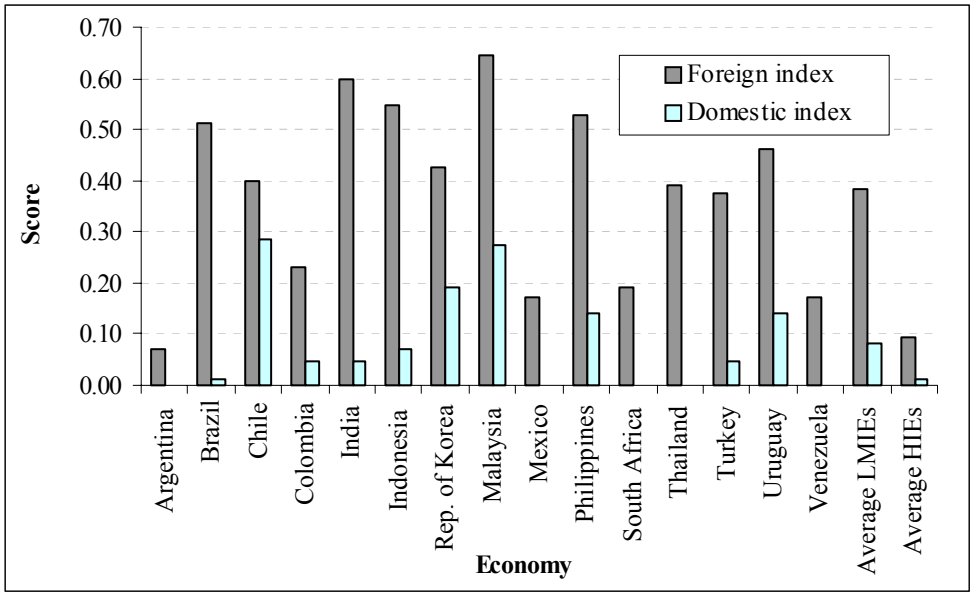
(Score)



Source: McGuire (2000).

Figure 3. Banking services[a]

(Score)



Source: McGuire and Schuele (2000).

[a] Based on available information on restrictions in place as at 31 December 1997.

1. Trade restrictiveness index results for developing economies

The results from the trade restrictiveness indices show that developing economies tend to have higher trade restrictiveness index scores than developed economies. Many of the economies experiencing financial difficulties in recent years, mainly Asian and South American economies, have medium to high restrictiveness index scores. These economies were also found to be the most discriminatory against foreign service suppliers.

Figures 3 to 7 show the results for selected service sectors from the trade restrictiveness indices for low- and middle-income economies (LMIEs) (or developing economies) and the average for high-income economies (HIEs) (or developed economies). The World Bank (2001) provides the groupings for LMIEs and HIEs.

The Productivity Commission (2001a) provides data for each service sector with greater economy coverage and data disaggregation for the trade restrictiveness indices. Insufficient information is available for calculating trade restrictiveness indices for a number of developing economies.

The commentary on each service sector for each economy provides an overview of the type of restrictions imposed. More specific details are available from the relevant identified papers.

Brazil, India, Indonesia, Malaysia and the Philippines are the most restricted markets for banking services in this grouping (see figure 3). These economies are all characterized by very tight entry controls and restrictions on business operations. Generally, they limit new foreign bank entry, strictly limit foreign equity participation and prohibit banks from expanding their existing operations.

Chile, the Republic of Korea, Thailand, Turkey and Uruguay are moderately restricted. These economies have at least one

significant restriction that limits foreign access to their markets. This includes either a restriction on licensing foreign equity participation in domestic banks or restrictions on their operations, such as opening new outlets and street branches.

Argentina, Colombia, South Africa and Venezuela are the least restricted in this grouping. They have fewer restrictions on licensing, and foreign equity participation.

Brazil, India and Indonesia have the most discriminatory restrictions against foreigners for banking services as measured by the large difference between the foreign and domestic index scores.

India, Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand are the most restricted markets for distribution services (see figure 4). Some of these economies are characterized by one or more of the following – foreign firms being prohibited from participating in retail distribution, limits on the number of import licences granted to foreigners, and limits and performance requirements on foreign equity participation in domestic firms. The Republic of Korea imposes on all distributors non-discriminatory restrictions that limit the availability of land and the ability of firms to establish large-scale stores.

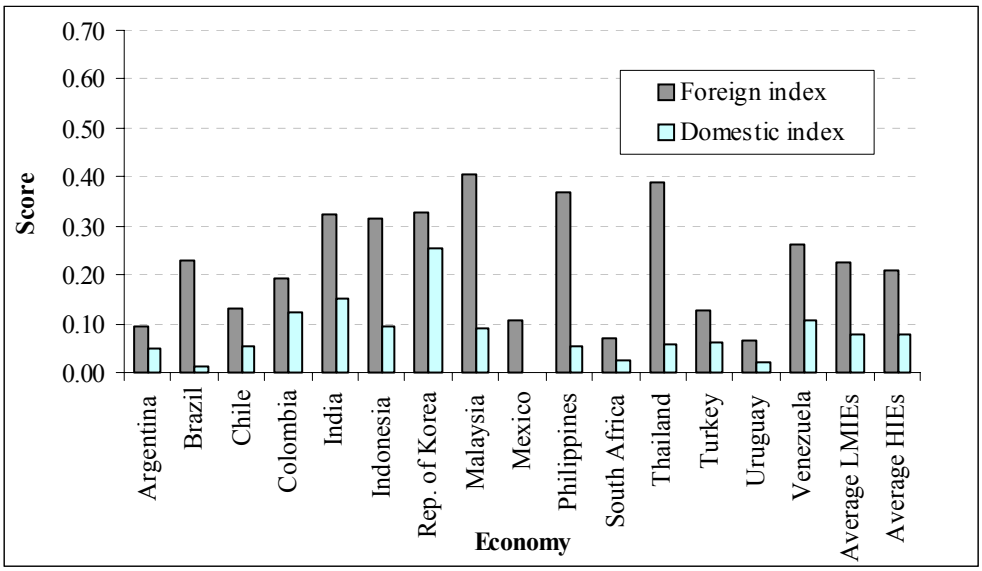
Brazil, Chile, Colombia and Turkey are moderately restricted. These economies have a number of restrictions on ongoing operations. They typically impose restrictions on opening hours and promotional activities, impose licensing requirements on management and restrict the movement of people.

Argentina, Mexico, South Africa and Uruguay are the least restricted. They require screening of foreign investment and licensing of management.

Malaysia, the Philippines and Thailand have the most discriminatory restrictions against foreigners with regard to distribution services.

Figure 4. Distribution services[a]

(Score)



Source: Kalirajan (2000).

[a] Based on the available information on restrictions in place as at 30 June 1999.

India, Indonesia, the Philippines, the Republic of Korea and Thailand are the most restricted markets for maritime services (see figure 5). These economies all have several significant restrictions on maritime services. They permit the formation of liner conferences, require ships to use specified suppliers for port services and restrict ownership of shipping service suppliers.

Brazil, Chile and Malaysia are moderately restricted. These economies require foreigners to have a commercial presence in the form of a joint venture with a domestic supplier, non-commercial cargoes to be carried by a government-owned shipping line and the majority of crews on national flag vessels to be nationals.

Argentina, Colombia, Mexico and Turkey are the least restricted in this grouping. They permit liner conferences and impose minor restrictions on foreign vessels, with some economies requiring the mandatory use of certain port services.

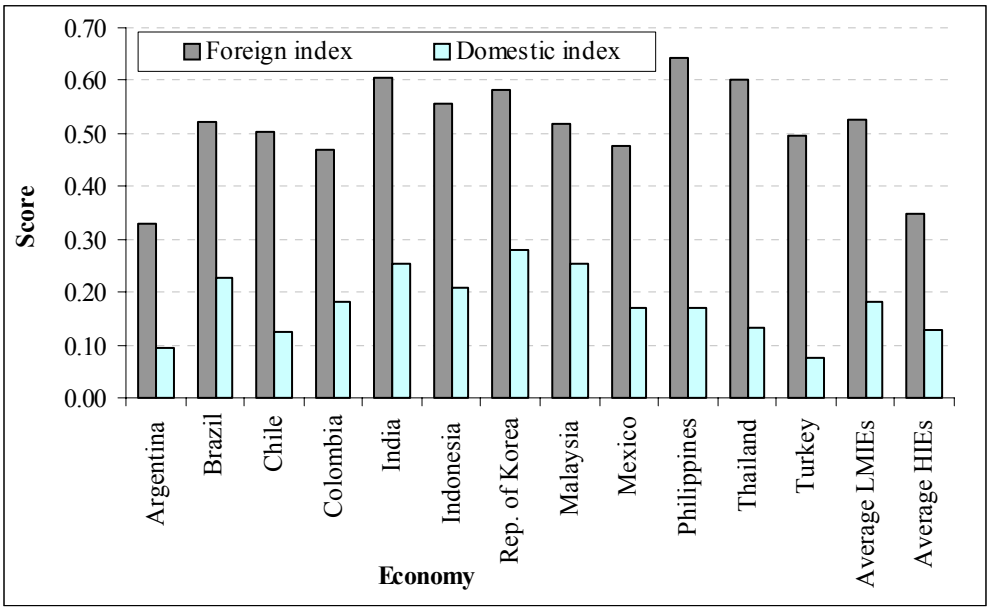
The Philippines, Thailand and the United States have the most discriminatory restrictions against foreigners with regard to maritime services.

Indonesia, Malaysia, Mexico, the Philippines and Turkey are the most restricted markets for professional services (see figure 6). These economies require nationality and residency requirements for the delivery of professional services. In some professional services, they require foreign firms to enter the market through joint ventures with local firms, apply economic needs tests to the number of professionals admitted to practise, limit the form of establishment and limit foreign investment in local firms.

Brazil, Chile, India, the Republic of Korea and Thailand are moderately restricted. These economies usually have moderate residency requirements, licensing of professionals, restrictions on the form of establishment and limits on non-professionals investing in professional services firms.

Figure 5. Maritime services[a]

(Score)

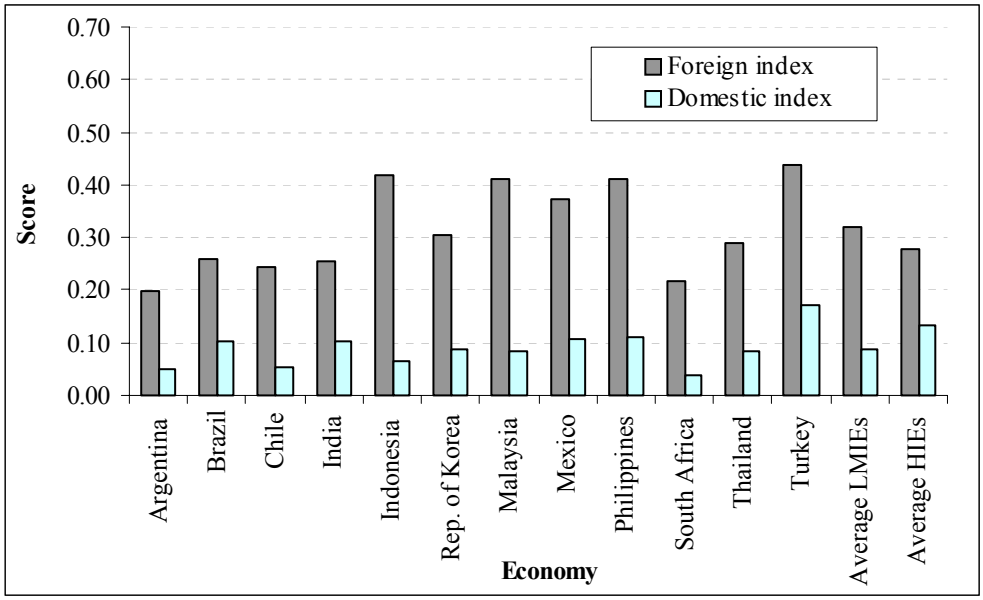


Source: McGuire et al. (2000).

[a] Based on the available information on restrictions in place as at 31 December 1998.

Figure 6. Professional services[a,b]

(Score)



Source: Nguyen-Hong (2000).

[a] Based on the available information on restrictions in place as at 30 June 1999.
[b] The results for professional services are the average results of the trade restrictiveness indices for accountancy, architectural, engineering and legal services.

Argentina and South Africa are the least restricted. They generally have liberal requirements regarding residency and foreign ownership, and recognize foreign qualifications.

Indonesia, Malaysia and the Philippines have the most discriminatory restrictions against foreigners with regard to professional services.

India, Indonesia, the Republic of Korea, Thailand and Turkey are the most restricted with regard to telecommunications services (see figure 7). Some of these economies are characterized by one or both of the following – major limitations on FDI in fixed network and mobile phone services. They tend to have greater restrictions on FDI in fixed network services than mobile phone services. They also have varying levels of restrictions on access to leased lines and networks.

Colombia, Malaysia, Mexico, the Philippines, South Africa, Uruguay and Venezuela are moderately restricted. These economies have moderate limitations on FDI in telecommunications service suppliers. Their restrictions on access to leased lines and networks are similar to those of the most restricted economies.

Argentina, Brazil and Chile are the least restricted. These economies were found to have few restrictions on FDI and cross-border trade of telecommunications services.

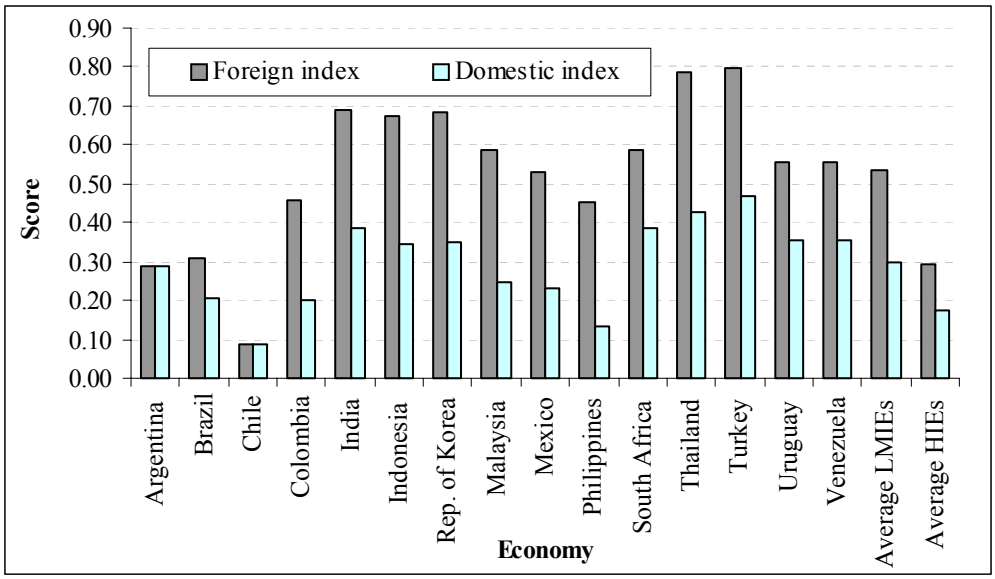
Malaysia, the Republic of Korea and Thailand have the most discriminatory restrictions against foreigners with regard to telecommunications services.

2. Restrictions on services and GDP per capita

A comparison of the foreign trade re-

Figure 7. Telecommunications services[a,b]

(Score)



Source: Adapted from Warren (2000a).

[a] Based on a 1998 International Telecommunication Union survey (ITU, 1999).
[b] The results are calculated from Warren (2000a). This is a subset of trade restrictiveness indices. Warren also calculated a number of results for other developing economies.

strictiveness index scores with GDP per capita suggests that economies with less restricted service sectors tend to have higher GDP per capita. Data on GDP per capita at purchasing power parity for 1997 are sourced from the World Bank (2001).

The average foreign index scores for five service sectors — banking, distribution, maritime, professions and telecommunications — and GDP per capita shows that economies with greater discriminatory and non-discriminatory restrictions tend to have lower GDP per capita (see figure 8). India, Indonesia, Malaysia, the Philippines, Thailand and Turkey have particularly high average foreign index scores and some of the lowest levels of GDP per capita. Other economies are relatively close to the trendline.

In banking and telecommunications services, a number of developing economies in Asia and South America have particularly high restrictions and low GDP per capita (see figure 9 and 10). Developing economies have particularly high foreign trade restrictiveness index scores and low GDP per capita. There are also a number of economies that are away from the trendline. In banking services, the Republic of Korea and Singapore have relatively high restrictiveness scores and medium GDP per capita income. Argentina, Colombia, Mexico, South Africa and Venezuela have relatively low restrictiveness index scores and medium per capita income. In telecommunications services, Thailand and Turkey have high restrictiveness index scores and low GDP per capita. The Republic of Korea, Singapore and Canada have medium restrictiveness index scores and GDP per capitas. Chile has a low restrictiveness index score and GDP per capita.

Many other studies find similar relationships between the openness of service sectors and income. Mattoo et al. (2001) found a positive relationship between openness in financial and telecommunications sectors and long-run economic growth. The growth of economies with fully open tel-

ecommunications and financial services is 1.5 per cent higher than that of other economies. Levine (1997) found that economies with financial systems that are better at performing key financial services functions tend to be economically developed, have higher income per capita and grow at a faster pace than those that are less developed. The Pacific Economic Cooperation Council (1995) found a positive relationship between wealth and openness, in that APEC member economies with a higher number of GATS commitments also tend to have higher GDP per capita.

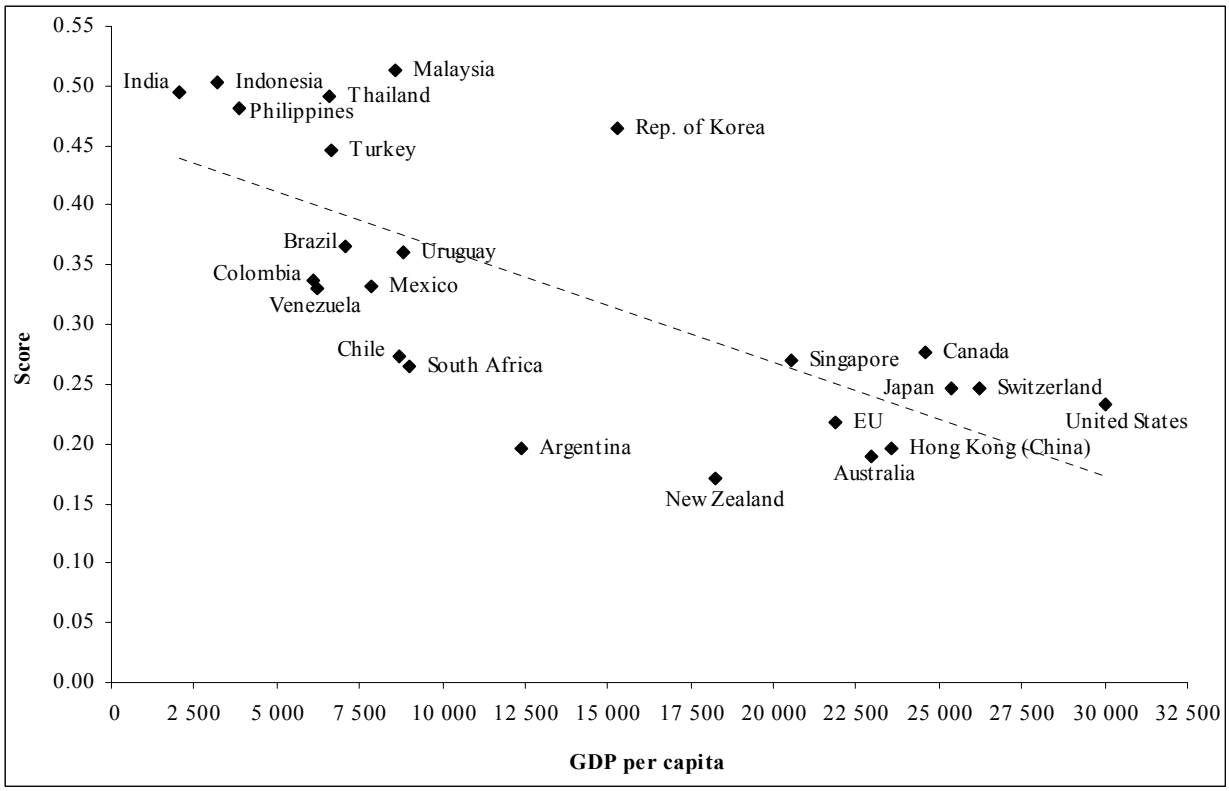
B. The effect of restrictions on the price and cost of services

The results from the trade restrictiveness indices can be used to estimate the effect of restrictions on the economic performance of service suppliers — prices and costs or price/cost margins. Restrictions on trade in services can have the effect of being:

- *Price-increasing* — restrictions protect incumbent firms from competition, and allows firms to increase their *prices* and expand their price/cost margins;

Figure 8. GDP per capita at PPP and average foreign trade restrictiveness index scores for the service sector[a,b]

(Score and GDP per capita at purchasing power parity)



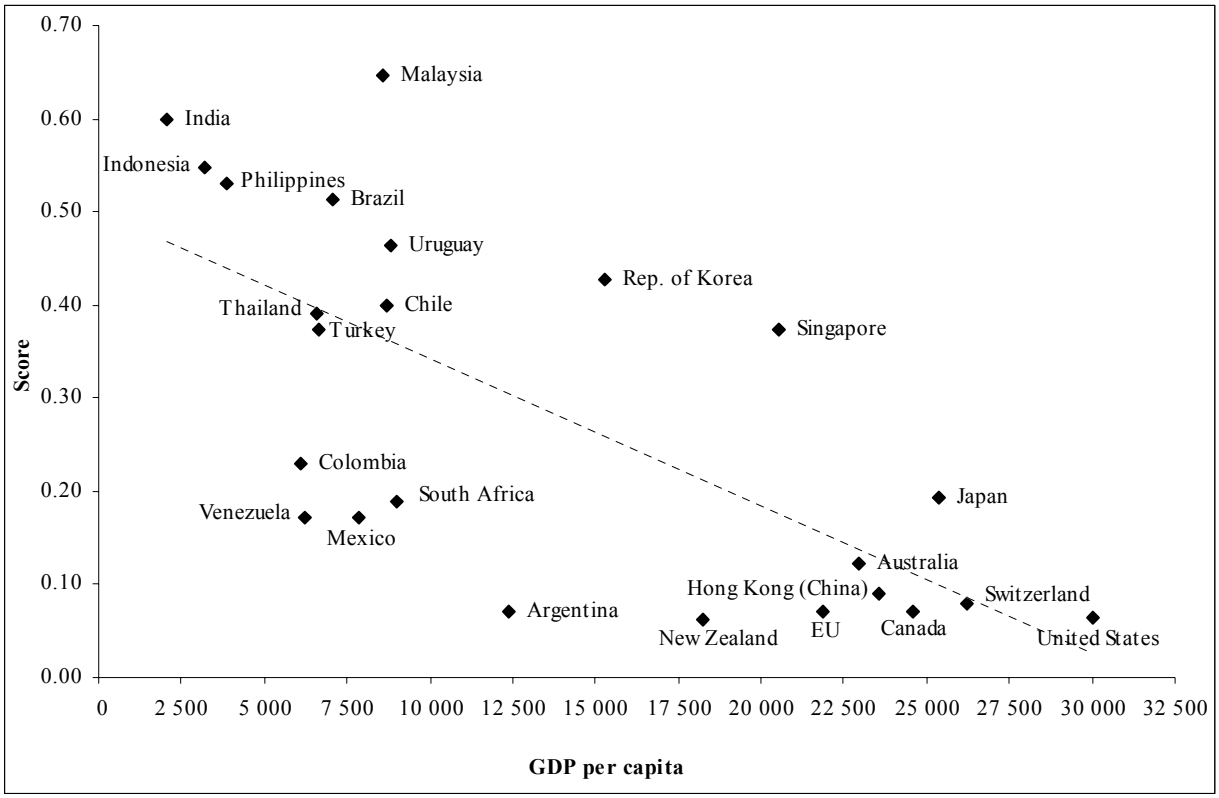
Sources: World Bank (2001); Productivity Commission (2001a).

[a] The average foreign trade restrictiveness index scores are the average scores for banking, distribution, maritime, professions and telecommunications.

[b] The "line of best fit" (or the regression line) is a very simple econometric exercise. Restrictions on trade in services are only one of many determinants of GDP per capita. That said, the r-squared of 0.52 is high for cross-sectional analysis. Greene (1990) states that r-squared values of 0.50 are relatively high for cross-sectional analysis.

Figure 9. GDP per capita at PPP and foreign trade restrictiveness index scores for banking services[a]

(Score and GDP per capita at purchasing power parity)



Sources: World Bank (2001); Productivity Commission (2001a).

[a] The "line of best fit" (or the regression line) is a very simple econometric exercise. Restrictions on trade in services are only one of many determinants of GDP per capita. That said, the r-squared of 0.48 is high for cross-sectional analysis.

- *Cost-increasing* — restrictions prevent potential or existing firms from operating efficiently and thus push up business *costs*; or

- A combination of *cost-increasing* and *price-increasing*.

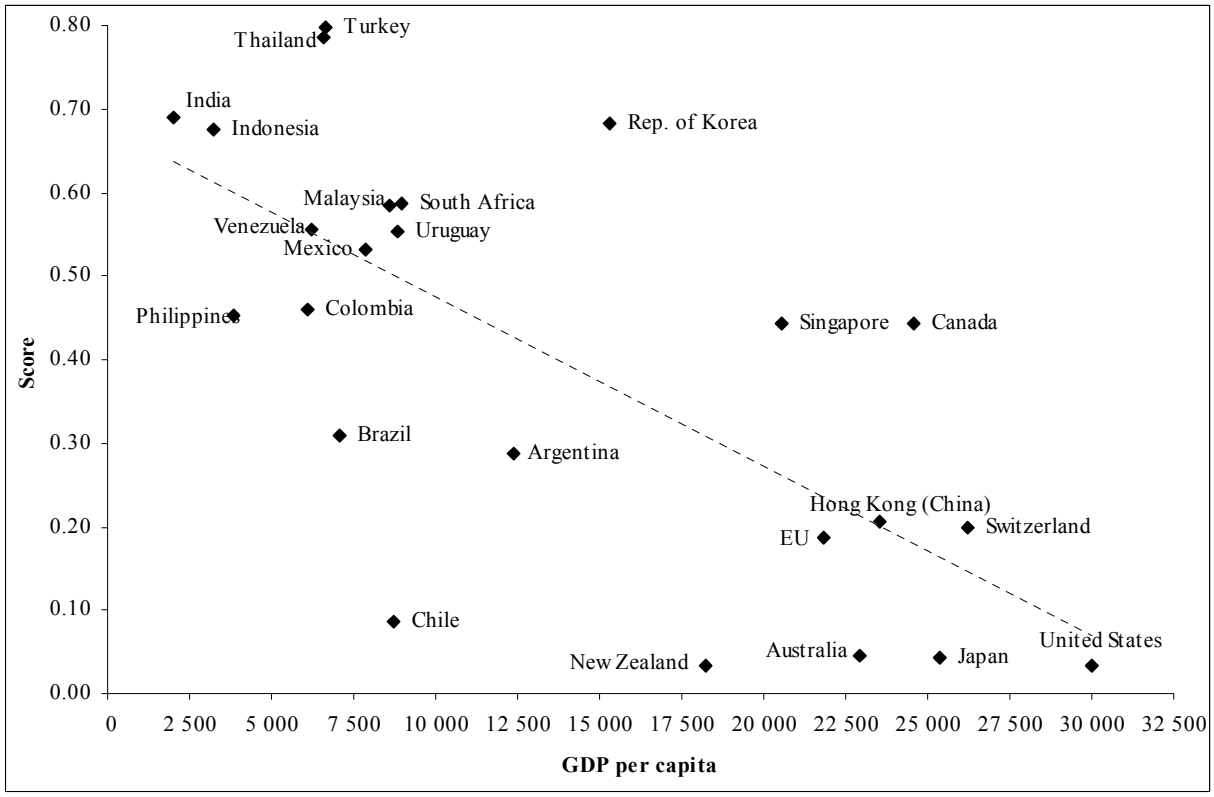
Econometric techniques can be used to estimate these different effects. This generally involves developing an econometric model from economic theory that includes all the relevant determinants of economic performance of service firms in that service sector — firm-specific and economy-wide influences — plus the trade restrictiveness index as a measure of restrictions on trade. The econometric model is then used to estimate the determinants of economic performance in that service sector and the effect of restrictions (McGuire, 2000).

1. Results from the price and cost estimations

The price and cost effect measures for most developing economies are up to 150 per cent higher than what they would be in the absence of restrictions. These effects show the extent to which restrictions, as measured by the trade restrictiveness index, increase the price and/or cost of services. As expected,

Figure 10. GDP per capita at PPP and foreign trade restrictiveness index scores for telecommunications services[a]

(Score and GDP per capita at purchasing power party)



Sources: World Bank (2001); Productivity Commission (2001a).

[a] The "line of best fit" (or the regression line) is a very simple econometric exercise. Restrictions on trade in services are only one of many determinants of GDP per capita. That said, the r-squared of 0.49 is high for cross-sectional analysis.

the results are similar to those from the trade restrictiveness index because they reflect, to a certain extent, the restrictions captured in the index.

The average price and cost effect measures are significantly higher for developing economies than for developed economies (see tables 4 and 5). The average foreign price effect in developing economies for banking services is 33 per cent as compared with 7 per cent in developed economies. Thus, restrictions in developing economies increase the price of banking services 33 per cent above what they would be in the absence of restrictions.

Restrictions on establishment contribute the most to increasing the price and cost of services. These are mainly restrictions on market access that include restrictions on the licensing of new firms and on FDI, as well as requirements for foreigners to enter the market through a specific type of legal entity.

The foreign and domestic cost effect measures for distribution and engineering services are significantly lower than the price effects. These restrictions increase the costs of service suppliers, but by a lesser extent than the price effects.

Table 4. Price and cost raising effect of restrictions for developing economies[a]

(Percentage)

	Foreign				*Domestic*			
	Price			*Cost*	*Price*		*Cost*	
Economy	*Banking*	*Telecommunications*	*Engineering*[b]	*Distribution*[c]	*Banking*	*Telecommunications*	*Distribution*[c]	*Engineering*[b]
Argentina	5.34	3.81	na	na	0.00	3.81	na	na
Brazil	45.56	5.68	na	na	0.87	3.81	na	na
Chile	34.00	1.68	na	1.32	23.20	1.68	1.92	na
Colombia	18.35	24.27	na	na	3.54	10.55	na	na
India	55.08	>150.00[d]	na	na	3.54	>150.00[d]	na	na
Indonesia	49.33	138.41	10.22	3.66	5.35	70.70	0.00	3.23
Malaysia	60.61	16.08	11.98	8.23	22.11	6.73	3.97	5.28
Mexico	13.40	14.43	14.17	na	0.00	6.24	na	1.95
Philippines	47.36	72.85	na	na	10.99	21.43	na	na
South Africa	14.90	20.89	3.73	0.47	0.00	13.77	0.00	0.69
Republic of Korea	36.73	8.43	na	na	14.93	4.30	na	na
Thailand	33.06	55.12	na	na	0.00	29.90	na	na
Turkey	31.54	33.53	na	na	3.54	19.59	na	na
Uruguay	40.34	11.92	na	na	11.00	7.61	na	na
Venezuela	13.44	14.94	na	na	0.00	9.57	na	na
Average	**33.27**	**38.14**	**10.03**	**3.42**	**6.60**	**23.98**	**1.47**	**2.79**

Sources: Kalirajan et al. (2000); Warren (2000b); Nguyen-Hong (2000); Kalirajan (2000).

na = not available. Insufficient data are available to estimate a price and/or cost effect for these economies.

a The table shows the price and cost raising effects of restrictions. That is, the percentage by which restrictions raise prices and/or costs higher than what they would be in the absence of restrictions.

b Nguyen-Hong (2000) calculated price and cost effects for one professional service – engineering. Insufficient data were available to calculate price and cost effects for accountancy, architectural and legal services.

c These cost effects are for restrictions on establishment.

d These economies have significantly large price effects that are greater than 150 per cent and are capped at 150 per cent.

Table 5. Price and cost raising effect of restrictions for developed economies[a]

(Percentage)

	Foreign				*Domestic*			
	Price			*Cost*	*Price*		*Cost*	
Economy	*Banking*	*Telecommunications*	*Engineering*[b]	*Distribution*[c]	*Banking*	*Telecommunications*	*Distribution*[c]	*Engineering*[b]
Australia	9.31	0.31	2.82	0.57	0.00	0.31	0.00	2.09
Austria	5.32	0.85	14.54	na	0.00	0.85	na	6.78
Belgium	5.32	1.31	0.52	4.87	0.00	0.65	6.69	0.66
Canada	5.34	3.37	5.31	3.09	0.00	1.07	0.98	2.68
Denmark	5.32	0.20	1.14	na	0.00	0.20	na	0.69
Finland	5.32	0.00	2.28	na	0.00	0.00	na	0.73
France	5.32	1.43	0.92	5.16	0.00	0.34	7.10	0.69
Germany	5.32	0.32	10.17	na	0.00	0.32	na	2.93
Greece	5.32	4.52	na	0.25	0.00	2.56	0.00	na
Hong Kong (China)	6.91	1.26	5.06	0.06	2.65	1.26	0.00	2.34
Ireland	5.32	2.67	na	2.70	0.00	1.46	0.00	na
Italy	5.32	1.00	na	na	0.00	1.00	na	na
Japan	15.26	0.26	6.57	2.26	10.03	0.26	6.79	2.24
Luxembourg	5.32	1.05	na	na	0.00	1.05	na	na
Netherlands	5.32	0.20	3.67	2.73	0.00	0.20	0.00	5.25
New Zealand	4.69	0.27	na	0.77	0.00	0.27	0.00	na
Portugal	5.32	6.25	na	na	0.00	3.80	na	na
Singapore	31.45	2.72	5.04	0.03	8.15	2.10	0.00	0.78
Spain	5.32	3.93	8.73	na	0.00	2.03	na	3.86
Sweden	5.32	0.65	6.76	na	0.00	0.65	na	0.74
Switzerland	5.95	1.23	na	5.24	0.00	1.23	8.32	na
United Kingdom	5.32	0.00	2.54	2.76	0.00	0.00	0.00	1.39
United States	4.75	0.20	7.38	2.26	0.00	0.20	0.00	3.79
Average	**7.11**	**1.48**	**5.21**	**2.34**	**0.91**	**0.95**	**2.13**	2.35

Sources: Kalirajan et al. (2000); Warren (2000b); Nguyen-Hong (2000); Kalirajan (2000).

na = not available. Insufficient data are available to estimate a price and/or cost effect for these economies.

a The table shows the price and cost raising effects of restrictions. That is, the percentage by which restrictions raise prices and/or costs higher than what they would be in the absence of restrictions.

b Nguyen-Hong (2000) calculated price and cost effects for one professional service – engineering. Insufficient data were available to calculate price and cost effects for accountancy, architectural and legal services.

c These cost effects are for restrictions on establishment.

2. Benefits of removing restrictions on market access

The price and cost effect measures can show the benefits of removing certain types of market access restrictions for developing economies.[1] The most common types of restrictions on market access are:

- Restrictions on foreign direct investment;
- Licensing requirements for foreign service suppliers; and
- Restrictions on the form of establishment or type of legal entity for foreign service suppliers.

Restrictions on FDI are estimated to increase the price of services in developing economies by up to 13 per cent for banking and up to 56 per cent for telecommunications (Productivity Commission, 2001a). In addition to the direct reductions in price, liberalizing FDI regimes will bring many dynamic benefits to developing economies. FDI is a major source of capital, technology transfer and improved managerial skills which significantly contributes to building economic capacity in developing economies.

Restrictions on the number of licences for foreign service suppliers are estimated to increase the price of services in developing economies by up to 15 per cent for banking and up to 5 per cent for engineering services (Productivity Commission, 2001a). Removing these restrictions contributes to a greater number of service suppliers, innovation and wider consumer choice.

Restrictions on the form of establishment of a foreign service supplier are estimated to increase the price of services in developing economies by up to 5 per cent for banking and by up to 2 per cent for engineering services (Productivity Commission, 2001a). Permitting service suppliers to enter a market via the most suitable legal entity provides them with the ability to structure their business and supply services in the most efficient way. Restrictions usually require foreign service suppliers to enter only as a representative office, branch, partnership, subsidiary or through a joint venture with a domestic service supplier.

[1] There are implications in the sequence of removing certain restrictions. Dee and Hanslow (2000) note that some approaches to partial liberalization can worsen disparities in protection and real income by moving resources further away from a pattern in a world free of distortions.

V. LIBERALIZATION, EFFICIENCY AND THE DOMESTIC SERVICE SECTOR

The greatest benefits from liberalization are achieved through domestic reform or liberalizing one's own service sector, irrespective of the efforts of other Governments to liberalize their service sectors. This is reflected in the empirical research on the effect of restrictions on the prices and costs of service suppliers and the real-income gains for developing economies. The processes that produce these gains are complex, but mainly involve removing restrictions so that resources can be mobilized or allocated to their most productive uses.

The most gains from trade reform come from the economic efficiencies created when an economy opens itself to the pressures and opportunities of international competition, *irrespective of the trade restrictions which may prevail abroad* (Productivity Commission, 2001b). McKibbin (1997) estimated that the gains to Australia from unilaterally meeting its own APEC commitments would account for almost 90 per cent of the gains which would accrue to it if all APEC countries met their commitments.

As mentioned above, liberalizing trade in services is about reforming regulation that restricts trade, so as to improve national welfare. While it is necessary for Governments to maintain regulation to meet social and economic objectives, certain regulation may intentionally or unintentionally restrict trade in services. Such restrictions are likely to reduce economic efficiency and hence national welfare by limiting the extent to which economies specialize in providing services according to their comparative advantage.

There is substantial empirical evidence to show that significant benefits accrue to those economies undergoing trade liberalization, whether it is in the traditional area of goods or the important growth area of services. Sachs and Warner (1995) found a close association between trade openness and economic growth in developing economies. From 1970 to 1989, "open" developing economies grew at an average annual rate of 4.5 per cent, while "closed" economies grew at a rate of 0.7 per cent. Dollar and Kraay (2001) found a strong positive effect of trade on growth. Srinivasan and Bhagwati (2001) found that, after accounting for numerous economy-specific factors, "trade does seem to create, even sustain, higher growth".

Liberalization increases competition, lowers prices and improves the quality of services. Competition, especially international competition, is the best guarantee that domestic service suppliers are and will remain efficient. Competition forces service suppliers to reduce waste, improve management and become more efficient. Costly rent-seeking activities, for the purpose of gaining or maintaining preferential access to a services market, are also less feasible in a liberalized environment. These pressures reduce the operational costs of providing services. Competition then forces service suppliers to pass on cost savings to consumers in the form of lower prices. The excess profits of service suppliers are reduced and the number of service suppliers is increased.

An increase in the number of service suppliers increases the choice of services for consumers and businesses. More service suppliers are attentive to the needs or demands

of consumers, and provide services in line with these demands. Innovations produce new services where existing services previously met consumer demands inadequately. Also, consumers will be more attentive to purchasing "value for money" services and the quality of services supplied will improve.

FDI plays a key role in services trade and development. Establishing a commercial presence in an economy, often through direct investment, is an important mode of delivery for most services, particularly where ongoing contact with consumers is important or the nature of the services means that other modes of supply are not feasible or viable. FDI is a major source of capital, technology transfer and improved managerial skill in host developing economies (see box 3).

Liberalization not only introduces competition and improves the quality of services in developing economies, but also improves their economic capacity and facilitates trade in goods — a traditional export earner for developing economies.

The prosperity of many developing economies is hampered by inefficient, unreliable and expensive service sectors. Some service sectors — telecommunications, financial and transport — not only provide final consumer services, but also are essential inputs for the production of other goods and services. Financial services facilitates an efficient transformation of savings into investment, ensuring that those resources are deployed to their most productive uses. Telecommunication services disseminate information and knowledge. Transport services distribute goods within an economy and with international trade partners. Developing economies often supply these essential services through government monopolies. Such services are provided at extremely high prices and cripple the ability of other sectors of an economy to compete internationally. Liberalization of services, including institutional changes, promotes the competitiveness of many downstream activities while improving overall economic performance.

Services also complement goods trade. Inefficiencies in the service sector of a developing economy impact negatively on the export competitiveness of its agriculture and manufacturing sectors, and thus contribute to an unfavourable balance of trade. International trade in goods depends on the performance of a number of essential services. Telecommunications services are required in order to communicate with the importer on prices and quantities of goods to export, financial services are required to arrange payment and insurance, and transport services are required to transport goods to the foreign market. A competitive and efficient transport service sector is particularly important for international trade in goods — approximately 95 per cent of goods for international trade are transported via maritime services.

In reducing protection, economies expose their service sectors and employees to short-term adjustment and transition costs. Less efficient service suppliers with high operating costs are likely to suffer from competition, and domestic production may decline in the previously protected service sector as resources are reallocated. There may be strong resistance by some minority groups, but the resistance of a few should not limit or deprive the whole community of the substantial benefits from liberalization.

There is clearly a role for government to balance the benefits of liberalization against these costs and to provide appropriate assistance to those adversely affected. Adjustment costs from changing international competitiveness can only be delayed or shifted to others within the economy, they cannot be avoided. By strengthening the overall economy, trade liberalization adds to an economy's ability to maintain and improve living standards while dealing with pressures for change (Productivity Commission,

Box 3. Foreign direct investment and developing economies

Developing economies are increasingly recognizing the role of foreign direct investment (FDI), both inward and outward, in economic development. FDI represents a source of long-term capital, employment in more technologically complex activities and, most importantly, technology and know-how. It serves as a conduit for exports from the host country even as they increase competition in domestic markets.

A number of developing economies have been highly successful in pursuing a development strategy based on FDI in their economies. In these cases, FDI has been associated with rapid industrialization and an expansion of increasingly technologically sophisticated manufactured exports. The benefits of FDI usually manifest themselves in the host economy's trade performance. In the short term, inward investment by foreign firms influences the pattern of trade and the type of goods and services that are exported. In the long term, transfers of technology and linkages with the domestic economy enhance the competitiveness of domestic firms in world markets.

In addition to increasing exports, technology transfers result in improved productivity that promotes economic growth. A recent study of 69 developing economies found that FDI stimulates economic growth and investment by domestic firms. FDI is seen as contributing to growth through two channels. First, it adds to the stock of capital in the host economy. Second, it is more productive than domestic investment. Rather than crowding out domestic investment, FDI has been found to stimulate such investment. The ultimate effects on growth depend importantly on human resource considerations in host economies, with the greatest benefits accruing to those economies with the highest educational attainment. FDI flows directed towards services is close to 60 per cent.

Foreign firms operating in developing economies also pay higher wages than domestic firms – for example, wages paid by foreign manufacturing firms are up to 38 per cent higher than those paid by domestic firms in Hong Kong (China), China and Singapore. Data for Thailand in 1990 suggest that wages, average labour productivity and capital intensity were, on average, higher in foreign firms than in domestic firms.

Firms from developing economies are becoming major outward investors in their own right. Hong Kong (China), Taiwan Province of China, Singapore and China ranked among the top 20 source countries for FDI during the 1990s. Many of these investments flow to other developing countries and involve activities in which the home country no longer enjoys a comparative advantage. An increasing share of this FDI is invested in the service sector, where developing countries are becoming increasingly competitive.

The benefits from FDI are enhanced in an environment characterized by open trade and investment, an active competition policy, macroeconomic stability, privatization, regulatory reform and flexible labour markets. In such environments, FDI plays a key role in improving the capacity of the host economy to respond to the opportunities offered by global economic integration, a goal increasingly recognized as one of the key aims of any development strategy.

Source: Adapted from OECD (1998).

2001b).

A. The importance of the financial services sector

The financial services sector is typically the largest service sector of an economy and is vital in mobilizing savings for investment and facilitating business transactions. All economic transactions require, to varying degrees, efficient and reliable access to financial services. The development of modern economies relies on diversified intermediation and risk management services provided by the financial system. A healthy and stable financial system, underpinned by sound macroeconomic management and prudential regulation, is an essential ingredient for sustained growth (Kono et al., 1997). Levine (1997) finds a strong positive link between an open and efficient financial system, and long-run economic growth.

Liberalization of a financial sector is likely to contribute more to economic growth than any other service sector. Like trade in other services, competition in financial services reduces prices, improves quality and widens consumer choice. Liberalizing trade in financial services reduces prices through the transfer of technology and knowledge. New and innovative financial instruments improve management and risk assessment techniques. Financial services also directly facilitate trade by providing trade finance, transport insurance and foreign exchange services.

Competition forces financial service suppliers to increase their efficiency and adopt new technologies for the delivery of their services at the lowest costs. Financial reform in many economies between 1972 and 1992 resulted in improvements in most indicators of bank operational efficiency (OECD, 1995, 1997; Kono et al., 1997). Improved technology and greater competition result in cost and efficiency savings being passed on to bank customers. New delivery channels, such as Internet banking, reduce the cost of providing financial services. For example, the cost of an average payment transaction over the Internet is as low as US$0.01, compared with US$0.27 for an automatic teller machine, US$0.54 using telephone banking and US$1.07 through a bank branch (Kono et al., 1997).

Consumers and businesses also benefit from liberalization by having a greater choice of financial services. Financial innovation produces new services in areas where existing services inadequately meet customer demands. Effective competition forces financial service suppliers to provide services in line with customer demands. The range of financial services increases as customers search for financial services which better meet their needs. Financial services liberalization within the European Union increased the number (and choice) of cross-border bank services by 58 per cent between 1993 and 1995 (OECD, 1998).

A strong interdependence exists between the trade regime, macroeconomic management and financial regulation. An open financial services sector is likely to improve a host economy's macroeconomic policies and encourage the Government to rely on more effective prudential regulation. Liberalization of financial services usually entails the removal by monetary authorities of less efficient prescriptive controls on interest rates and credit lending, and greater use of market-based instruments for influencing economic activity. Market-based policy instruments, including open-market transactions in securities, place pressure on Governments to maintain economic stability through appropriate monetary, fiscal and exchange rate policies. The implementation of monetary policy through these instruments, rather than through the use of prescriptive interest rate controls, is considered less distortional and is likely to better develop financial markets.

The existence of foreign banks also adds to the stability of the financial system. Foreign banks provide a stable source of funding and are able to draw on capital of the parent company for liquidity during times of difficulties (OECD, 1998). Foreign banks also improve the regulatory framework in their host economy. Claessens and Glaessner (1998) argue that foreign banks exert pressure on domestic regulators to improve regulation and supervision, including intensifying linkages with foreign regulators. Goldstein and Turner (1996) report that relatively high shares of foreign ownership contributed to maintaining stable banking systems in Chile, Hong Kong and Malaysia.

B. Unilateral and multilateral liberalization

Multilateral liberalization is a necessary complement to unilateral liberalization. Unilateral liberalization, whereby Governments liberalize trade regardless of the efforts of other economies, plays an important role in reforming service sectors. Reform often takes place as Governments realize the benefits of promoting competition and establishing an efficient supply of services. These benefits accrue to the liberalizing economy and are largely independent of whether trading partners choose to liberalize or not.

Multilateral liberalization under the General Agreement on Trade in Services (GATS) complements the efforts of Governments to liberalize unilaterally (Sorsa, 1997). GATS commitments and ongoing negotiations can advance services liberalization in a non-discriminatory manner within internationally enforceable rules. The multilateral system can help to lock in unilateral reforms to limit possible backsliding by Governments in the future. However, the effectiveness of the GATS in meeting these objectives, at least in the short run, will depend in large part on the extent to which WTO Members have bound their existing policies, or preferably committed themselves to new liberalization.

VI. CONCLUSION

The economic modelling results put the importance of liberalizing or removing restrictions on services into perspective. The global gains from liberalizing services are similar to those from liberalizing agriculture and manufacturing combined. The projected real income gains for developing economies are expected to be US$ 130 billion. The largest gains will accrue to those economies with the greatest restrictions.

Gaining market access to foreign services markets is important for developing economies, but relatively greater real-income gains will be achieved by liberalizing services independently of others. Liberalization introduces service suppliers to the pressures and opportunities of international competition, which forces them to allocate resources efficiently to their most productive uses for economic development.

These benefits of liberalizing independently are not confined to the service sector. Some service sectors — telecommunications, financial and transport — not only provide final consumer services, but also are essential inputs for the production of other goods and services. This interlinkage between the service sector and other sectors produces substantial benefits beyond the service sector that directly feed into improving an economy's trade and economic performance.

The effects of restrictions on trade in services are complex and recent economic modelling provides an indication of the real-income gains, but more research is needed. There are a large and varied number of restrictions on trade in services, and it is often difficult to capture all the effects of restrictions on the prices and costs of services. General equilibrium models also need to be developed further to incorporate more detailed services trade data and accurately simulate price and cost effects.

Liberalization is beneficial for an economy, but this raises issues about the pace and sequencing of reform. Many economists believe that faster is better, but it is a fact that rapid liberalization may have short-term structural adjustment and hence political costs. This suggests that it is important to have a comprehensive package of measures in place, including some kind of social safety net to facilitate change. The "right" environment also needs to be developed to foster liberalization. In the service sector, an adequate regulatory framework is needed, which is lacking in many developing countries, in order to provide certainty for foreign service suppliers and to encourage investment in infrastructure.

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