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Services provisions in regional trade agreements: stumbling or building blocks for multilateral liberalization?

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Introduction

A remarkable feature of the recent wave of regional trade agreements (RTAs) is the inclusion of a trade in services component in many agreements. At the end of 2006, the WTO counted 54 such services accords, of which only 5 predate the conclusion of the Uruguay Round.¹ The rising interest in services trade agreements reflects a number of developments. First, as tariffs have come down, policymakers have turned their attention to other barriers restricting international commerce. The growth of world goods trade and the emergence of international production networks have highlighted the importance of an efficient services infrastructure—whether in telecommunications, finance, logistics, or legal advice. Market opening in services offers the prospect of performance improvements in services and allows goods producers to draw on multinational service networks in organizing their business.

Second, technological progress has vastly expanded the range of services that can be traded cross-border. The well-known outsourcing phenomenon has led to the emergence of new dynamic export industries in services, which hold significant potential for low-wage developing countries. Finally, many governments have transferred the provision of infrastructure services to the private sector, expanding the scope for foreign participation in services. Indeed, services FDI has grown faster than total FDI in recent years, as service providers from high and middle income countries seek out new commercial opportunities in foreign countries.

Economists have long worried about the systemic consequences of RTAs. Will these agreements undermine the multilateral trading system—one of the cornerstones of the post-war growth in world trade and rise in economic prosperity? Or will they actually be helpful for stimulating further multilateral integration? This so-called “building blocks versus stumbling stones” debate has so far been mainly confined to the liberalization of goods trade. However, the different nature of services trade warrants separate thinking, which is the objective of this paper. To preview our conclusion, we find that we can be overall more optimistic about the building block properties of services RTAs than in the goods case. However, certain forms of regional integration raise concern about their discriminatory impact, suggesting a disciplining role for the WTO.

The paper is structured as follows. After a brief introduction into the nature of trade in services (Section 1), we will review the main features and liberalization accomplishments of recent RTAs in services (Section 2). This review will point to a relatively modest degree of discrimination established in these agreements, for which we offer several political economy explanations (Section 3). With these considerations in mind, we will explore whether services RTAs are more likely to be building blocks or stumbling stones for the multilateral cause (Section 4). We then discuss what role the WTO can play a constructive role in ensuring that RTAs fit comfortably within the multilateral trading system (Section 5). Our final section offers brief concluding remarks (Section 6).

1. What is trade in services?

(a) Four modes of services trade

Services are often seen as intangible, invisible and perishable, requiring simultaneous production and consumption. It is because of the latter characteristic that services trade often requires producers and consumers to be in the same place.² This tends, for instance, to be the case for dentist treatments and hotel services. For services which require personal contact between customers and clients, trade is

¹ See the WTO’s website, http://www.wto.org/english/tratop_e/region_e/regfac_e.htm.

² Copeland and Mattoo (forthcoming 2008).

possible only if either the customer or producer travels across borders. This explains why in the case of services the concept of trade is broadened to include concepts of investment and labour.

The importance of personal contact between customer and client is reflected in the wide definition of services trade adopted by the General Agreement on Trade in Services (GATS). This definition not only includes traditional cross-border trade, but also “investment” and “labor movements”. In particular, the Agreement distinguishes among the following four modes of supply:

Mode 1 or "cross-border" trade refers to services supplied from the territory of one country into the territory of another. Examples include financial transactions conducted over the phone, and software services supplied by a supplier in one country through mail to consumers in another country.

Mode 2 or "consumption abroad", refers to services supplied in the territory of one country to the consumers of another. Examples are where the consumer moves to, for instance, consume tourism, education or medical services in another country.

Mode 3 or "commercial presence" refers to services supplied through any type of business or professional establishment of one country in the territory of another. An example is an insurance company owned by citizens of one country establishing a subsidiary or branch in another country.

Mode 4 or "presence of natural persons" refer to services supplied by nationals of one country in the territory of another. This mode includes both independent services suppliers and employees of the services supplier of another country. Examples are a doctor of one country providing treatment to a patient in another country by moving (temporarily) to the patient's country, or the foreign employees of a foreign bank.

Mode 3 and 4 thus refer to foreign direct investment and to labour movements but they clearly restrict this to the supply of services. Numerous RTAs follow the GATS approach but many others feature horizontal disciplines on investment and the movement of natural persons, instead. This explains why relevant preferential agreements on investment or movement of labour play an important role in this paper.

Services represent around two thirds of global GDP and the share of services value added in GDP tends to rise with countries' level of income. The share of services trade in total global cross-border trade is around 20 per cent, a number that has been relatively stable in the past years. The discrepancy between the important role of services within national economies and their role in international trade reflects, *inter alia*, the difficulties to trade services across border.

Measuring services trade is not straight forward with existing statistical databases and things become more complex when trying to distinguish different types of services trade, like the four modes of trade. Recent estimates by the WTO Secretariat underline the important role of mode 3 for services trade.³ Trade through commercial presence represents 50 per cent of total services trade and cross border supply 35 per cent. The role of the other two modes of trade is much smaller: 10 to 15 per cent for consumption abroad and only 1 to 2 per cent for the presence of natural persons. In other words, services “trade” is to a large extent about foreign investment, which is one reason why the perceived wisdom about regional integration coming from the traditional trade literature may not apply to regional agreements in services.

³ WTO(2005)

(b) Services trade and market failures

Many services sectors are characterized by market failures implying that markets cannot function properly without appropriate government intervention. Government has mainly a regulatory role in services sectors with the nature of regulatory intervention depending on the underlying market failure. When services sectors are opened up to foreign competition this automatically raises the question of how to ensure that appropriate regulation is defined and applied among trading or investment partners. The answer to this question is not necessarily straight forward and probably differs across services sectors.

(i) *Reasons for regulatory intervention*

Information asymmetries

Information asymmetries play an important role in a number of services sectors, such as financial services and professional services. In the case of the financial sector, for instance, it is for outsiders difficult to judge the financial situation of banks or insurers. Yet, the stability of banks is crucial for their clients and for the economy as a whole. In case of bankruptcies, bank clients may lose large parts of their savings and the entire financial system and potentially other parts of the economy may suffer. The literature is therefore unanimous on the need for appropriate financial regulation in order for financial markets to function smoothly. There is less agreement, however, on - and maybe even insufficient understanding of - the exact characteristics of "appropriate financial regulation" especially at the international level.

The typical textbook example for an information asymmetry refers to professional services like accounting or legal services. Clients tend to find it hard in the case of such services to evaluate their quality even ex-post. In order to provide some assurance to clients and avoid wide-spread abuse, the government often imposes qualification requirements on individuals wishing to exercise the relevant services.

Economies of scale and scope

The provision of many services entails substantial economies of scale and scope. For example, the operation of telecommunication services requires significant up-front investments in network infrastructure that serves a large number of customers. Similarly, technology in distribution, transport, and many other service industries is such that marginal production cost falls with the scale of service output. Economies of scope are important in transport, where operators can lower costs by offering services on connected routes—leading to the formation of hub-and-spoke networks.

The presence of economies of scale and scope leads many service markets to be served by only a relatively small number of suppliers. As a result, policymakers are often concerned about the state of competition in those markets, sometimes even leading to direct regulatory intervention to prevent anti-competitive behaviour. For example, in telecommunications governments often set terms of interconnection between different network operators.

Network externalities

Certain products or services generate value to users only if they are consumed together with other users. In a communication network, for example, such as a network of mobile phone users, consumers find subscribing to the network only valuable if this allows them to communicate with other people. This is an example where so-called network externalities are at work and were co-

ordination failures can occur that lead to the existence of an inefficient number of small networks rather than one single large network.

Compatibility can be reached through standardization, whereby products or services have to correspond to certain specifications. But standardization creates new possible problems. It reduces variety and may lead to dynamic inefficiencies as it tends to be costly to switch from one standard to a new one that may represent a new generation of technology.

In markets characterized by network externalities, industry standards often arise de facto and they often do so because one suppliers manages to obtain a dominant position in the market (e.g. Microsoft with respect to computer software). The supplier setting the standard is therefore in a position to abuse his market power and the role of competition authorities become crucial. Standards can also be set by governments. Again, the choice of standard is crucial. To the extent that promoters of different standards come from different countries and the winner can claim rents from the adoption of the standard, strategic trade policy considerations come into play.

Distributional concerns

The demands for water, power and telecommunication services are some of the most basic needs. Consumption of these goods and services also often represents a sizeable chunk of poor household's budgets. Because many countries consider access to these services a right, governments often adopt policies aiming at ensuring "universal access" to these services. In the case of telecommunication, such policies include direct transfers to users that the government wishes to help, regulatory measures whereby universal service obligations are included in the concessions and licences granted to operators, network interconnection regimes favouring rural operators and universal access funds. In the latter case all providers obtaining a licence or concession are required to contribute to a universal service fund and each can draw resources from it when providing a service to the targeted (poor) population or (rural) area.

(ii) How to regulate at the international level

The above described market failures often justify regulatory intervention. Regional and multilateral liberalization therefore lead to the question how regulation should be organized at the regional or multilateral level. In some services sectors it appears to be easier to agree on regional or global standards than in others. The International Telecommunication Union, for instance, sets global standards for the telecommunication sector and the Basel II framework developed by the Basel Committee on Banking Supervision defines widely accepted standards governing capital adequacy of internationally active banks.⁴ In other services sectors, national standards are still prevailing. Stephenson (2002), for instance, argues that construction/engineering and other professional services are often highly restricted sectors as they are subject to national standards for compliance that may set out quite restrictive criteria for the determination of the equivalence of qualifications by these service providers. According to Stephenson (2002) regional agreements can play a useful role in these sectors, as it should be generally easier to develop a common set of criteria for the recognition of the equivalence of standards and/or the equivalence of diplomas and educational and professional training for the granting of licences to practice various professional services when this is carried out among a smaller sub-set of member countries.

Questions do not only arise as to the feasibility of regional or multilateral collaboration, but also as to its desirability. Regulation targets different market failures in different services sectors. If standards

⁴ The appropriateness of these standards for developing countries has, however, been questioned, in particular with respect to the Basel II framework. See, for instance, Bailey (2005).

try to promote connectivity like in the case of certain telecommunication standards, or comparability like in the case of accounting methods, harmonization of standards across countries is likely to have large benefits with only minor drawbacks. If standards try to remedy information asymmetries like in the case of capital adequacy rules for banks, harmonization also has benefits as it promotes international transactions. But it can have non-negligible drawbacks at the same time, as the optimal capital adequacy rule may be country specific. Harmonization of standards may therefore be more desirable in some sectors than in others. This argument also holds for mutual recognition as mutual recognition agreements are usually not concluded among countries having significantly different standards.

Harmonization and mutual recognition also raise the question about who regulates. A precondition for mutual recognition is that foreign regulators are trusted. In the case of harmonization, regulation can rest in the hands of national regulators, but an alternative is to have a regional regulator, like a regional central bank with regulatory functions.

When it comes to regulatory measures targeting distributional concerns or aiming at preventing the abuse of market power, the issues of harmonization or mutual recognition do not really arise and it is above all the rules of conduct of regulators themselves that are of relevance for foreign suppliers.

In other words, the type of international regulatory collaboration that can facilitate services trade and/or national welfare is likely to differ significantly across sectors and possibly also across modes. In this context it is important to emphasise that what is best for the promotion of trade is not necessarily best for national welfare, as international regulatory collaboration may have effects on both trade and the relevant market failures.

(c) The economic effects of services RTAs⁵

(i) *Expected effects*

Mattoo and Fink (2004) have analyzed the economic effects of preferential versus MFN-based liberalization of trade in services. They draw three main conclusions from the viewpoint of a country that engages in liberalization. First, relative to the status quo, preferential liberalization in services brings about static welfare gains. This finding differs from the more ambiguous conclusion drawn in the goods case. The key difference is that protection in services does not generate fiscal revenue, as do tariffs on imported goods. Thus, trade diversion effects associated with preferential liberalization in services do not lead to any loss in government revenue that can lead to negative welfare effects in the case of goods.

Second, MFN liberalization generally yields greater welfare gains than preferential liberalization. Non-discriminatory market opening does not bias competition from abroad and therefore promotes entry of the most efficient service providers. Additional gains from trade, associated with greater economies of scale and knowledge spillovers, are also likely to be greater if liberalization proceeds on an MFN basis. There is one exception to this conclusion. If ‘learning by doing’ effects are important, preferential liberalization may enable domestic service suppliers from member countries to become more efficient, as they face some competition from within the FTA territory, but are not yet exposed to global competition. In theory, preferential liberalization can thus prepare infant domestic suppliers for competition at the global level. This ‘learning-by-doing’ rationale would apply mainly to agreements among developing countries, where firms operate below best-practice productivity levels.
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⁵ This section draws on Fink and Molinuevo (2007).

⁶ However, this variation of the infant industry argument relies on the strong assumptions that competition from FTA service suppliers is sufficiently mild to favor learning-by-doing and that governments are

Third, there is a special long-term trade diversion effect to worry about. High location-specific sunk costs and network externalities can give first-movers a durable advantage in service markets. Preferential liberalization may thus lead to the entry of second-best service providers that will not be replaced by first-best providers from outside the RTA when trade is eventually liberalized on an MFN basis. Thus, even if preferences are temporary, they may have long-term implications for a country's ability to attract the world's most efficient service providers.

(ii) *Rules of origin and the level of discrimination introduced by services RTAs*

The degree of trade preferences—and thus the potential for trade diversion effects—depends critically on the rules of origin adopted by a RTA. In the case of goods trade, rules of origin typically lay down in a rather detailed way which level of transformation a good needs to undergo in the partner country in order for it to be exported to another FTA partner at a preferential tariff. This level of transformation is typically measured in terms of the percentage of final product value that has been added in the partner country.

In the case of services FTAs rules of origin based on value added criteria are not used. This may be the case because the concepts of imported service inputs and domestic transformation are conceptually and statistically not well-developed in the case of services trade. Indeed, it is not clear whether a transformation rule could be meaningfully applied in this area. In the case of modes 1 and 2, rather than using a value added criterion, services RTAs merely stipulate that liberalization measures apply to services that are supplied from or in the territory of another party. It is not clear from this definition to what extent services relying on imported services inputs would be eligible for trade preferences. In the case of modes 3 and 4, RTAs do not provide for any rule of origin for services.

Instead of focusing on the origin of services, RTA provisions have mainly sought to delineate the origin of service providers. Indeed, the need for physical proximity between services suppliers and consumers implies a strong link between the service and its supplier, whether in the form of a juridical or natural person.

In services RTAs rules of origin with respect to services suppliers typically take one or several of the following forms:

- Criteria concerning the jurisdiction to which an entity belongs. In particular, FTAs often require that enterprises eligible for privileges are incorporated under the laws of one of the partner countries and that eligible individuals ("natural persons") be citizens or residents of one of the countries.
- Criteria concerning the location of services suppliers' economic activities. In particular enterprises may be required to have "substantial business activities" within the region and individuals are expected to have their "centre of economic interest" (check wording) in the region.
- Criteria concerning "ownership and control" of enterprises

Under restrictive rules of origin, the set of service suppliers eligible for trade preferences is small and the scope for trade diversion effects will be more pronounced. Under liberal rules of origin, the set of eligible service suppliers is large. Specifically, the level of discrimination in this case will depend on three factors: (i) the openness of RTA parties to foreign investment by non-parties; (ii) whether non-party service suppliers would voluntarily do business in a RTA party; and (iii) the tax and business

in a position to correctly predict the extent of learning-by-doing in different service industries. In addition, even if these assumptions were to hold, non-discriminatory liberalization combined with subsidies to the infant firms may be a better policy instrument to address the underlying market failure.

transaction costs associated with departures from a service supplier's preferred international corporate structure.

(iii) *Additional considerations*

Additional considerations apply from the viewpoint of a country that would see an expansion in services exports as a result of market opening in a RTA partner country. What may be considered as trade diversion from a global perspective amounts to an export opportunity from the perspective of the country benefiting from preferential market access abroad. Such export opportunities may underpin possible 'learning-by-doing' effects mentioned above. In addition, preferential access to foreign markets may attract export-oriented investment from abroad. Indeed, a country with liberal entry conditions for suppliers from outside the RTA area can become a hub for companies wishing to access markets within this area. The benefits from export-oriented foreign investment depend on the nature of the services supplied, but can include short-term employment gains, increased tax revenues, and the transfer of knowledge and managerial skills.

Again, the rules of origin adopted in a RTA are critical in shaping the eventual economic outcome. If they are restrictive, the benefits of preferential access would mostly be captured by domestic firms and the learning-by-doing rationale would be strengthened. If they are liberal such that it is easy for service suppliers from outside the RTA area to become eligible for trade preferences, incentives for export-oriented foreign investment would be strengthened.

In sum, the welfare implications of preferential versus MFN-based liberalization differ for the preference-granting and preference-receiving countries and depend on a number of complementary factors—such as the rules of origin adopted and the significance of learning-by-doing effects. Unfortunately, the economic literature provides only little guidance on what type of economy would gain or lose under which circumstances.⁷

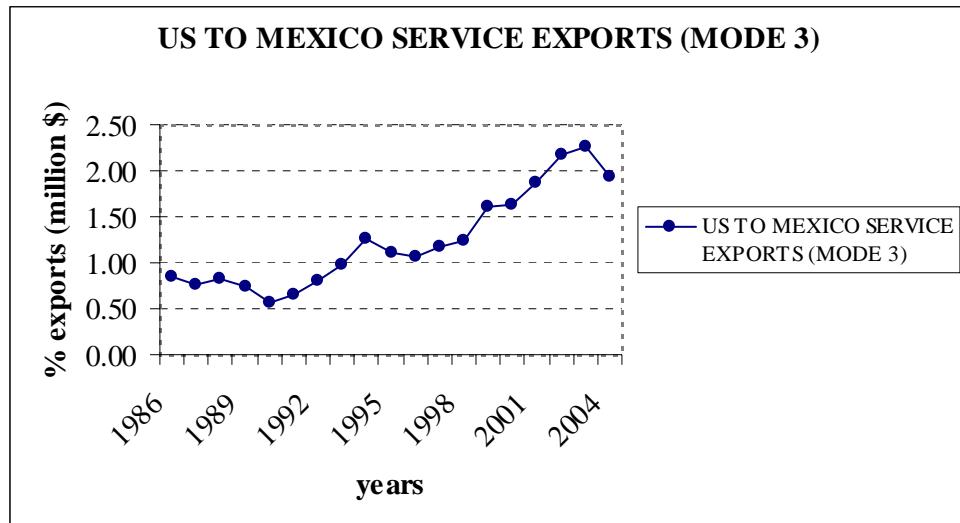
(iii) *Measuring the economic effects of RTAs*

It is difficult to determine the economic effects of regional services trade agreements, because insufficient data. In principle, balance of payment data would allow us to analyse the effect of such agreements on Mode 1 trade and Foreign Affiliate Trade Statistics (FATS) allow us to analyse the effects on Mode 3 trade. However, relevant bilateral data are available only for selected, mostly developed, countries. In addition, most services RTAs are rather recent and not enough time has passed to allow us to analyse their effect on firm behaviour.

As an illustration, consider the North American Free Trade Agreement (NAFTA), which was ratified in 1994. The following chart shows the evolution of Mexico's share in total US mode 3 services exports over time.⁸ A simple look at the chart does not allow for the conclusion that NAFTA has had a significant impact on mode 3 exports from the US to Mexico. Even though sales of US services affiliates in Mexico have increased significantly, they started to increase a number of years before the ratification of NAFTA. A more thorough analysis, using econometric techniques, would be necessary in order to determine the real impact of the regional trade agreement. However, such an analysis is precluded by too few observations on relevant services trade flows.

⁷ Mattoo and Fink (2005) review available evidence from the EU's Single Market Program. However, they note that this evidence remains difficult to interpret in welfare terms.

⁸ The US-Israel FTA was ratified in 1985, but services trade data do not go far enough back to compare "before" and "after" FTA. U.S.- Jordan was ratified in 2001, but no bilateral data are available for Jordan. The other agreements have been ratified in 2004 or later and data are only available until 2005.



2. Ongoing liberalization in the context of preferential trade agreements

(a) How much explicit liberalization has taken place?⁹

The recent popularity of services RTAs has prompted a number of studies that have assessed what these agreements have actually accomplished. Notably, Sauvé (2005) and Fink and Molinuevo (2007) discuss the different architectural approaches adopted by services RTAs. Stephenson (2005), Roy et al. (2006), and Fink and Molinuevo (2007) evaluate the liberalization content of selected agreements. Sáez (2005), Marconini (2006), and Pereira Goncalves and Stephanou (2007) review the negotiating experiences of countries in the Western Hemisphere.

In what follows, we summarize the landscape of services RTAs as described in these studies. No services RTA has established immediate free trade in all service sectors. Like the GATS, RTAs come with schedules of commitments that detail the remaining trade restrictive measures for the four familiar modes of supply—either on a positive or negative list basis. Trade restrictive measures usually fall into two categories: (i) a list of explicit market access barriers, including non-discriminatory and discriminatory quantitative restrictions; and (ii) national treatment limitations, covering all remaining discriminatory measures.¹⁰

A comparison of a country's multilateral and RTA commitment schedules reveals the trade preferences one RTA party grants to another. Table 1 offers an overview of five different categories of trade preferences created by RTA commitments. The first category covers cases where a country's RTA undertaking reproduces in part or in full its GATS commitment. For example, Cambodia's and Vietnam's commitments under the ASEAN-China Agreement on Trade in Services fall into this category. The only 'preference' created by such a commitment is that RTA parties can avail themselves of the RTA's dispute settlement mechanism to enforce another party's treaty obligations. However, this type of preference is arguably weak. The WTO's Dispute Settlement Understanding (DSU) already offers parties a credible forum for adjudicating state-to-state disputes. The advantages

⁹ This section draws on Fink (2007).

¹⁰ Negative list agreements typically establish additional classes of measures. However, these additional classes are either due to commitments in negative list schedules not distinguishing between modes of supply or they relate to measures that would otherwise be captured by a RTA's national treatment obligation. See Fink and Molinuevo (2007) for further explanation.

of resorting to a state-to-state dispute settlement mechanism under a RTA are likely to be minor—if they exist at all.¹¹ In any case, from the viewpoint of service suppliers seeking to do business in a foreign market, a commitment of this type is probably irrelevant.

Table 1: Trade preferences created by services RTAs

	Type of commitment	Nature of preference	Example	Degree of discrimination
1	RTA commitment reproduces GATS commitment	Parties can invoke dispute settlement mechanism of RTA to enforce trade commitment	Cambodia's and Vietnam's commitment under the ASEAN-China Agreement on Trade in Services	None
2	RTA commitment goes beyond GATS commitment, but does not imply actual liberalization	Reduced risk of policy reversal for service suppliers from parties	Indonesia's commitments under the ASEAN Framework Agreement on Services	None
3	RTA commitment implies actual liberalization, which is implemented in a non-discriminatory way	Reduced risk of policy reversal for service suppliers from parties	Chile's commitment to permit insurance branching under the Chile-US FTA	None
4	RTA commitment implies actual liberalization, rules of origin are liberal	Service suppliers from parties benefit from improved market access, set of eligible service suppliers is wide	China's commitments under the Mainland-Hong Kong Closer Economic Partnership Agreement	Weak
5	RTA commitment implies actual liberalization, rules of origin are restrictive	Service suppliers from parties benefit from improved market access, set of eligible service suppliers is narrow	Thailand's elimination of a foreign equity limitation for construction and distribution services under the Thailand-Australia FTA	Strong

The second category of trade preferences consists of RTA commitments that go beyond a country's GATS commitment, but do not imply any new market opening. For example, most commitments scheduled under the ASEAN Framework Agreement on Services fall into this category.¹² Again, the preference created by this type of RTA commitment is only weak. There is no discrimination in the actual application of trade policies. Service suppliers from RTA parties are offered greater assurance that another party's policy will not become more restrictive—or at least not more than what is committed. Such an assurance is not irrelevant. For certain infrastructure services, foreign investors incur substantial sunk costs at the time of entry and may generate profits only after several years. By signalling a stable policy environment, a RTA commitment can improve a country's investment climate. At the same time, a RTA commitment is only one among many variables that service suppliers consider in their investment decisions.

¹¹ In fact, several of the state-to-state dispute settlement mechanisms embedded in RTAs fall short of the WTO DSU in that they do not provide for an automatic right to a panel. See Fink and Molinuevo (2007).

¹² See Fink (2007).

Commitments in the third category consist of undertakings that imply new market opening. However, the associated changes in laws and regulations are implemented in a non-discriminatory way, such that service suppliers from non-parties equally benefit from the more liberal policy environment. Chile's commitment to permit branches of foreign established insurance companies under the Chile-US FTA is an example of this type of market opening measure. For service suppliers from parties, commitments falling into the third category create only a weak trade preference. It is the same as the one associated with RTA commitments of the second category: a reduced risk of policy reversals.

The fourth and fifth categories of commitments cover cases where RTA commitments imply new market opening, which is implemented in a discriminatory way. In other words, only services trade between RTA parties benefits from the more liberal policy environment. The difference between the two categories is the origin rule associated with the market opening commitment. Notwithstanding important nuances in the rules of origin adopted by RTAs, one can distinguish between two basic approaches.¹³ The more liberal approach extends RTA benefits to all companies that are incorporated in one of the parties and are engaged in substantive business operations there. The more restrictive approach limits RTA benefits to companies that are ultimately owned or controlled by domestic persons.

As an example, China's commitments under the Mainland-Hong Kong Closer Economic Partnership Agreement (CEPA) imply new market opening in China, but the agreement extends trade preferences to all service suppliers incorporated in Hong Kong that can prove substantive business operations.¹⁴ Preferential market opening of this type is only weakly discriminatory. Service suppliers that are owned or controlled by persons from non-parties are not categorically denied better treatment. Discrimination only occurs with respect to those non-party service suppliers that are not commercially active in a RTA party.

The Thailand-Australia FTA exemplifies the more restrictive approach. Under this agreement, Thailand permits full foreign ownership in construction and distribution services, but restricts this benefit to companies that are owned and controlled by Australian persons. Service suppliers from non-parties—even if they are established and engaged in substantive business operations in Australia—continue to face a 49% foreign equity limitation when investing in these sectors in Thailand. Studies have shown that an ownership and control requirement can substantially reduce the set of service suppliers eligible for preferential treatment, implying the strongest form of discrimination.¹⁵

Similarly, trade commitments that lead to the actual liberalization of ‘mode 4 trade’ also bring about strong discrimination. Rules of origin for natural persons are relatively straightforward, because individuals, unlike companies, cannot be simultaneously present in many countries. All RTAs extend trade benefits in this area to nationals of parties. Some agreements also include non-nationals that are permanent residents of parties. In either case, the set of eligible service suppliers is well-circumscribed.

Having established the five categories of trade preferences, an obvious question is how many RTA commitments fall into which categories. We cannot answer this question precisely. Studies that have

¹³ For a detailed discussion of the rules of origin adopted by East Asian RTAs, see Fink and Molinuevo (2007). There is some variation, for example, on the eligibility of branches of foreign enterprises. Some agreements do not extend RTA benefits to branches of non-party service suppliers. In financial services, such a restriction may have prudential motivations, as branches are typically regulated by the country of the parent firm.

¹⁴ See Fink (2005) for a more detailed discussion of this trade agreement.

¹⁵ See Fink and Nikomborirak (2007) for a review of simulation studies on the implications of different rules of origin undertaken for ASEAN countries.

evaluated the liberalization achievements of RTAs have shown that the overwhelming majority of agreements offer at least some value added commitments relative to countries' GATS undertakings. Thus, we can easily characterize category 1 as an exception to the rule. However, it is difficult to assess comprehensively to what extent RTA commitments imply new market opening and, if so, how such market opening is implemented. No database exists on countries' laws and regulations in services that would allow for a comparison of RTA commitments to domestic policies.

Still, some inferences are possible. Roy et al. (2006) analyze 28 services RTAs and identify 27 instances of so-called liberalization pre-commitments—promises to open up a particular service activity at a future point in time. It is reasonable to assume that these pre-commitments imply new liberalization. In addition, the rules of origin for companies adopted by the overwhelming majority of RTAs are of the liberal type. We are aware of only two agreements—the Thailand Australia FTA mentioned above and the India-Singapore Economic Cooperation Agreement (ECA)—that have opted for a domestic ownership and control rule.¹⁶ In other words, for the most part, commitments in RTAs concluded thus far fall into categories 2, 3, and 4, creating only weak discrimination.

There is one possible exception to this conclusion. As pointed out above, actual liberalization commitments for 'mode 4' trade create strong discrimination. Indeed, there are several RTAs that have offered new market opening for this form of services trade. Most prominently, under the Japan-Philippines Economic Partnership Agreement (EPA), Japan permitted the entry of Filipino nurses and caregivers—provided that they meet certain qualification requirements. However, the evidence from the studies cited at the beginning of this section suggests that actual liberalization commitments for mode 4 are still the exception rather than the rule.

A final important feature of many RTAs is the inclusion of a non-party most-favored-nation (MFN) clause. For example, Article 101 of the Japan-Malaysia Economic Partnership Agreement reads:

"Each Country shall accord to services and service suppliers of the other Country treatment no less favourable than that it accords to like services and service suppliers of any third State."

In other words, Malaysia and Japan will extend to each other any preference granted to any third country. In fact, parties to a RTA with such an obligation might as well—and for transparency purposes would be well-advised to—include in their commitment schedules any benefit previously granted to a non-party. The inclusion of a non-party MFN clause serves to soften discrimination inherent in existing services agreements. It also reduces discrimination in future RTAs, as countries need to extend any negotiated trade preference to existing RTA partners.¹⁷

How prevalent are non-party MFN obligations? In the East Asia region, twelve out of twenty-five services RTAs feature such obligations (see Fink and Molinuevo, 2007). Most RTAs negotiated by the European Free Trade Association (EFTA), Japan, and the United States have incorporated them. In addition to RTAs, many bilateral investment treaties (BITs)—notably those negotiated by Canada and the United States—have also incorporated non-party MFN clauses.¹⁸ A government bound by such a BIT clause has to extend all investment preferences to its BIT partner, including those emanating from RTA commitments under mode 3 in services. In brief, there is a multitude of MFN

¹⁶ See Fink and Molinuevo (2007) for a detailed review of the rules of origin adopted by 25 East Asian RTAs.

¹⁷ Services RTAs typically allow for exceptions to MFN treatment. However, actual exceptions lists are usually narrow in scope.

¹⁸ BITs negotiated by other countries typically also include a non-party MFN obligation, but exempt RTAs from the scope of this obligation.

promises between countries that serves to further weaken the discriminatory effects of current and future trade preference in services.

(b) *Removing implicit regulatory barriers*

In services sectors characterized by information asymmetries, like the financial sector and business and professional services, regulatory measures are often used in order to guarantee the quality of services provided. Such regulatory measures take the form of licensing, certification and/or qualification requirements.

RTAs tend to discipline the use of such barriers to trade by a provision that resembles GATS Article VI.4.¹⁹ The NAFTA Agreement, for instance, stipulates the following in Article 10 of Chapter 12:

“With a view to ensuring that any measure adopted or maintained by a Party relating to the licensing or certification of nationals of another Party does not constitute an unnecessary barrier to trade, each Party shall endeavour to ensure that such measure:

- a) is based on objective and transparent criteria, such as competence and the ability to provide a service;
- b) is not more burdensome than necessary to ensure the quality of a service; and
- c) does not constitute a disguised restriction on the cross-border provision of a service.”

Disciplines along these lines can help prevent the abuse of regulatory measures for protectionist purposes. However, the mere difference between regulatory standards and practices can still create a prohibitive obstacle to trade. Consider, for example, a doctor facing different qualification requirements in a foreign country, which all serve to meet legitimate consumer and public health objectives. Re-qualification may take years and can be prohibitively expensive. The only way to overcome these types of barriers is through positive regulatory cooperation between relevant regulatory authorities. Such cooperation can take the form of harmonization of regulatory standards or the negotiation of recognition agreements. Indeed, the former is often a pre-requisite for the latter. Another example of trade-creating regulatory cooperation is the exchange of information between financial regulators on the health of financial institutions. In the area of mode 4 trade, governments often cooperate on matters such as pre-movement screening and selection, accepting and facilitating return, and combating illegal migration.

Regulatory cooperation, by nature, results in more favourable—i.e., discriminatory—treatment for service providers from certain countries. RTAs offer an obvious form to pursue regulatory cooperation, though it often takes place outside the realm of trade agreements. It is difficult to draw a complete picture of these types of regulatory cooperation initiatives, as they are often not exclusively designed to promote services trade. Still, some information is available on services-related mutual recognition agreements (MRAs). Mutual recognition in the context of services can in principle span a wide range of practices including recognition of prudential measures under financial services (in order to facilitate Mode 3)²⁰, recognition of educational qualifications with a view to enrolment in higher education or further training (to facilitate Mode 2 consumption of education services), as well as recognition of professional qualifications (to facilitate trade under Mode 4).

¹⁹ For a more thorough discussion of GATS Article VI:4 and the necessity test included in it, see WTO document S/WPDR/W/27.

²⁰ Approaches concerning financial services are typically dealt with in separate chapters on financial services rather than in MRAs.

OECD(2003) provides an overview of services related MRAs that have been notified at the WTO. The overview indicates that many MRAs are undertaken by neighbouring countries or as part of broader regional cooperation or integration initiatives. Most MRAs are between developed countries, and even then seem to be largely based on a shared region or common cultural/historical ties (e.g. agreements within the EU or between UK/US/Canada/Australia/Ireland). Agreements between non-OECD countries seem to be largely limited to inter-Latin America agreements, with the exceptions of a number of agreements between Brazil and other non-OECD countries. Examples also exist of non-OECD Asian and African countries being included in recognition arrangements with OECD countries. China, Hong Kong China , Malaysia, Philippines, Singapore and Vietnam, for instance, all have some form of Mutual Exemption Arrangement with the Engineering Institute of Australia. The South African Institute of Chartered Accountants is party to a bilateral agreement with the Institutions of Chartered Accountants in Australia. The latter example reflects that a number of agreements are not government to government per se, but are managed and enforced by the responsible professional bodies.

OECD (2003) also reveals that, notwithstanding their titles, many of the MRAs covered in the Annexes do not provide for automatic recognition of qualifications. Some are far-reaching (e.g. within the EU), others provide merely for reduced requirements or procedures, provide a degree of facilitation or are limited to broader types of cooperation or dialogue. While some agreements relate to specific sectors other agreements are based on a general recognition of diplomas in partner countries. In the context of RTAs most progress has been made in the case of specific sectors, notably those internationalised professions where most progress has also been made bilaterally or at the industry level: architecture, engineering and accounting. Industry initiatives have also led to some progress in nursing, given the increasing international demand for this profession. Overall, OECD (2003) concludes that there has been limited progress on MRAs at the regional level and that even progress between similar countries has been modest.

Preferential trade agreements containing MRAs that are restricted to parties to the RTA can, in principle, contain a strong discriminatory element. But the above description reveals that existing MRAs are unlikely to have this effect in practice. They tend to apply mostly to restrictions relevant for Mode 4 movements, a mode of trade that even at the regional level has not benefited from significant levels of liberalization. Besides, they tend to apply mainly to certain sectors, notably accounting, architects and engineering and even there progress has been weak.

This lack of progress in reducing implicit regulatory barriers to trade at the regional or bilateral level could indicate that the prospects for reducing such barriers at the multilateral level are rather bleak. On the other hand, in professions with great shortages in OECD countries, like medical and ICT professionals, workers are moving in large numbers via Mode 4, even in the absence of extensive networks of MRAs. It could therefore be argued, that if real trade interests are present, solutions other than MRAs to recognition are being found (OECD, 2003).

3. Explaining the design and scope of services RTAs

In the previous section, we established that services RTAs have created only weak, if any, discrimination. This experience differs markedly from goods RTAs. In the latter case, countries apply lower tariff rates only to imports from RTA parties and prevent the transhipment of goods from non-parties through elaborate rules of origin. In this section, we will attempt to explain this difference in treatment by analyzing how the inherent characteristics of services trade alter the traditional political economy of negotiating preferential agreements.

(a) Why do governments implement their RTA commitments in a non-discriminatory way?

One reason may be the practicability of policy discrimination. Trade protection in services does not take the simple form of a tax on trade flows, but consists of a myriad of laws and regulations affecting services and service suppliers. Discrimination in the application of these measures may not always be feasible. Even if it were feasible, it would require governments to verify the origin of services or service suppliers, increasing the bureaucratic burden on implementing agencies.

At the same time, the practicability argument does not seem fully convincing. Just because trade protection is not exercised through tariffs does not mean that governments cannot discriminate. Indeed, the history of trade policy in international air transport—which is largely excluded from the GATS and from RTAs—has shown that discrimination in services can be put into effect. In addition, the Mainland-Hong Kong CEPA illustrates how governments can verify the origin of service providers. A special certification mechanism under that agreement requires interested service suppliers to prove compliance with the agreement’s rules of origin.²¹ By June 2007, 1123 service suppliers had submitted applications for certificates to be eligible under CEPA, of which 1087 had been approved.

Two additional explanations are possible. First, governments may seek to avoid the economic distortions associated with actual discrimination. Our understanding of trade diversion effects and their consequences in services is still at its infancy. As pointed out above, one notable concern is the creation of a first-mover advantage for globally second-best firms (see Mattoo and Fink, 2004). Second, a country may be bound by non-party MFN clauses in other RTAs (or in BITs)—see the discussion above. If such MFN clauses cover a country’s most important trading partners, discrimination against the remaining countries may be of little relevance. That said, even though RTAs have been proliferating rapidly, most countries are still far away from complete coverage of their key trading partners.

(b) Why do most RTAs opt for liberal rules of origin?

There is a seemingly straightforward answer to this question: ‘because they have to’. Like its goods *alter ego*—GATT Article XXIV—GATS Article V prescribes a series of conditions that treaties on economic integration in services must fulfil in order to constitute a lawful exception from the multilateral MFN principle. One of these conditions, GATS Article V.6, reads:

“A service supplier of any other Member that is a juridical person constituted under the laws of a party [...] shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement.”

In other words, this provision prescribes precisely the liberal rule of origin found in most RTAs, as described in the previous section.²² GATT rules on regional integration have frequently been characterized as doing little to disciplines goods RTAs.²³ Yet in the case of the GATS, one can argue

²¹ The Mainland-Macao CEPA has established a similar certification mechanism. See Fink (2005).

²² Notwithstanding the liberal character of most RTAs’ rules of origin, certain elements of these rules raise questions of compliance with GATS Article V. See Emch (2006) and Fink and Molinuevo (2007). Interestingly, GATS Article V does not establish any discipline on rules of origin for natural person. As pointed out in the previous section, however, the choice of origin rules for natural persons is by nature more closely circumscribed than in the case of companies.

²³ See, for example, World Bank (2005).

that Article V.6 has meaningfully limited the extent to which WTO members can discriminate through preferential arrangements.²⁴

The explanation offered by this GATS requirement is not sufficient, however. Why did WTO members agree on Article V.6 in the first place? In addition, a special and differential treatment provision in Article V offers RTAs “*involving only developing countries*” the option to limit trade preferences to service suppliers owned or controlled by persons of the parties.²⁵ Yet most RTAs among developing countries have not taken advantage of this option.²⁶ Why do countries appear to voluntarily adopt rules of origin that extend trade preferences to established non-party service suppliers that show substantive business operations?

One explanation may be that governments consider domestically established non-party service suppliers as part of the domestic economy. Surely, such service suppliers employ domestic residents and pay taxes to the government. Improved access to RTA markets by such suppliers may be associated with employment gains and greater fiscal revenues. A government may even purposely seek liberal rules of origin in its RTAs to attract foreign direct investment (FDI) from non-parties, turning the economy into a trading hub for services.

While likely relevant for some countries, this explanation again fails to be fully convincing. The benefits of enhanced access to RTA markets depend critically on the mode through which services are supplied. In the case of modes 1 and 2, for which the supply of the service occurs from or in the domestic territory, the expectation of employment gains and greater tax revenue seems reasonable. However, for the commercially more important third mode—the establishment of a commercial presence in the territory of the RTA partner—employment gains may be small. The domestic economy may still benefit from greater tax revenue, though much depends on how companies transfer profits between countries and how these profits are taxed.

In addition, from a political economy perspective, it is not clear whether politicians and trade negotiators consider domestically established non-party service suppliers as part of their constituencies. For example, it is interesting to note that membership of the US Coalition of Service Industries—the main US interest group lobbying for market opening abroad—seems to be made up almost entirely of US household names. It does not appear to extend to major non-US service suppliers established in the US.²⁷ Similarly, the European Services Forum, which promotes the same interests in the EU, mostly represents European service suppliers—though selected non-European companies participate in the Forum as well.²⁸

Even if we assume that the exporting country has an economic or political interest in a liberal rule of origin, the adoption of such a rule is subject to bargaining between RTA parties. It is not clear whether a country that primarily imports services necessarily goes along with a liberal proposition. A wider set of service suppliers eligible for trade preferences implies greater import competition, which may or may not conform to the objectives of the importing country’s government.

²⁴ Emch (2006) has characterized GATS Article V.6 as the restoration of the multilateral MFN principle for service suppliers from non-RTA parties.

²⁵ See GATS Article V.3(b)

²⁶ For example, the ASEAN Framework Agreement on Services, the ASEAN-China Trade in Services Agreement, and the MERCOSUR Protocol of Montevideo on Trade in Services extend trade preferences to all established service suppliers that engage in substantive business operations in a party.

²⁷ See <http://www.uscsi.org/members/current.htm>.

²⁸ See <http://www.esf.be/pdfs/Members%20Biographies.pdf>. Examples of non-European companies that are members of the Forum include Electronic Data Systems, Oracle, and Universal Music.

A second explanation may relate to the network characteristics of many service activities. As pointed out above, service providers in a variety of sectors—whether financial intermediation, transportation, telecommunications, distribution, or professional services—can reap economies of scale and scope by simultaneously supplying services in several countries. They therefore seek the greatest possible flexibility in designing their global corporate structures, with the freedom to choose from which location and through which mode to service any given market. Even though restrictive rules of origin may offer selected companies a competitive edge, a RTA landscape with restrictive rules of origin will make multinational service providers collectively worse off. In other words, this explanation offers a rationale for GATS Article V.6—a global requirement for RTAs to adopt a liberal rule of origin.²⁹

Finally, a third explanation may relate to the fact that services sectors, like telecommunication and finance, were often in public hands in the past. The relevant lobbies probably suffered significant losses when the public entity was transformed into a private one and also when the sector was opened up for internal competition. Resistance against policy change may have focused on this transition. Once this painful step was taken a further move towards international competition may have been relatively painless and political resistance against it weak. In other words, privatization may have eliminated the pro-interventionist contingent at home much along the lines of the arguments developed in Feeney and Hillman (2001). They argue that privatization of a home state-owned firm in any sector and in any form that ultimately permits trade in equity of the firm, weakens pro-interventionist forces at home and creates a political climate that constitutes free trade.

(c) *Why do RTA partners establish non-party MFN clauses?*

The inclusion of a non-party MFN clause in a services RTA or BIT is best explained by bargaining considerations. To begin with, for any given RTA, each party has an incentive to ask its trading partner for MFN treatment, as it ensures that domestic service providers benefit from current and future trade preferences extended to non-parties. However, a country bound by many non-party MFN obligations faces a less favorable bargaining situation in future RTAs. A new RTA partner knows that any negotiated preference will be extended automatically to others. Thus, service exporters and investors from that partner will not have exclusive access to the domestic market, reducing the value of a future RTA commitment. Consequently, the willingness of a new RTA partner to “pay” for additional market opening may be reduced.

On balance, a country with liberal trade policies in services has a stronger interest in a non-party MFN clause than a country that maintains substantial trade restrictions under a RTA. The former has few preferences left to grant and can only benefit from the extension of future market opening measures by RTA partners. The latter may be more cautious about widening the scope of any future liberalization undertaking and may not want to weaken its bargaining position for negotiations with other trading partners. It is thus not surprising that RTAs involving developed countries typically feature a non-party MFN obligation, whereas agreements between developing countries do not always incorporate such a discipline.³⁰

²⁹ A possible third explanation may be the difficulty of determining the nationality of a company. Multi-level equity holdings, the presence of nominees, and public trading of equity can obfuscate a company's ultimate ownership and control. However, this problem can be solved by putting the burden of proof of domestic ownership and control on the preference-seeking service suppliers, as is practiced in agreements that operate a domestic ownership and control requirement. See Fink and Nikomborirak (2007) for further discussion.

³⁰ See Table 6 in Fink and Molinuevo (2007).

All these considerations diminish in relevance if RTA commitments do not actually discriminate. If service providers from country C benefit from A's market opening under the RTA between A and B in any case, a non-party MFN clause does not offer any new market opening. Its only value would be legal security, as country C could invoke the dispute settlement system of its RTA with A to enforce A's liberalization undertaking.

4. Are services RTAs building or stumbling stones for multilateral services liberalization?

The economic literature offers several political economy models that analyze countries' incentives to engage in multilateral liberalization after signing a RTA. Supporting the stumbling stones view, Krishna (1998) shows how a trade diverting RTA will generate vested interests against further multilateral liberalization. Inefficient firms that can only export because of preferential market access to a RTA partner will oppose any further market opening towards third countries with more efficient firms. Similarly, Levy (1997) demonstrates that a bilateral RTA that offers the median voter greater overall gains than a multilateral trade agreement will undermine support for the latter.

However, there are also forces backing the building blocks view. Businesses in countries left out by RTAs may feel that they are harmed by not having preferential access to foreign markets. RTAs may thus strengthen the incentives of governments left out by such agreements to also engage in reciprocal liberalization. Such a change in incentives may directly enhance the support for multilateral liberalization or prompt the negotiation of new RTAs. In the latter case, a 'domino' dynamic may be triggered that leads governments to enter into RTAs with all their major trading partners (Baldwin, 1995). Such a situation is still not equivalent to free multilateral trade, as producers still face origin rules when exporting to different destinations. However, Baldwin (2006) argues that increased production unbundling will then generate systemic political economy forces favoring the multilateralization of preferential agreements.

A fundamental assumption underlying all these models is that RTAs lead to actual discrimination. If non-parties benefit from RTA liberalization commitments, the political economy forces that alter governments' attitude towards multilateral liberalization in these models are not unleashed. Indeed, a move from regional to multilateral liberalization would hardly alter the competitive conditions in RTA parties. From this view, we may conclude that weakly discriminatory services RTAs neither help nor hinder the multilateral cause.

Even though there is a grain of truth in this conclusion, there are several other considerations that lead to a more refined assessment of the systemic consequences of services RTAs. We start with arguments that favour the building blocks view of RTAs. First, preferential agreements do offer inroads towards more open markets. The additional step of locking in that commitment under the GATS seems minor. In fact, one may argue that a positive reform experience at the RTA level may strengthen the support for binding services trade policy at the multilateral level. In addition, partial liberalization in a RTA may weaken opposition to further market opening. This may be particularly the case where a RTA cracks a hard reform nut, such as the break up of a monopoly. As argued above, once a country has taken the most painful step, any further expansion of international competition may face little political resistance.

Second, the inclusion of a non-party MFN clause in services RTAs and BITs strengthens incentives to negotiate at the multilateral level. A country that has concluded agreements with such clauses covering all its major trading partners will find itself in a situation where the difference between a new RTA commitment and a WTO commitment is minor.

Third, there may be positive spillovers from RTA to WTO negotiations. Reciprocal bargaining in services trade is more information-intensive than in the goods case, requiring a resource-intensive

stock-take of domestic laws and regulations across a large number of sectors that might be considered measures subject to trade disciplines. Information gaps have arguably been one of the factors contributing to the slow progress of multilateral services negotiations. Governments that have carried out a comprehensive stock-take in the course of RTA negotiations are likely to be better prepared for services talks at the WTO.³¹

In opposition, several arguments can be put forward to challenge the building blocks view. First, preferential deals in services may remove important bargaining chips from the multilateral negotiating table. In particular, the proliferation of RTAs may undermine a multilateral grand bargain whereby developed countries would commit to trade reforms in agriculture in return for emerging economies committing to trade liberalization in non-agricultural market access (NAMA) and services. Such a multilateral bargain appears essential for negotiating the reduction of domestic subsidies in agriculture, which by nature cannot be reduced on a preferential basis. At the same time, it is uncertain how a link between agriculture, NAMA and services will be effectuated, should the current multilateral trading round ever come to a successful conclusion. Trade concessions in services are not straightforwardly negotiated through a formula approach, complicating any quantitative linkage between the different negotiating areas.³²

In any case, the current RTA landscape does not seem to pose a significant obstacle to striking multilateral bargains. The countries targeted most frequently in the 2006 ‘plurilateral’ services requests are middle income countries which, for the most part, have not entered into RTAs with developed countries.³³ In addition, even though the number of RTAs is bound to further increase in the next few years, important commercial relations will unlikely be subject to preferential arrangements in the foreseeable future (e.g., China-Japan, Brazil-US). In other words, the scope for grand multilateral bargains—if WTO members were ever able to strike such bargains—will likely persist for some time to come.

The second potential objection to viewing services RTAs as building blocks concerns mode 4. As described in Section 2, rules of origin for individual service suppliers are by nature more restrictive, bringing about strong discrimination. As explained above, discriminatory preferences do not automatically alter incentives in such a way that governments will oppose further multilateral liberalization. However, a stumbling stone scenario is a distinct possibility. For example, would the Philippines easily accept the erosion of its preferential access to the Japanese market for nursing services by Japan making a similar commitment at the WTO?³⁴

Notwithstanding the soundness of this argument, a bigger question is whether non-discriminatory liberalization of mode 4 trade will ever become a reality. One may argue that it is precisely the

³¹ At the same time, one may argue that RTAs divert scarce negotiating resources. The negotiation of each trade agreement requires its own share of preparation, consultation, coordination, and travel. For countries negotiating many RTAs, there is the risk that the devotion of negotiating resources to these agreements comes at the expense of reduced engagement at the WTO. However, there is no credible evidence to this effect—not least because the services talks under the WTO’s Doha Development Agenda have been “held hostage” by the lack of progress in negotiations on agriculture and non-agricultural market access.

³² In the run-up to the Hong Kong WTO Ministerial Conference in 2005, European Union advanced the idea of establishing quantitative negotiating benchmarks for services. However, this approach was rejected by developing country WTO members and finds no mentioning in the final Hong Kong Ministerial Declaration. It is also interesting to note that the Hong Kong Ministerial Declaration only calls for “a comparably high level of ambition in market access for Agriculture and NAMA”—without mentioning services.

³³ The 12 most frequently targeted countries are Argentina, Brazil, China, Egypt, India, Indonesia, Malaysia, Pakistan, Philippines, South Africa, Thailand, and Turkey.

³⁴ It is interesting to note, however, that Japan made an almost identical commitment on the entry of nurses and caregivers in its EPA with Thailand.

multilateral MFN obligation that may lead countries to shy away from committing under the GATS. Mattoo (2005) advances that the entry of foreign service providers raises certain deeply rooted fears—including loss of national identity, competition for jobs, and illegal immigration—which are better addressed in a bilateral or regional forum. Preferential arrangements allow host governments to manage labor inflows more carefully, taking into account cultural and other ties between countries. In other words, even though discriminatory treatment of mode 4 may complicate progress at the WTO, it may equip countries with the necessary flexibility to achieve at least *some* liberalization in this area.³⁵

A similar argument applies to trade-creating regulatory cooperation between countries, whether it takes places in a RTA context or elsewhere. As discussed previously, such regulatory cooperation includes first and foremost the harmonization of regulatory standards and the conclusion of recognition agreements, but also extends to information exchanges between regulators and cooperation on law enforcement activities. By nature, regulatory deepening leads to discriminatory treatment of service providers from non-participating countries, possibly complicating progress towards multilateral integration. However, in many areas, regulatory cooperation may be neither feasible nor desirable at the multilateral level to begin with, due to differences in preferences, legal systems, and levels of development. The ultimate impact of preferential regulatory cooperation will also depend on whether they are open for participation by initially excluded countries. As we will argue in the section, the WTO has an important role to play in disciplining cooperation agreements in this respect.

Two final considerations bear brief discussion. First, the importance of economies of scale in many service sectors may have important implications for the sequence of market opening. For example, the conclusion of a RTA could allow regional service suppliers to reap economies of scale, allowing them to survive upon further multilateral market opening. Such dynamics may well have an effect on the political economy forces resisting or supporting multilateral services liberalization. More generally, it is difficult to predict, however, in which direction these forces will push for different countries at different stages of integration. In any case, this argument again pre-supposes that services RTAs lead to discernible discrimination, which the current RTA landscape does not seem to support.

Second, it is worth noting that services RTAs do not give rise to the ‘spaghetti bowl’ syndrome intrinsic to the proliferation of goods RTAs. As pointed out above, in the latter case a world of zero preferential tariffs will still falls short of free multilateral trade as exporters continue to face origin requirements affecting their use of imported intermediate inputs. In services, rules of origin primarily deal with the origin of service *providers* rather than the origin of the traded services. Service exporters remain free to rely on the import of intermediate inputs of goods and services from anywhere in the world.³⁶ At most, exporters face a one-time certification process which is unlikely to noticeably affect a supplier’s production cost. Thus, a world of barrier-free services RTAs will indeed approximate free multilateral trade.

³⁵ In the end,

³⁶ One might argue that RTAs establish a rule of origin for services supplied through modes 1 and 2. For example, cross-border trade in services is typically defined as the supply of a service ‘from the territory of one party into the territory of another party’. At what point is a service supplied from outside the territory of a party if a service supplier relies on the import of intermediate service inputs from a non-party? While legal questions of this type may well arise at some point, they still seem academic. See Fink and Molinuevo (2007) for further discussion.

In sum, only time will tell whether the current wave of RTAs proves to be helpful or harmful for the WTO. A multitude of political economy forces are pushing in different directions. In the specific case of services, however, there are reasons to believe that preferential agreements are more likely to be building blocks than stumbling stones. The main grounds for this more optimistic outlook are the weakly discriminatory nature of services RTAs and the web of non-party MFN clauses to which many countries are already bound in existing agreements. There is some concern about preferential market opening of mode 4 and regulatory cooperation agreements, which are inherently more discriminatory. However, it is not clear to what extent full multilateral progress in these areas will ever be feasible.

5. Facilitating the move from regional to multilateral services liberalization: is there a scope for the WTO?

(a) Services RTAs as an exception to the MFN principle

The MFN principle is a fundamental principle of the multilateral trading system and the existence of RTAs, in principle, sits oddly with this principle. Yet, the GATT has from its beginnings allowed for the existence of customs unions and free trade areas and the GATS does the same. GATS Article V stipulates under which conditions RTAs are not considered to be in conflict with WTO rules. GATS Article V.1 notably requires regional agreements to have "substantial sectoral coverage" and elaborates in a footnote that this "condition is understood in terms of number of sectors, volume of trade affected and modes of supply".

The requirements in GATS Article V concerning the sectoral coverage of regional agreements are defined rather loosely. It is indeed difficult to see how these conditions can be effectively monitored with the data that are normally available on trade in services. Some observers (e.g. Feketekuty, 2000) have therefore asked for a redrafting of GATS Article V.

In light of the arguments developed in this paper, it is not clear whether redrafting of the paragraph would have any significant effects on trade or welfare. Section 2 of this paper revealed that rules of origins in existing RTAs tend to be rather liberal and that non-Parties to the RTA can in principle take advantage of its preferences. The main source of discrimination from regional services liberalization therefore does not seem to lie in the RTAs, but in preferential regulatory cooperation agreements if these accompany regional liberalization. A redrafting of Article V would not serve this purpose. In addition, it is not clear whether the same Members concluding RTAs would have much appetite for disciplining them.

(b) The WTO and implicit regulatory barriers

Preferential Trade Agreements in services provide for greater market access than existing multilateral commitments on services and tend to be characterized by rather liberal rules of origin. They would thus appear to have contributed to services trade creation in a way that is not very distortive and is unlikely to jeopardize further multilateral liberalization.

However, an important unknown factor continues to exist in the form of implicit regulatory barriers to trade. Such barriers continue to exist within RTAs and often such regulatory measures pursue valid policy objectives and target existing market failures. With existing data and methodologies it is difficult to assess their impact on regional and multilateral trade and even harder to assess their impact on welfare. But regulatory measures can easily be used for protectionist purposes and questions arise as to the role of the WTO in facilitating trade by devising rules of conduct as to the use of regulatory measures in services.

The GATS Agreement disciplines the use of regulatory measures in Article VI and paragraph 4 of that Article foresees that the WTO's role may even go further: "With a view to ensuring that measures

relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services, the Council for Trade in Services shall, through appropriate bodies it may establish, develop any necessary disciplines.”

Pursuant to this mandate the so-called Working Party on Professional Services was created and one of the outcomes of its work has been the “Decision on Disciplines on Domestic Regulation in the Accountancy Sector” adopted in 1998.³⁷ These voluntary and non-binding guidelines elaborate on the requirements of Article VI:4 of the GATS that stipulates that measures related to qualification requirements and procedures, technical standards and licensing requirements should be based on objective and transparent criteria and should not be more burdensome than necessary to ensure the quality of the service.

The Working Party on Professional Services has in the meantime been renamed into the Working Party on Domestic Regulation. One of the focuses of this Working Group has been to analyse whether the Disciplines on Domestic Regulation in the Accountancy Sector are suitable for other professions. In this respect consultations with international professional organizations have taken place.

Section 2 of this paper discussed existing efforts to agree on common disciplines as to the use of regulatory measures. These efforts have resulted in a number of MRAs. We argued that regulatory cooperation agreements can have discriminatory effects. Since progress on MRAs at the regional level has been slow, the severity of this concern is questionable.

In principle, by extending trade benefits to one country (or a small group of countries), MRAs may depart from the MFN obligation under the GATS. However, GATS Article VII allows for such a departure provided that the WTO member in question notifies the MRA and affords adequate opportunity to other interested members to negotiate a comparable arrangement. This obligation already promotes the “friendliness” of such agreements with the multilateral trading system. Nonetheless, there seems to be a loophole to this discipline. It is not clear whether MRAs concluded in the course of a PTA fall under the scope of Article VII or are covered under GATS Article V on economic integration agreements. Indeed, most WTO members seem to hold the latter view (see Adlung, 2006). A uniform rule requiring notification and an opportunity to negotiate a comparable agreement would seem more desirable in this context.

The previous literature has also argued that the WTO’s role with respect to MRAs could be strengthened. OECD (2003), for instance, suggests that the WTO Guidelines for accounting services could also be applied as a template for MRAs in other professional services. This could, according to Nicolaïdis and Trachtman (2000), lead to the creation of a more open and transparent system of MRAs. Indeed, such a system of MRAs based on a unique template would very likely represent a building block rather than a stumbling stone for multilateral liberalization as it would be easier to match the regulatory regimes of different regions if they are built according to the same template.

In principle such a template could also be useful with respect to licensing or qualification requirements concerning the movement of natural persons in the context of the supply of other services, like health services (doctors, nurses) or transport services (pilots). In addition, the use of templates could be extended even further to other forms of regulatory cooperation besides recognition.

³⁷ WTO Document S/WPPS/W/21.

6. Conclusion

The arguments put forward in this paper suggest that, for the most part, we can be optimistic that services RTAs will be a building block for multilateral trade liberalization. The main cause for this optimism lies in the weakly discriminatory nature of these agreements—as reflected in non-discriminatory implementation of trade commitments, liberal rules of origin, and the inclusion of non-party MFN clauses.

However, there are two important exceptions to this conclusion. First, RTAs liberalizing mode 4 trade show greater discrimination, due to more restrictive origin rules. Second, preferential regulatory cooperation, by its very nature, also leads to discernible discrimination. The latter often pertains to mode 4 trade, but is also relevant for the other forms of services trade. Arguably, the depth of RTA commitments on mode 4 and the number of regulatory cooperation initiatives is still relatively small, though selected agreements have shown that deeper liberalization is possible.

Multilateral progress in these areas may not always be feasible and sometimes not even desirable, especially when it comes to the harmonization of regulatory regimes. From this view, the WTO should not stand in the way of countries wishing to go deeper. However, there is some scope for disciplines to promote the friendliness of regional initiatives within the multilateral trading system. The GATS already has sensible rules promoting such friendliness—notably Article V.6 mandating a liberal rule of origin for juridical persons and Article VII requiring WTO members to afford adequate opportunity for the extension of MRAs. Arguably, there is additional room for the WTO to scrutinize regional regulatory initiatives. It could further promote the transparency of such initiatives, establish additional principles that ensure their openness to initially excluded countries and promote templates for regulatory cooperation that lend themselves to eventual multilateralization.

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