Political Economy of Services Liberalization and Multilateral Negotiations

Jaime Andres Niño.

London School of Economics and Mark Twain Institute

Introduction

The General Agreement on Trade in Services (GATS) laid the foundations for future services trade liberalization in much the same way as the GATT, where countries make reciprocal trade concessions in successive negotiating rounds. The GATS also sought to bind regulatory regimes in place at the time of the negotiations. Although the comprehensive set of enforceable rules and principles developed by drafters of the agreement is remarkable given the lack of statistics and knowledge of trade impediments in services at the time, the actual liberalization achieved is sought to be limited a the very best. Developing countries not only made relatively few liberalization commitments, but in many cases they also committed to less liberalization than the market access and national treatment granted by regulatory regimes in place at the time of the negotiations[1].

The 2000 Services Negotiations that where expected to get on with the business of reducing impediments to trade in all services appear to be making very little progress in terms of liberalization. A large number of services industries continue to maintain anticompetitive market structures as well as regulations and artificial barriers that impede international delivery of services. Most of the liberalization made until now under the GATS has been in sectoral negotiations where the opportunities for trading commitments between parties have been constrained. With reciprocal concessions absent from the telecommunications and financial services agreements, achievements made in terms of liberalization may owe more to unilateral determination and domestic politics than to multilateral bargaining.

[1] Hoekman 1996, Hoekman and Primo Braga, 1997

Trade agreements such as the GATS are also important instruments to lock-in reforms and prevent policy backlash. Developing countries that have weak institutions are sought to benefit most from unilateral binding commitments. Yet, it appears from the schedules of commitments that some of the countries that would benefit most from the stability provided by the multilateral framework have made less use of it. Even, the use of the GATS as an instrument that provides credibility to trade policy by ensuring future trade liberalization and preventing regulatory and trade authorities from being "captured" by entrenched interests would seem to have been neglected by many developing countries.

Domestic regulatory reform and trade liberalization has been limited to only a handful of services industries. Most of the progress has been in telecommunications and financial services and even in these industries reform has neither been uniform nor complete. Many countries maintain regulations that continue to limit market access or discriminate against foreign providers of telecommunications and financial services. Thus making imperative to understand what factors have fostered trade liberalization and which have hindered it. In the next section these aspects of the political economy of trade policy in the services sector are discussed in detail. The following section discusses how the GATS is expected to overcome such policy failures. The third section presents a series of tests for the determinants of services liberalization in the telecommunication and financial services industries.

Focus on financial services and telecommunications is due to methodological as well as practical reasons. Few other services industries have achieved so much progress in the GATS or gone so far in terms of pro-competitive regulatory reform that reduces distortions to the international delivery of services. In addition, assessments of GATS commitments and regulatory reform in these industries have been carried out for a large number of countries in recent years that make the effort of evaluating the different influences on these policy outcomes possible. The last section presents the concluding remarks.

II. Political Economy of Services Trade Policy

For years provision of many services has been either regulated or limited to the State to achieve public goals. State intervention in either form has been justified by the existence of market failures that prevent markets from realizing the public welfare. Unless transaction costs were negligible, externalities could only be overcome with the use of government regulation (Coase, 1937 and 1960, Varian 1994). Developments in regulation in the last two decades to ensure better information standards and reduce transaction costs in the provision of many services have rendered public supply less and less necessary in a number of services industries and made these markets potentially more competitive.

Governments intervene to serve other purposes such as redistributing income. Instruments to achieve equity goals vary, yet governments consistently select the less efficient intervention mechanisms to achieve redistributive objectives. Trade policy and regulation are among the most studied spheres of inefficient government intervention[2]. For decades governments have placed tariffs and non-tariff barriers to limit competition and favor a minority of providers at the expense of a large majority of consumers. These same objectives could be achieved more efficiently through lump sum transfers to compensate losers from increased competition, while allowing them to make better use of their resources in other sectors of the economy (Dixit and Londregan, 1995). Instead of implementing policies that encourage relocation of factors of production to their best possible use, government intervention in trade tends to encourage resources into less productive uses.

Protectionist policies and regulatory barriers frequently bring about large gains that are concentrated in a few suppliers while dissipating the costs more or less evenly in a large group of consumers. Thus suppliers are both well aware of the gains and can organize

[2] See Rodrik (1995) for an exhaustive survey on political economy of trade and Noll (1987) for comprehensive review of the politics of regulation.

easier to exert political pressure on politicians and regulators at the expense of a disperse majority of consumers.

Trade protection and anticompetitive regulation is common to both developed and developing countries where powerful minorities gain access to institutions by providing campaign contributions and information. Yet, it is argued that in the case of developing countries corporatist institutions create an even stronger bias against free trade and sound economic policy (Dornbusch and Edwards, 1991, Krueger, 1993). This type of institutions favor organized interests in well-established industries and unionized urban workers that rally for protection.

Employees of public monopolies have resisted vehemently to privatizations or pro-competitive regulatory reform in many services(Warren and Findlay 2000). This opposition is motivated by the need to protect political rents from being eroded by greater competition. According to Petrazzini (1996), employment in competitive telecommunications markets increased by about 20% while new jobs in markets supplied by a public monopoly increased by only 3%. Thus, competitive markets may enjoy high levels of mobility that reduce resistance to additional reform, but regimes which are heavily protected find reforms difficult to implement given the high rents accrued by privileged groups. These high rents are also likely to prevent the creation of additional jobs in these services industries.

Influential conglomerates in developing countries that have financial as well as large manufacturing outlets also lobbied for barriers to entry in financial services and tariffs and quotas to prevent competitors from eroding profits. Aided by these trade and regulatory regimes, business conglomerates channeled financial resources raised cheaply in the domestic market into connected, but increasingly inefficient manufacturing outlets. In essence, domestic banks connected with other commercial interests could cover these risky operations with the revenues accrued from large net interest margins, thus keeping these financial institutions healthy. Barth et al(2000) find that there is a positive correlation between net interest margins of financial institutions and ownership of other

commercial assets. Not surprising, these authors also find that financial institutions are more prone to instability where such connected interests exist.

Following the reduction of barriers to trade in goods in the 1990s, a large number of conglomerates and large manufacturers further diversified their portfolios to include privatized services industries that enjoyed regulatory barriers to entry. For instance, in Argentina five of the six largest manufacturers acquired assets in telecommunications, power generation, utilities, and infrastructure development, while in Brazil five of eleven manufacturing firms acquired large equity participations in telecommunications and financial institutions (Garrido and Peres, 1998). Most important, in most of these services industries foreign equity participation was restricted to force foreign services providers to form partnerships with local manufacturers.

The lack of transparency, common to the different practices detailed above, makes protection politically feasible. While a lump sum transfer to otherwise protected interests would increase efficiency and benefit all groups in society, the transparency of this policy makes it less politically acceptable to the majority who bare the burden of government intervention in favor of entrenched interests (Coates and Morris 1993). Thus, lack of transparency about the gains and losses accrued by the different groups in society make protectionist policies possible. Certainly, a traditional feature of developing countries is the lack of transparency in almost all spheres of government, perhaps because institutional settings such as corporatist arrangements are more prone to special interests.

Trade and regulatory reforms should be more likely if the benefits were better known by society. Unfortunately, the benefits from the elimination of impediments to the international delivery of services are less evident than the reduction of tariffs or quotas to a vast majority of the public. In a typical protectionist regime foreign goods are frequently consumed by domestic consumers, albeit more expensive than their true cost to reflect tariffs and quantity restrictions. Thus, domestic consumers may more easily asses the benefits of trade reform were they given information about the consequences of protectionist policies. Impediments to trade in services traditionally ban foreign delivery

of services all together, particularly when there is a state monopoly in the provision of the service. Thus, services lack the demonstration effect that may have been critical to goods liberalization.

Of course, this is until the service comes to a halt or inefficiencies become overwhelmingly noticeable. Crises have long been singled as a motivation for reform (Williamson 1990, Krueger 1993, Edwards and Dornsbusch, 1994). While it is a truism that if a policy is no longer sustainable another one must follow, it is also possible that crises may make the costs of inefficient policies more evident to the naked eye, and thus facilitate the development of coalitions supporting reforms.

For example, East Asian economies eased their limits on foreign equity following the financial crisis that affected the region so pervasively. However, reductions of barriers to entry have been less common following financial crisis. This policy combination may be explained by the interest of authorities to strengthen financial institutions in distress (Quian, 2000 and Mattoo, 1999), while encouraging foreign investment to ease foreign currency constrains.

Financial sector liberalization was also an essential element of the IMF structural adjustment programs for resolving the crisis in the East Asian economies. In the case of Thailand and Indonesia, that had the most battered financial systems, foreign equity restrictions were substantially eliminated.

Table 1
Restrictions to Foreign Equity after the Asian Financial Crisis

Country	Post Crisis Foreign Equity Limits
Indonesia	99%
Thailand	100%
Korea	10%
Malaysia	30%
Philippines	60%

In Malaysia, Korea and Philippines where the number of institutions in distress was more limited, reduction of restrictions to foreign equity was more limited. While the severity of the crisis may have conditioned the degree of reform, it is also true that sound crisis management recommends to increase foreign participation gradually when the crisis is not pervasive. A dramatic surge in competition can further disrupt the system in these circumstances by enticing domestic banks to opt for increasingly risky investments (Bird and Rajan, 2001 and Claessens et al 2001).

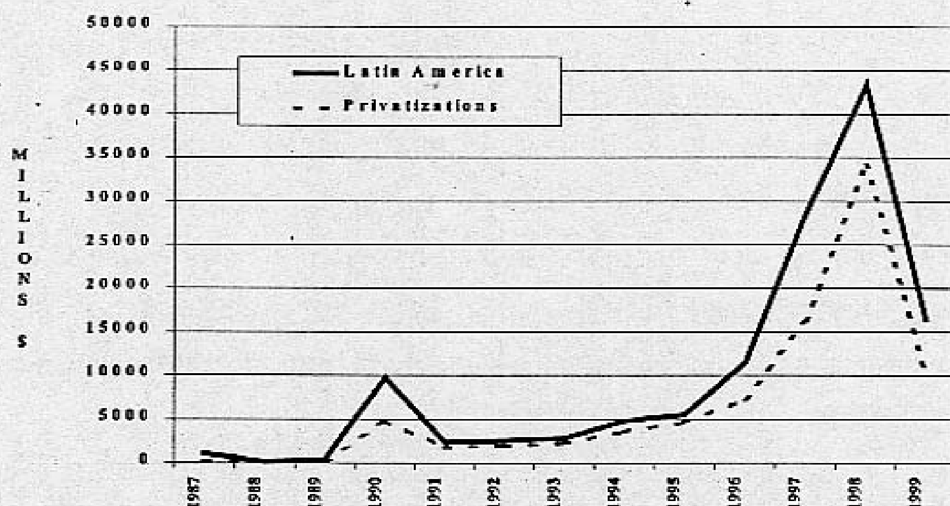
Telecommunications and power supply, among many services industries, have also suffered temporary interruptions of provision that have triggered regulatory reform. Examples are common in both Latin America and Asia. Colombia liberalized power markets following the 1992 energy crisis that led to temporary energy shortages throughout the country. The reforms were sought to encourage private investment in coal and gas power plants. Similarly, strikes that halted the provision of telecommunications services in Venezuela, Argentina, and Mexico led to the privatization of the state owned monopolies in the 1990s.

However, regulatory reforms that have led to more competitive services markets are not limited to situations of crisis of existing regulatory regimes. The existence of large consumers with concentrated losses from trade and regulatory barriers that lead to anticompetitive market structures in services have also played a critical role in fostering reform. In particular, financial services providers that use telecommunications services intensively have become a countervailing force in much the same way that large manufacturing outlets have pressed for more competitive markets in power supply.

Large consumers not only have large losses from inefficient policies, but they also tend to overcome collective action problems that make them influential in the policymaking process. Losses need to be large and concentrated to offset protectionist policies since political action by a large number of consumers may be undermined by free-riders (Wilson, 1989 Chap. 5). Industries such as tourism that have a large number of providers have been unable to influence governments into liberalizing air travel services (Adlung, 2000 and WTO 1998).

Governments have pursued privatization of state-owned monopolies and services suppliers as well as auctioned monopoly or oligopoly rights in an effort to raise extraordinary revenues. These policies have been common to most countries in the past two decades as governments have found increasingly difficult to meet the investment needs to keep up with technological developments while meeting demands to reduce consolidated budget deficits.

Graph 1. Privatizations in Latin America



In light of increasingly expensive public delivery of services that made public failure more evident than market failures, governments may have opted for privatizations that gave bureaucrats and politicians additional resources for expenditure in areas where such resources could have stronger political and social impact, while also shifting blame on service delivery failures on to others (Dunleavy, 1986)). Thus, privatization with restrictive regulatory practices offered politicians the possibility of maximal hands-on influence with minimal political accountability.

Privatizations may appear as significant steps in favor of liberalization of international delivery of services, yet artificial entry barriers to increase the premium paid by the private sector as well as limits to foreign ownership may have limited any gains from such policies. The absence of increased competition prevents the realization of the full static and dynamic gains from privatization (Mattoo, 2000).

The GATS and the Political Economy of Services Trade Liberalization

Services trade liberalization is sought to spur growth in much the same way that goods liberalization may lead to the efficient allocation of resources and productivity gains. Yet services liberalization is usually accompanied by foreign investment and increased competition that may have an even more significant impact on growth than goods liberalization. Mattoo et al (2001) find that economics with a fully open financial sector and a competitive telecommunications industry grow by 1.5 percentage points faster than other countries.

The welfare gains for services liberalization have also been estimated and are sought to be quite significant. A reduction of services barriers is sought to generate $389.5 billion in welfare gains to the world and over $62 billion to developing countries (Brown et al. 2001). Despite the statistical and anecdotic evidence in favor of services liberalization many countries have failed to eliminate trade barriers as pointed earlier in this paper.

The GATS, like many other trade agreements are sought to encourage trade liberalization by mobilizing domestic support for reforms. In this case, the potential beneficiaries of enhanced export markets are expected to rally governments and constitute a countervailing force to entrenched protectionist interests (Helpman and Grossman 1993). Thus, the trade agreements constitutes an important institutional arrangement that transforms otherwise latent interests into an effective political force.

The Uruguay Round brought in, for the first time, most of the developing world into the international trading system. Although this outcome was in itself an achievement, the fact is that most developing countries have liberalized very little under the influence of the GATS (Hoekman and Messerlin 2000). In fact, most countries bounded their tariffs, market access and national treatment commitments bellow their actual levels of liberalization (Finger and Schuknecht 1998).

Table 2
Degree of Services Liberalization in the GATS 1994 Schedules of Western Hemisphere Countries

Very High (100%-60%)	Moderately High (<60%-40%)	Moderate (<40%-20%)	Moderately Low (<20%-10%)	Low (<10%-5%)	Very Low (<5%)	
		Argentina Canada United States	Colombia Dominican Republic Ecuador Jamaica Mexico Nicaragua Panama Uruguay	Antigua & Barbuda Chile Guyana Haiti Trinidad & Tobago Venezuela	Barbados Bolivia Costa Rica El Salvador Guatemala Paraguay St. Kitts & Nevis St. Lucia	Belize Brazil Dominica Grenada Honduras Peru Suriname St. Vincent &Grenadine

Source: Stephenson, S. (2001). "Multilateral and Regional Services Liberalization by Latin America and the Caribbean."OAS Trade Unit Studies.

There are considerable 'transaction costs' within the GATS framework that inhibit a dynamic liberalization in the way observed in the GATT. In the first place, the potential for trading reciprocal concessions is severely limited by the lack of transparency in commitment schedules. Critical to the dynamic of GATT liberalization of developed countries was the simplicity of exchanging tariff reductions for traded goods. The presence of regulatory barriers that limit international trade in services constitute a considerable transaction cost as it is always difficult to compare the effects of market access limitations across countries. In addition, any exchanges in concessions realized can be potentially overturned by the development of new regulations that achieve similar or comparable effects to impediments removed under previous negotiations. Thus, commitments are all but credible and constitute an impediment to further liberalization. As a result, proving nullification or impairment in services is potentially harder than in goods trade (Hoekman and Messerlin, 2000).

Another potential hurdle preventing developing countries from taking advantage of multilateral services negotiations is the inter-industry nature of services trade for these economies. A clear pattern of developed countries specializing in services and developing