



WORLD TRADE ORGANIZATION

Council for Trade in Services

ECONOMIC EFFECTS OF SERVICES LIBERALIZATION

Background Note by the Secretariat

1. The Secretariat has prepared this Note at the request of the Council for Trade in Services. The Note is intended to form part of a broader information exchange programme, as outlined in the Report of the Council for Trade in Services to the General Council (S/C/3), which seeks to (contribute to the assessment of trade in services which would assist future negotiations in the services sector). In keeping with the Council's request, the following considerations are general in nature and do not elaborate on sector-specific developments. A Bibliography of empirical studies examining the effects of liberalization policies in individual countries and sectors, published since 1990, has been annexed for further information.

A. THE ROLE OF SERVICES IN ECONOMIC DEVELOPMENT

2. While there are many differences in employment and production patterns among countries - reflecting development levels, geographic location or resource endowment - economists have long identified a few common features or trends. These include in particular the strong and, as incomes grow, expanding of services as a source of economic activity. In the mid-1990s, for example, the services sectors share in GDP amounted to some 40 per cent in Uganda, 50 per cent in Zambia, over 60 per cent in Korea and Brazil, and 80 per cent in the United States.

3. The services sectors expansion has been attributed to demand as well as supply factors. On the one hand, demand for many services is highly income-elastic, i.e. as people grow richer, their consumption of services such as tourism, education and health, expands more rapidly than their demand for manufactures and agricultural products. On the other hand, productivity growth is lower in many services sectors than in manufacturing and modern agriculture, reflecting the fact, among other things, that it is generally more difficult to substitute capital for labour in services production (restaurants, hotels, bus transport, etc.). In turn, this has led prices of many traditional services to increase relatively faster than prices of goods.



4. To a certain degree, the growing share of services in GDP, in particular if measured at current prices, also reflects organisational changes in an economy. On efficiency grounds, manufacturing companies have tended increasingly to outsource services such as design, financing or transport, which they previously provided in-house, and purchase them from specialised suppliers. Reflecting their infrastructural nature, many modern services sectors, including telecommunications, financial services and transport, not only provide final consumer products, but basic production inputs for a wide variety of user industries.

5. While also rising over time, the services share in foreign trade has been smaller than its share in production and employment. International trade flows continue to consist predominantly of goods, corroborating the conventional perception of services being less transportable and tradeable than goods. For instance, while accounting for some four-fifths of domestic production, the United States services sector currently contributes no more than one-fourth of total U.S. exports. (The share in imports is one-sixth.) Overall, according to balance-of-payments statistics, the share of services in total world trade is in the order of one-fifth. In absolute terms, this represented some US\$1,200 billion in 1995, which was about twice the value of total world trade in office machines and telecom equipment.

6. Conventional trade statistics, on a balance-of-payments basis, heavily understate the economic stakes involved. First, they do not cover services incorporated in goods, such as design or technical expertise. Second, data on cross-border flows do not capture a critically important mode of services trade, namely production and sales through affiliates abroad. (Hotel and fast-food chains, tour operators, consultants, banks and insurance companies, credit-card operators, etc.) Using a wider definition including such supplies, services prove far more (tradeable) than conventional accounting may suggest.

B. THE CASE FOR MARKET LIBERALIZATION

7. From an economic perspective, there is no difference in principle between the production of goods and services. Both are governed by similar sets of objectives, incentives and constraints. In both cases, the genuine economic task of a firm consists of employing and co-ordinating the use of production factors - capital, labour and technology - with a view to satisfying the demand of potential customers, domestic or foreign. The firm's profitability and, thus, its potential for survival and growth is determined by its capacity to anticipate, and respond to, demand and supply factors such as wages, capital cost, input prices and the market conditions for the final product.

8. In a market economy, private profitability considerations are the driving force in determining the allocation of production within and between firms, sectors and countries. Open markets are expected to encourage quality improvement and product and process innovation; reduce the scope for waste and rent-seeking; constrain the economic power of any individual actor; and ensure users of the continued availability of the relevant goods and services. Market-based structural change is thus helping to promote an optimal balance, from a users perspective, between product quality, product variety and price. At the same time, the possibility of drawing on alternative sources of supply reduces the risk of economic shocks and disturbances. What does this imply for the orientation and conduct of economic policies?



C. POLICY IMPLICATIONS

9. The focus of market-based policies is on creating and improving the institutional framework for private decision-making. In this context, emphasis is placed on ensuring competitive conditions on factor and product markets, enhancing transparency, removing entry barriers and price distortions, and avoiding divergences between private and social efficiency considerations. Appropriate initiatives might thus include, depending on the actual situation in a sector and country, (a) pro-competitive policy initiatives to abolish, for example, traditional exclusivity rights and access barriers; (b) external market opening to confront domestic industries with best international practice; (c) information requirements and, in sensitive areas, prudential rules to protect public interests; (d) institutional reforms providing for independent regulatory supervision; and (e) measures to incorporate social costs, attributable to environmental impacts and other externalities, in production and investment decisions.

10. While such policy initiatives are likely to benefit any sector of economic activity, it may be argued that they tend to be more urgent and, at the same time, more challenging and promising in key services industries. The need for, and the potential benefits of, institutional reforms in services sectors are underscored by the following considerations:

- The traditional framework of administrative regulation and control in many services areas, intended to ensure reliability and stability of supplies, is ill-suited to an environment characterized by rapid technological and economic change.

The quantity of investment and the expertise required to up-grade and operate modern services sectors, like telecom, may go well beyond what government bureaucracies are normally prepared to handle. At the same time, empirical evidence suggests that early liberalization can contribute substantially to a countrys locational attractiveness for new investment in modern services industries.

- Large services sectors have long been tightly regulated, suggesting that the potential for liberalization, and the ensuing economic benefits, are particularly high.

In many countries, liberalization and deregulation initiatives have initially eluded services, reflecting the operation of long-entrenched public monopolies (e.g. in basic telecommunications, insurance, retail banking and rail transport) and the traditional view of services as being less transportable and tradeable - and thus less amenable to trade liberalization - than goods. However, this view has been confounded by regulatory and technical developments (e.g. the emergence of satellite communications and electronic banking) and the attendant reduction of both policy-induced and technological barriers to competition and trade.

- In the absence of market-driven reforms, the secular expansion of many services sectors in the development process would gradually broaden government regulation and control.

Demand and supply shifts benefiting sectors such as financial services, telecommunications or air transport would expand, if current were maintained, the reach of regulatory control over production and employment in an economy.

- Given the infrastructural nature of many services sectors, efficiency enhancing reforms - including regulatory and institutional changes - are likely to promote the competitiveness of many downstream activities and, thus, improve overall economic performance.



From that perspective, services liberalization would not be viewed as a concession to other countries, but a precondition for enhancing domestic industrial performance. The inclusion of services into the mainstream of the multilateral system, in the Uruguay Round, enables governments to lock in such reforms in an international context and, thus, protect them from slippages and reversals.

11. In many cases, a distinction between international and domestic liberalization would be artificial. From a trade policy perspective, external and internal market opening should normally go hand in hand in order to ensure that the potential benefits of more liberal access conditions are not contravened by persisting internal barriers. This is also reflected in the scope of market access commitments assumed by WTO Members under the GATS. The disciplines of Article XVI extend to both discriminatory and non-discriminatory restrictions, covering measures targeted specifically against foreign suppliers as well as others affecting all market participants.

D. ADJUSTMENT-RELATED COSTS AND BENEFITS

12. Adjustment is at the core of a market system, and adjustment is not without cost. While economic policies may aim to improve the conditions for investment and growth - through infrastructural improvement, tax and tariff reform, and prudent macroeconomic management - they can not reasonably guarantee prosperity without pain. Governments thus tend to be confronted with demands for protection, in particular if large and well-organized sectors come under pressure.

13. Most obvious, from a social policy perspective, are the costs associated with labour displacement, the depreciation of skills, the need for professional re-training and, possibly regional relocation. Although there may be a case for government assistance to facilitate adjustment, it is doubtful whether such costs could justify initiatives to suspend market signals and slow down or prevent structural change. First, adjustment processes tend to be temporary in nature and any ensuing losses would need to be set against future income flows. Second, from an economy-wide perspective, such losses should be compared with the consequences of non-adjustment and the dynamic costs inflicted on taxpayers, consumers and/or user industries. Governments would also need to contemplate the possibility, if one sector is shielded from market forces, that this might serve as a precedent for many others. Sectoral protection can prove extremely contagious.

14. It may be argued with some justification, however, that the direct social consequences of adjustment are less serious in many services sectors than in traditional mining and manufacturing industries or in agriculture. Consider the following hypotheses:

- Adjustments in services industries, such as banking, insurance or telecommunications, generally occur within a dynamic sectoral environment, where expanding segments rapidly offer employment alternatives for redundancies in shrinking areas.
- Owing to a lower degree of sector-specific professional specialization, service sector employees tend to be more mobile in general than, for example, miners or farmers.
- Professionals in some traditionally protected services areas - such as air transport or legal services - are not normally at the bottom of the national income league and, thus, may have more scope for (concessions) than workers in sunset manufacturing industries.



Moreover, it is worth recalling that liberalization-induced adjustment is likely to generate significant dividends, in terms of overall economic performance, given the infrastructural nature of many modern services sectors. Potential (losers) will find it easier to re-position themselves within a dynamic economy generating favourable income and employment opportunities than in a stagnant system defying change.

15. The key played by telecommunications, banking and other services in a modern-day economy is not without risks. Technical or financial disturbances emanating from these sectors may have profound economy-wide implications. It would be next to impossible, for example, to shield even the smallest producer in a remote region from the shockwave of a larger bank crash. Similarly, the interruption of transport and telecommunication links could, within a very short time period, bring any economic activity to a halt. In turn, such risks have inspired the enactment of myriad regulatory constraints -capital adequacy and asset quality requirements, telecommunications technical standards and the like -intended to ensure the continued availability of core technical and commercial services.

16. There is nothing in the GATS - or in the GATT - that would oblige governments to sacrifice any reasonable level of technical or commercial regulation.¹ The GATS imposes constraints, however, on the use of unnecessarily restrictive or discriminatory requirements in scheduled sectors. Governments may thus be required to complement market-opening measures with a review of domestic regulation. The ensuing reforms may imply political costs, in particular if the income interests of well-defined producer groups are at stake, but should not normally result in lower levels of consumer or creditor protection.

17. Considerable research has been done in recent years to verify whether and under what conditions such expectations materialize. The following Bibliography provides an overview of publications issued since 1990. Its sector and country focus has been determined exclusively by the availability of published material and does not reflect any *a priori* selection by the Secretariat.