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Regulating Services Trade

Matching Policies to Objectives

Richard H. Snape

3.1 Introduction

Analysis of the relationship between objectives and optimum policies has a long history, at least back to Tinbergen, Haberler, Meade, and others in the early 1950s. Bhagwati and Ramaswami, and then Harry Johnson, Max Corden, and Bhagwati developed it further in a trade context, in Johnson's case in his classic "Optimal Trade Intervention in the Presence of Domestic Distortions" (1965) and for Corden most completely in his *Trade Policy and Economic Welfare* (1974).

The general message is that the policy instrument should be targeted closely on the policy objective, minimizing by-product distortions. In the context of international trade policy, domestic "market failures" are best addressed by domestic policies, whereas international trade policies are best reserved for objectives associated with international trade itself. In the latter category, as far as national economic objectives are concerned, a country's ability to affect its terms of trade is usually regarded as the principal reason for using a trade policy instrument. Although second-best considerations may modify these conclusions, they still provide a good starting point.

As far as noneconomic objectives are concerned, similar considerations apply. To the extent that such objectives are associated with trade as such (such as to satisfy isolationist objectives), trade policies would be the efficient means to pursue the objective. To the extent that they are essentially

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domestic (for example, to expand production of cars in Australia) trade policies are not optimum policies, in the absence of second-best or administrative cost considerations.

Most of this analysis has been in relation to trade in goods, where the goods move between countries but the factors of production and the consumers or users of the goods do not. More recently, appropriate regulation of services trade has been addressed, within countries and internationally, particularly in the context of the negotiation of the General Agreement on Trade in Services (GATS) and subsequently.

In this paper the policy-objective link is addressed for services. First, the value of generic, rather than industry- or sector-specific, policies is emphasized. International aviation is referred to to show the problems that can emerge from sector-specific policies in the context of (bilateral) international agreements. Various objectives for the regulation of services are then considered. These are objectives associated with foreign investment and establishment, consumer protection, social and cultural matters, and access to the services of “essential facilities.” In all of these the desirability of defining the true objectives clearly and of adopting consistent policies across sectors and, where appropriate, across international agreements, is highlighted. Extensive reference is made to some of the reports of the Australian Productivity Commission to illuminate these issues.

3.2 Generic Policies

The rules of the General Agreement on Tariffs and Trade (GATT) are mostly framed in forms that cover all goods (although there are exceptions for agriculture and for clothing and textiles). In the GATS the general rules are quite modest in comparison. The GATS is a framework agreement with special provisions being negotiated for each sector. Much of the activity by the members in the GATS has been sector specific, with little or no attempt to develop cross-sector rules or trade-offs.

In some quarters there have been recent attempts to develop generic, or horizontal, disciplines for services at the domestic and multilateral level (Mattoo 2000, 483–7). As Mattoo points out, “a generic approach is to be preferred to a purely sectoral approach for at least three reasons: it economises on negotiating effort, leads to the creation of disciplines for all services rather than only the politically important ones, and reduces the likelihood of negotiations being captured by sectoral interest groups” (484). In addition, a generic approach helps to ensure that the same criteria and policies are applied for different products and industries to address the same policy objective. Provided the policies are well chosen, this reduces the distortions of resource allocation and choice. However, the case here applies not only to services: it applies to goods as well.

Further, despite the many differences between some forms of goods trade and services trade, and the different forms of regulation, the arguments for

generic or horizontal policies that apply to policies for goods and to policies for services also apply to policies across both goods and services. Where there are objectives that relate to both goods and services, there is a strong case for applying generic policies—nationally and internationally—that embrace both.

As an example of what can develop when services policy is not generic but is highly industry specific, international aviation stands out. A very restrictive framework of bilateral aviation agreements has developed, and the trade-offs are all within aviation. There is no “nondiscrimination” rule, as there is under both GATT and GATS: indeed, discrimination is of the essence.

For the last fifty-odd years, international aviation has been conducted within the context of bilateral reciprocity, based on protection of national designated flag carriers. International aviation (except ground handling and similar services) is explicitly excluded from the provisions of GATS. There are now more than three thousand of these bilateral agreements worldwide. They are based on “freedoms”: that is, nothing is allowed unless it is explicitly permitted. The agreements typically specify the number of seats that can be offered by the designated airlines of the two parties to the agreement for flights between the two countries and whether they may pick up traffic en route and fly beyond the parties. They rarely allow carriage within the foreign partner. They may also contain provisions relating to fares, which may range from notification to governments to fare approval or control by governments. Some agreements provide for the sharing of revenue between the airlines of the two parties. Typically the agreements (or other legislation) limit the foreign ownership of airlines.

Partners to agreements may effectively veto foreign takeovers of airlines in their partner countries by refusing to recognize an airline as a designated national airline of the partner country, for the exercise of the rights under the air services agreement. (This was threatened by the United States when Aerolineas Argentinas was taken over by Iberian Airlines; in response to the threat, the United States received concessions from Argentina.) Thus, the ownership provisions are at the core of the system.

There has been substantial liberalization of air service agreements by many countries in recent years, but still on a bilateral basis. The United States has entered into more than thirty bilateral “open-skies” agreements, which involve the removal of most of the restrictions on capacity and routes but still prohibit foreign airlines from carrying domestic passengers within the United States, and they do not ease the tight restrictions on the national ownership of U.S. airlines.

Within this context, the Productivity Commission¹ was asked by the Australian government to recommend the best policy for the Australian people

1. The Productivity Commission, an independent statutory agency, is the Australian government’s principal advisory body on microeconomic policy and regulation. Its reports, together with submissions made to it in the course of its inquiries, are available without charge on its website: <http://www.pc.gov.au>.

as a whole.² Industry protection as such was not an objective within the government's Terms of Reference for the inquiry, nor is it within the matters that the commission is required to consider by its act.

The commission caused surprise in some quarters by not recommending unilateral liberalization (Productivity Commission 1998). The reason was that in the tight bilateral system, unilateral liberalization could not be guaranteed to increase the traffic between Australia and other countries. The trading conditions have to be agreed upon by the parties at both ends of a flight (and with intermediate countries, if there are any). Thus, the terms of trade (here meaning the terms of aviation trade) are negotiated between the parties, and no country is a "small country" in the usual economic sense of being unable to affect its terms of trade.

The commission recommended that the Australian government try to negotiate an open plurilateral club of open-skies agreements and, better still, a liberal multilateral agreement for aviation under the GATS. However, within the constraints of the bilateral system the commission's main recommendation was that the government attempt to negotiate agreements that are as unrestricted as possible with the bilateral partners. The policy would offer unrestricted capacity, routes (including intermediate and beyond points), fares, code sharing, number of designated airlines, and ownership as a basis for designation. (A policy of unilateral unrestricted open skies, within overall negotiated capacity, was recommended for all airports with the exception of Sydney, Melbourne, Brisbane, and Perth, on the grounds that negotiating power was limited for all airports except these four.) Domestic cabotage was to be negotiated bilaterally. The government has accepted these recommendations, with the exception of that relating to cabotage.

Lessons that can be drawn from this inquiry relate to the danger of going down the path of product-specific reciprocity (Snape 2001). Even if industry protection is not a part of the objective of the policy framework (and even if it were, there are likely to be other and better means by which to pursue it), the ability to pursue the general interest is limited by the stance of foreign partners to the bilateral agreements.

Generic principles and agreements are, of course, of no use for those industries for which their application is excluded. However, there would appear to be no reason in principle that generic principles and regulations (international and national) could not be applied to all forms of international transport (of goods, people, and services), whether it is provided in physical form, by wire, or by the electromagnetic spectrum. The regulation could

2. The commission's act requires it to have regard (inter alia) to the need "to improve the overall economic performance of the economy through higher productivity in the public and private sectors in order to achieve higher living standards for all members of the Australian community" and "to reduce regulation of industry . . . where this is consistent with the social and economic goals of the Commonwealth Government."

then address the basic national objectives, rather than being specific to particular modes of transport. If the objective is industry protection as such, there are more efficient means by which to achieve it than through a morass of bilaterally restrictive agreements, which in many cases provide few incentives for economy efficiency.

How international aviation would develop in a multilateral, nondiscriminatory aviation world is a matter of conjecture. Hub and spoke systems could well develop, as in the United States, together with airline mergers that would in part replace the current alliances. General competition policy, national and across jurisdictions, would then have a higher profile in aviation. Such generic policies could be expected to promote competition, whereas the current bilateral system has at its roots the restriction of international competition.

3.3 Objectives for Services Regulation

Services are regulated to pursue a variety of objectives, economic and noneconomic. Among the former are problems associated with asymmetric information (including consumer protection and prudential requirements), monopoly (including natural monopolies), public goods and externalities, protection of intellectual property, and the improvement of the terms of foreign trade and investment. There are also technical matters (e.g., the scarcity of the radio frequency spectrum) that are of economic importance. Among the noneconomic objectives are distributional matters including universal availability, cultural and social objectives, and national ownership. Of course, there are also straight-out industry protection objectives for many governments.

3.3.1 Foreign Investment and Establishment

Of the national economic objectives, only the terms of trade and investment, and some externalities (in particular in the form of technology transfer), would seem to be matters on which policy would lead necessarily to a consideration of measures that would discriminate between foreigners and nationals. However, there would seem to be no difference in principle here between policies for goods and for services. The fact that many services could not be traded without establishment would not of itself imply that different principles should be applied to investment in the production of goods and investment in the production of services. Many goods also might be traded only (or more efficiently) if a local presence is established for assembly or distribution.

If there are externalities associated with some investments but not others (for example, knowledge transfer), then these differences may lead to differential treatment of different investments. However, that does not necessarily lead to different treatment of investments in goods production in gen-

eral and investments in services production in general. There seems to be no reason to assume that as a general proposition investment in services is more or less a source of knowledge transfer or of other externalities than investment in goods production. Similarly, if national ownership is a government objective, there would seem to be no reason to discriminate on a general basis between goods and services (although, of course, governments may decide such ownership is more important for some industries than others).

Thus, there would appear to be a case for generic rules to apply to investments in both goods and services domestically as well as in international agreements. However, the fate of the proposed Multilateral Agreement on Investment suggests that such a broad approach at the multilateral level will be some time away. In the meantime, the multilateral rules governing investment related to goods trade are quite weak; for services, apart from the requirement for nondiscrimination, their strength under the GATS depends mainly on the specific commitments undertaken by members for particular sectors.

3.3.2 Consumer Protection

As to asymmetric information or consumer protection, there is much that is applicable to both goods and services. Just as many services are regulated for consumer protection, many goods are subject to regulations aimed at the same type of objective—for example, safety specifications for motor vehicles. Generally it is better to specify requirements in terms of performance rather than inputs: for example, that tractors should not turn over on forty-five-degree slopes, rather than that they should have a tonne of ballast at wheel level. Since 1947, Article III of the GATT has stated that regulations and requirements affecting the internal sale of products should not be applied so as to afford protection to domestic production. However, this has not prevented the adoption of unique national requirements.

The Agreement on Technical Barriers to Trade (as well as the Agreement on the Application of Sanitary and Phytosanitary Products) addresses such matters for goods.³ The agreement requires that technical barriers “are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination among countries where the same conditions prevail or a disguised restriction on international trade” (Preamble), and that foreign (WTO member) products should receive treatment that is no less favorable than like products of national origin (Article 2.1). Technical regulations should not create unnecessary obstacles to international trade and

3. The emphasis of the Agreement on Sanitary and Phytosanitary Products is on harmonization of international standards, but allowing for different standards when there is scientific justification that is related to the protection of human, animal, or plant life or health. Measures should not discriminate among members of the WTO where identical or similar conditions prevail.

should not be more trade restrictive than necessary to fulfill a legitimate objective. These objectives are national security, prevention of deceptive practices, and protection of human health or safety, of animal or plant life or health, or of the environment (Article 2.2). Adoption of international standards and standards based on performance are encouraged.⁴ These provisions apply to all goods, whether or not they have been subject to negotiated trade barrier reductions and commitments.

In services, performance standards designed for the protection of consumers are often difficult to apply: medical practice is the classic example. (Ex ante rather than ex post protection is generally preferred.) Thus, domestic regulations frequently specify required qualifications for service suppliers, and professional titles (such as architect, doctor, lawyer, and university) are reserved by legislation for those persons or institutions with the qualifications deemed appropriate. Although the emphasis on the qualifications of providers rather than on performance makes it difficult to specify generic rules across professions at the national as well as at the international level, there is scope for generic rules in multilateral agreements in regard to the foreign treatment of national qualifications.

In the GATS, Article VI.4 provides for the Council of Trade in Services (through bodies it may establish) to develop any necessary disciplines to ensure that measures relating to qualifications, technical standards, and licensing requirements do not constitute unnecessary barriers to trade in services. It specifies that such disciplines should be based on objective and transparent criteria and are not more burdensome than necessary to ensure quality, and that licensing procedures are not in themselves a restriction on supply. Such provisions would cover all services. Until such disciplines are developed, GATS provides that in those sectors for which there are specific commitments by members, these principles should apply. Little progress appears to have been made to develop these disciplines of general application for services. This is in contrast to goods, where the Agreement on Technical Barriers to Trade has general application.

As well as these provisions, Article VII of GATS provides for mutual or unilateral recognition of qualifications acquired abroad. Importantly, it provides that such recognition should not be applied in a manner that would discriminate between members in whose countries similar qualifications or experience have been obtained.

It would seem desirable to have a common set of principles for the recognition of standards, qualifications, and licensing requirements covering goods and services. Although there are two agreements covering the same issue, one for goods, the other for services (and the latter only for scheduled

4. Many product standards fall outside these provisions (the screw pitch of nuts and bolts, for example), whereas many that may be covered (for example, different safety specifications for motor vehicles and electrical connections) may inhibit trade but do not appear to be constructed for this purpose.

services), there are possibilities of inconsistencies even if the intent is the same.

In three recent Productivity Commission inquiries related to services—gambling, broadcasting, and architects—consumer protection has been an important issue. In the broadcasting inquiry, the regulation of content was addressed, in particular pornography and other material deemed by Parliament to be unsuitable for broadcasting. There are many issues here, including whether the rules for the Internet should be akin to those for books and magazines or to those for free-to-air (or subscription) broadcasting. (Technological convergence could suggest that all electronic platforms be treated in a similar manner, although there are also arguments that would distinguish between one-to-one dissemination and one-to-many.)

During the course of the inquiry, the government introduced regulation of online content. The regulations attempt to prohibit objectionable material hosted on Internet sites in Australia. They also attempt to require Australian Internet service providers to prevent Australians from obtaining access to material found to be objectionable (PC 2000a, 482–3).

On gambling, among other things the commission was asked to report on “the social impacts . . . , the cost and nature of welfare support services . . . the effects of regulatory structure . . . the implications of new technologies (including the internet), including the effects of traditional government controls on the gambling industries. . . .”

While emphasizing that there were substantial consumer benefits (entertainment, etc.) accruing from gambling, the commission also drew attention to the risks and costs arising from problem gambling. Lack of adequate information regarding the “odds,” or price of gambling, and addictive behavior (together with the design of gambling machines that encouraged, or at least did not discourage, addictive behavior) were seen as the main problems. (There were also problems with government-legislated restrictions on competition in the supply of gambling facilities, complex and inconsistent regulation, and what some commentators have described as addiction by governments to the revenue from gambling.)

The commission saw avenues of regulation that would provide greater information and protection for consumers and support for problem gamblers. The development of Internet gambling raises questions, some of which were not unlike those associated with broadcasting, particularly in the international dimension. This involves taxation as well as consumer protection issues. Within Australia, the tax question is being solved by an agreement between jurisdictions that the tax revenue should be repatriated to the (Australian) jurisdiction of the gambler. Implementation requires licensing and enforcement. Internationally, such agreements would be much more difficult to achieve.

As with broadcasting of pornography, a main question was not whether online activities should be restricted, but the extent to which they could be

controlled (and by whom). The commission saw a reasonable objective as being to reduce demand for and access to unlicensed gambling sites. Licensing is much easier to enforce for domestic sites than internationally, and just as unlicensed organized gambling is illegal in many countries and there are penalties on both suppliers and customers, so it could be with domestic gambling sites.

International sites pose more difficulty; they could offer better odds if taxes are not levied, although they would not be popular if the payment of winnings was in doubt or unenforceable. Blocking international sites probably is technically feasible, but the cost effectiveness can be questioned—particularly if it were to be attempted on a general basis rather than in response to complaints. Blocking, other than in response to complaints, would be even more difficult for pornography: a search engine found about 7,000 “Internet gambling” sites but about 5 million sites that combined “XXX” and “sex” (PC 1999, 18.44). In broadcasting, the commission recommended that there be a review of the pornography policies when they have been in operation for one year.

A lesson from gambling and broadcasting is that addressing consumer protection objectives for services traded electronically is becoming more and more difficult. The consequence of e-commerce for international trade and trade rules is being investigated by many, including Drake and Nicolaidis (2000): regulation is likely to become increasingly difficult in some areas, and in some less necessary. (Of course, technological changes may lead to increased concentration and make the case for regulation stronger in some areas.) The principles of efficient regulation imply that generic rather than industry-specific platform-specific regulation should be sought as far as possible. The case for technological neutrality is strengthened substantially by rapid, and unforeseeable, technical change and by the impossibility of predicting the consequences. Here, however, as in some other service areas (for example, telecommunications), technology and other factors may require that the generic give way to the specific at some level. Good regulation would seem to call for the presumption to be for generic rules and principles, with the onus to be on justification for departures from them.

The Terms of Reference for the inquiry into architects specified that the commission report on “the preferred option for regulation, if any, of the architectural professional in Australia.” In its report the commission took the view that there was no strong consumer protection case for retaining the legislated protection of the title “architect” and that the relevant legislation should be repealed (PC 2000b). It took the view that if there were public benefit in providing a stamp of approval, then that could be given by a professional body, as it is in many other professions, such as engineering and accounting. Building regulations are such that safety considerations are not relevant for the legislated restriction on the use of the term *architect*.

International considerations were raised in the course of the inquiry. Ar-

ticle VII of the GATS, and its provisions for mutual recognition, were referred to above. If other jurisdictions require government certification of architects for them to practice in their country, would the lack of government certification in Australia imply that Australian architects would be disadvantaged? Of course, the mutual recognition provisions of Article VII do not require that certification must be in the same form in the mutually recognizing jurisdictions: professional body recognition could suffice. On the other hand, if government certification were required for export of architectural services, it could be provided for those who wished to export. The commission saw no consumer or other reason that it should be required for all architects.

3.3.3 Social and Cultural Objectives

Social and cultural objectives are high on the agenda for many governments. Such matters are, of course, particularly difficult to define or measure, but so too are love and beauty, but few would deny their existence and importance. For the commission's inquiry into broadcasting, the Terms of Reference required it to "advise on practical courses of action to improve competition, efficiency and the interests of consumers in broadcasting services. In doing so, the Commission should focus particular attention on balancing the social, cultural and economic dimensions of the public interest and have due regard to the phenomenon of technological convergence to the extent that it may impact upon broadcasting markets." The existing act was referred to in the Terms of Reference as seeking "to protect certain social and cultural values, including promoting a sense of Australian identity, character and cultural diversity; encouraging plurality of opinion and fair and accurate coverage of matters of national and local significance. . . ."

At present there are tight limits to foreign equity investments in free-to-air and subscription television and in newspapers, but no limits for radio. There are rules that restrict cross-media investments: for example, the same enterprise cannot own both a newspaper and a television station in the same broadcast licence area. There are also rules for commercial free-to-air television regarding minimum overall Australian content, children's programs and documentaries, and Australian advertising content, and agreed industry codes for Australian music on commercial radio.

The commission did "not attempt to evaluate or comment on the social and cultural objectives of content regulation. Rather it takes the stated social and cultural objectives as given and . . . attempts to clarify them and to consider whether the existing policies address them effectively" (PC 2000a, 379). It attempted to distinguish between those policies that were essentially industry protection and those that addressed the social, cultural, and diversity objectives. The rapidly changing technology had implications for its recommendations as well as for more general regulation of broadcasting.

The commission concluded that the case for restricting foreign invest-

ment on the grounds that foreigners would be less likely to promote Australian culture was at best weak. It was not regarded as an appropriate policy instrument for this objective, an objective that is also addressed by the content quotas. More important was that diversity of media ownership (and hence of sources of information and content) was more likely to be promoted by treating foreign investment in the media in the same manner as foreign investment in other industries, that is, by not prescribing any limits. Recognizing the media concentration can be a problem, that the current cross-media rules were rapidly becoming obsolete through technical change (the rules do not cover the Internet or subscription television), and that this technological change could in the future multiply the sources of information and comment greatly, the commission recommended that the Trade Practices Act should be amended immediately to include a media-specific public interest test that would apply to all proposed media mergers. Thus social, cultural, and political dimensions of the public interest would be considered, in addition to the standard economic questions attending mergers. The commission also recommended that after regulatory barriers to entry in broadcasting had been removed and spectrum became available for new broadcasters, and after the repeal of restrictions on foreign investment, the cross-media rules should be removed.

For the content rules, the commission made the judgment that the requirement that advertising be 80 percent Australian was essentially aimed at industry assistance and that any valuable cultural or social “Australianness” would be likely to be met by advertisers, in their own interests, as a means to engage their (Australian) audience. (In any case, the 80 percent minimum has been exceeded regularly by about 10 percentage points.) The commission also decided that the children’s, documentary, and Australian drama requirements were targeted to the social and cultural objectives more than is the advertising quota. In part the case for the quotas arises from the public-good nature of free-to-air television and Hotelling-type considerations.⁵ The 55 percent overall Australian requirement was regarded as being much less targeted to social or cultural (or Hotelling-type and public-good) considerations.

More important however, was the new technology. The commission took the view that it was better to target the social and cultural objectives directly, rather than through particular broadcast platforms. It rejected the view that as new broadcast platforms develop, the content rules should be extended to them according to their degree of “influence.”⁶ Such a policy

5. This refers to the tendency, when there are few commercial free-to-air broadcasters (financed by advertising), for all of them to focus on the mass market, with none catering for thinner demand, even though individuals in these parts of the market may have strong content preferences.

6. The supposed extent of influence of various forms of broadcasting is an important criterion for the degree of content regulation in the existing Broadcasting Act.

would at best be one of “catch-up.” Further, it recognized that regulating international electronic traffic will become increasingly difficult as its volume increases and as technologies develop. Instead, it recommended that to ensure that the social and cultural objectives of broadcasting continue to be addressed in the future digital media environment, the government should commission an independent public inquiry into Australian audiovisual industry and cultural policy, to be completed by 2004. Following this review, but prior to the final switch-off of analog television services, a new framework of audiovisual industry and cultural policy should be implemented. It recommended that the inquiry be based on the government’s competition principles: that is, that regulations that restrict competition should be retained only if the benefits to the community as a whole outweigh the costs and if the objectives can be met only through restricting competition.

The aim of the commission in these recommendations was to encourage policies that were targeted on objectives and that were generic. The intention was that the policies not be platform-specific, both with regard to cultural and social objectives of audiovisual services (and perhaps the performing arts in general) and with respect to diversity of sources of information and content.

3.3.4 Access to Essential Facilities

Access to essential facilities has been a burning issue since the early days of negotiation of the GATS. It is also a pressing topic of policy in competition policy within many Organisation for Economic Cooperation and Development (OECD) and other countries. It is a matter that may apply to services rather more than to goods, although there would be no point in removing tariffs on imported goods if the imported goods did not have access to ports, unloading facilities, and internal transport.⁷

It was argued during the negotiation of the GATS that there was no point in removing frontier barriers to, say, telecommunications, if access could not be obtained to (monopoly) domestic distributions systems. Consequently, Article XVI (Market Access) was negotiated. For sectors in which market access commitments are made, it provides that there should be no limitations on suppliers (number, output, etc., or legal structure), or on foreign capital, unless the restrictions are specified in the member’s schedule. Article VIII provides that for services subject to specific commitments, monopoly suppliers should not abuse their monopoly power, cross-subsidize

7. Article III.1 and III.4 of the GATT has some relevance here. For goods production there is also the matter of access to essential raw materials. This was much in the minds of the negotiators of the original GATT, with the backdrop of the trade policies of the 1930s. It is reflected in the Preamble of GATT 1947: “developing the full use of the resources of the world,” and in the provisions of Article XI (General Elimination of Quantitative Restrictions) that apply to exports as well as imports, although this article in fact allows for export prohibitions on “products essential to the exporting party.”

other activities, or act in a manner that discriminates among foreign members of the WTO or is inconsistent with specific commitments of the member.

In the course of GATS negotiations on telecommunications, a reference paper was developed to establish principles for interconnection—without distinction between domestic and foreign telecommunication suppliers. It provided for interconnection to be supplied on terms no less favorable than for the owner's own like services or for those for nonaffiliated service providers. Mattoo (1999, 22) proposes that the same principles should be applied to other network services (e.g., transport terminals, energy services, and sewage). It could also be extended to embrace all forms of internal distribution. In this way horizontal or generic rules could be developed that cover goods and services, although the specifics of application would have to be different for each industry.

There is some tension between requiring access to essential facilities and incentives to invest where, for reasons of economies of scale or scope, it is efficient for there to be only one network supplier. If access to upstream or downstream competitors is required (or feared), then an investment in the essential facility may not be undertaken or may be truncated, even though the investment may be in the general interest. International competition rules need to allow for such tensions, as do domestic competition rules. The analytical problems here are by no means settled in principle, while the policies stemming from them depend on circumstances. Thus, although objectives could be agreed under the GATS or elsewhere, international rules to achieve them are probably best framed to allow discretion for national authorities in pursuing the objectives and for cooperation among these authorities.

3.4 Conclusion

A lesson that one can draw from the above is not surprising: that it is best to use policy structures that are attuned to objectives and to seek generic policies in this context. Trade policies are appropriate for trade objectives, social and cultural policies are appropriate for social and cultural objectives, investment policies are appropriate for investment objectives, competition policies are appropriate for competition objectives, and so on. Policies attuned to particular trade, investment, social and cultural, and competition (and so on) objectives should extend beyond specific industries and beyond specific forms of production, consumption, and trading.

This then leads to the development of consistent domestic and international rules for cross-border trading of goods *and* services, and to the conclusion that these rules should address cross-border trading alone and not such other issues as conditions of competition that apply to both domestic and foreign enterprises. Competition rules (for goods and services) are best

designed generically to address all forms of competition, whether it is from domestic or foreign sources, although they will require adaptation to specific industries. Similarly, investment laws (domestic or international) are best designed to address investment consistently, whether it be for goods or services production.

Again, social and cultural objectives are best pursued by policies that do not discriminate between the platforms on which a particular service may be disseminated. As in many areas, it is consumption (and perhaps production) of cultural services (and goods) from which the cultural benefits may flow, not the platform of dissemination nor international trade as such. (Messerlin and Cocq [1999] discuss some of the problems in the European Union of attempting to assist cultural industries through the platforms of dissemination.)

In the multilateral context there is the question of how to go from here to there. A multilateral agreement on investment is off the agenda for the time being; an agreement for competition policy is also some distance away. The WTO reference paper on principles for telecommunications interconnection has been referred to above and could provide a basis for a generic policy on access to essential facilities, for incorporation into a competition agreement. The OECD secretariat is exploring a “cluster” approach for sector services that are closely related in terms of either production interconnections or the manner of regulation, and this could lead some way in the direction of generic policies.

A key issue is to contain the use of policies to address objectives for which the policies are not well suited. A prime example of this practice is the use of international trade policies to improve labor standards or the environment. However, perhaps most important is for countries’ domestic policies to align objectives and policies consistently and efficiently.

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Comment Takatoshi Ito

This paper is a useful survey on policy issues on service trade. As the title suggests, the author forcefully argues that matching policy objectives closely with policy tools is important. When policy objectives are given, it is better to use domestic subsidies, taxation, or regulations rather than international trade policies. I support this principle. The author, citing studies and reports done by the Productivity Commission, elaborated the principle with real-world examples in Australia, frequently referring to the General Agreement on Trade in Services (GATS).

In general, policy interventions in the market are called for when there are market failures—that is, when optimal resource allocation is not achieved through the market mechanism. Market failures arise from asymmetric information, externalities, public goods, scale economies, uncertainty, lack of complete markets, and other reasons. Cases have been explored in the literatures of advanced microeconomics and industrial organizations. Although the author is not explicit in this characterization, the author makes careful examinations of market failures in the context of services, as opposed to goods, and to the international aspects. It is interesting to examine what kinds of modifications are needed when well-known results in the domestic context are applied to international trades.

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Many services sectors have their own characteristics and particular policy requirements, even in the domestic context. It is important and interesting to explore how these services—such as aviation, banking and other financial services, telecom, legal service, medical service, and the like—are treated in international services trade policies.

Let me take up a particular example that the author highlights in the paper, namely, international aviation, that is a remarkable example of failure in the services trade framework. International aviation is governed by a network of bilateral agreements, rather than a comprehensive multilateral treaty; discrimination, rather than equal treatment, is the norm; domestic routes are typically prohibited for foreign airlines. The author explains a recommendation of the Productivity Commission to the government. The recommendation was “to negotiate an open plurilateral club of open-skies agreements and, better still, a liberal multilateral agreement for aviation under the GATS.” An interesting part of the recommendations is that unilateral unrestricted open skies was not recommended for airports in Sydney, Melbourne, Brisbane, and Perth, on the ground that “negotiating power was limited for all airports except these four.”

Now let me raise several issues that are inherent in international aviation. First, history matters. International aviation has been largely governed by a series of bilateral agreements and a cartel-like multilateral agreement (e.g., what used to be airfare agreements under the International Air Transport Association) on capacity controls and airfare controls. The United States, which is usually a harbinger of liberalization in many other areas, is not completely innocent in the field of international aviation, although the United States has recently been pushing for “open skies.” The United States still imposes a restriction in cabotage (foreign carriers operating the domestic routes) and a restriction on investment in domestic carriers (ceiling in percentage of ownership). These restrictions effectively protect domestic carriers.

It is difficult to scratch all bilateral agreements in order to establish a comprehensive multilateral aviation treaty. The past bilateral agreements have typically favored particular airlines as “incumbent” carriers. As deregulation proceeded, the dividing line of the common interest often lies between incumbents and newcomers. It is well known that in the United States-Japan air service negotiation of the late 1980s to 1990s, the interests of United and Northwest have more common elements with Japan Airlines than American and Delta.

Second, production of airline services is characterized by technology of scale economies, primarily due to large fixed costs and network externality. Even in the domestic markets of small advanced countries and emerging-market economies, only one or two airlines would be fit to survive under a completely deregulated environment. When deregulation is extended to international services, scale economies would imply that some countries

would lose domestic airlines (or “flag carriers”). Situations in Europe after its establishment of a single market vividly illustrate the point. Therefore, promoting liberal international aviation may result in a loss of domestically owned airlines. When the number of airlines declines domestically, regionally, and globally, there may be a danger of monopolistic pricing. The key to preventing monopolistic pricing is to guarantee free entry (and with affirmative action–like encouragement) and to promote contestable markets. A relevant question here is whether contestability is easier or more difficult to obtain in international airline markets compared to domestic airline markets.

Third, landing slots are scarce resources. When capacity constraints are binding, competition policy relying on deregulation and contestability may not work. A standard answer in economics for such a situation is an auction of scarce resources. However, auctions may further aggravate a problematic aspect of “scale economies.” There are similarities to telecom frequency auctions. Unless landing spots of destination cities’ airports are open or auctioned, unilateral auctions may not enhance national welfare of domestic consumers and companies.

Fourth, it has become difficult to define national welfare. Cross-border airline alliances—such as Star Alliance, One World, and Skyteam—have developed strong common business strategies, such as code sharing, through check-ins, and sharing airport lounges. Dividing lines of interest may be drawn between different alliances rather than across national borders. In this decade, Japanese airlines—Japan Airlines and All Nippon Airways—are aligned with U.S. airlines—American and United, respectively—in accordance with business affiliations. The nationality of airlines, or even the incumbent-newcomer classification, is no longer relevant in companies’ welfare. The national policy goal becomes complicated, although maximizing consumers’ welfare remains most important.

As shown above, a particular case such as international aviation can be studied carefully to analyze important factors in examining international service trade.

Let me raise some other issues that will be deemed important in the near future. Markets are changing, and regulatory considerations often have to chase the reality. First, e-commerce is spreading very quickly. One can purchase books, music, and financial products on-line. These will enhance competition internationally. Therefore, local physical stores will be under pressure. What used to be considered “nontradables” are now under international competitive pressure. Building transparent and equitable rules on these e-commerce transactions, including taxation rules, will be important. Second, loss of nationality is imminent from international alliances such as in international aviation and telecom companies. Other examples may follow. These will enhance the case for multilateral competition policy. Third, competition between different sectors may complicate competition policy.

Now, cable TV companies, local telephone companies, and mobile phone companies will be competing in similar products, such as in the market of “last mile” in local telephone service. Competition policy had to be reconsidered in this environment of greater contestability. Monopoly in one technology does not guarantee rents. This also calls for a multilateral framework for competition policy across industries that were traditionally different.

In sum, the paper is an excellent survey on the issues surrounding international service trade. My comments are meant to elaborate on some of the issues raised in the paper. International aviation was used to illustrate factors that should be considered in coming up with policy prescriptions, and some of the issues that arise from recent information technology are raised in arguing a case for multilateral competition policy.

Comment Edwin L.-C. Lai

This is a very interesting and stimulating paper. It tells us of the chaotic nature of the regulation of trade in services nowadays. It also makes us think about why trade in services is so much more regulated than trade in goods.

The main arguments and points being made are these: (a) generic rules should be applied across sectors; (b) countries should adopt policies that achieve the objectives directly rather than indirectly, be they economic, cultural, or social; and (c) it is desirable to have a set of generic principles that govern trade in both goods and services.

These are intellectually compelling and valid points. They are based on sound economic principles. The author has given good examples to illustrate how to apply generic rules to sectors of similar nature: for example, (a) transport should include physical (aviation), wire (internet, phone services), and electromagnetic wave (broadcast); (b) qualifications, technical standards, and licensing requirements should all be governed by one set of rules; (c) the “principle of interconnection” in telecommunications should be applied to all network services, such as transport terminals, energy sectors (electricity transmission), and sewerage.

It is hard to establish a set of generic principles for all services. If there is such a set, it is probably very general. Because of the heterogeneity of services, there should be different sets of generic principles for different groups of sectors. The process of grouping the sectors and tailor-making rules for each group of sectors can be a really challenging task because of the complex differences among the services. In any case, this would seem to be a necessary first step.

Should we adopt a systematic approach by first categorizing services according to their nature and then establishing a set of generic rules for each category? Or should we adopt an ad hoc approach—for example, begin with some sectors for which agreements have been reached, and then try to apply generic rules to sectors of similar nature? This would be a crucial question to be answered by the World Trade Organization (WTO).

In order to establish generic rules for services liberalization, we would also need to understand the fundamental differences between trade in goods and trade in services. According to the WTO, there are four modes of supply of services: (a) cross-border supply; (b) consumption abroad; (c) commercial presence; and (d) movement of natural persons. Trade in goods occurs mainly in mode (a), and to a lesser extent in mode (c) and (d) in the case of foreign direct investment (FDI) in manufacturing. Mode (b) is usually absent in the goods sector. On the other hand, all modes of supply are common in trade in services.

Moreover, the quality of a service usually depends on the qualification and competence of the personnel delivering the service. Examples are lawyers, engineers, medical doctors, and so on. In the absence of an international certifying body, individual countries have to have the right to determine which foreign qualifications to recognize. The challenge is to establish generic rules that disallow illegitimate discrimination against foreign entities yet allow for legitimate discrimination against foreign countries that have lower standards in the certification of personnel. Hence, harmonization of qualifications across countries would seem to be more complicated than harmonization of standards for goods.

Finally, the delivery of certain services, such as accounting and legal services, requires that the personnel understand the institutions and culture of the country. This necessity can serve as a barrier to trade in these sectors. Whether or not such culture-related knowledge should be part of the qualification requirement is a matter of debate. It has to be resolved before generic rules are set up in these sectors.

