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**Article — Digitized Version**

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Intereconomics

*Suggested Citation:* Knorr, Henning; Tegge, Andreas (1990) : Liberalization strategies for free trade in services, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 25, Iss. 5, pp. 220-228, <https://doi.org/10.1007/BF02933653>

This Version is available at:

<https://hdl.handle.net/10419/140258>

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Henning Knorr and Andreas Tegge\*

## Liberalization Strategies for Free Trade in Services

*Trade in services is being dealt with in GATT negotiations for the first time in the present Uruguay Round. The discussion on the proper liberalization instrument to be applied to trade in services is highly controversial. This paper attempts to clarify the discussion and outline rational policy options.*

Among most economists it is well understood that free trade will in general "increase economic growth and welfare by fostering greater efficiency in allocating resources, lowering prices and increasing the variety of options for consumers and producers".<sup>1</sup> Although long neglected by economic theory, in principle these findings also apply to trade in services.<sup>2</sup> However, though governments are well informed about the long-term benefits of free international trade, they have always made use of protectionist means to pursue their short-term interests. This fundamental problem is the basic justification for a legal order to foster and stabilize international trade. But while the need for a free trade regime is unquestioned, the proposed concepts and instruments for that order differ considerably. Especially in the light of the renaissance of protectionism, liberalization strategies are crucial topics for current GATT talks within the Uruguay Round.

This is even more true for present efforts to reduce existing obstacles to trade in services. Since developed countries have moved towards service economies,<sup>3</sup> services have become a trade issue. Multinational enterprises, which increasingly depend on services like telecommunications, banking or insurance, press for competitive international service markets. Service providers seek new business opportunities abroad. Countries that enjoy comparative advantages in many service industries, like the USA, push other governments to open their domestic service markets.

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The contracting parties to the GATT took these developments into account and decided to put services on the agenda for the Uruguay Round. In addition, bilateral treaties covering trade in services have been concluded, such as between the USA and Canada. Furthermore the European Community (EC) has formulated a trade policy on its own and is moving towards a common service market in Europe. The simultaneous negotiations on the bilateral, regional and global levels yielded a major controversy: while for some bilateral and regional efforts present the only way for effective liberalization, others argue that they distort world trade and undermine multilateral trade negotiations in GATT. The issue is closely intertwined with the discussion on the proper liberalization instrument to be used for trade in services: should future negotiations be predominantly led by the principle of reciprocity or should they first of all be based on the concept of most-favoured-nation treatment?<sup>4</sup>

This paper attempts to clarify the discussion and outline rational policy options. A liberalization strategy for trade in services should certainly take into account

<sup>1</sup> H. Klodt: Most-Favoured-Nation Principle and Negotiating Strategies, in: P. Robinson, K. Sauvart, V. Govitrikar: Electronic Highways for World Trade, San Francisco, London 1989, pp. 181-195, here p. 182.

<sup>2</sup> Cf. for example B. Hindley, A. Smith: Comparative Advantage and Trade in Services, in: The World Economy, Vol. 7 (1984), pp. 369-389.

<sup>3</sup> Cf. O. Giardini (ed.): The Emerging Service Economy, Oxford 1987.

<sup>4</sup> It should be noted here that of course there are other issues involved in trade in services: among them are the inclusion of other basic principles in a service agreement, like national treatment, transparency or procedures for dispute settlement; universal vs. sectoral liberalization; or the legal relationship of a free trade regime in services with existing sectoral service regimes. Although these issues will not be dealt with here at length, they will be considered whenever appropriate. For a profound discussion cf. G. Fekete: International Trade in Services – An Overview and Blueprint for Negotiations, Cambridge Mass. 1988, pp. 191 et seq.

theoretic findings, experiences in trade in goods as well as the characteristics of trade in services. Therefore, the first part comprises a comparative analysis of selected liberalization regimes. Subsequently, special characteristics of trade in services that are relevant for our purposes are discussed. The final sections then present an outline for a possible liberalization regime for trade in services.

### Alternative Liberalization Regimes

Though international trade liberalization can be initiated through unilateral actions of states, it usually requires negotiations between governments on the bilateral, plurilateral or multilateral level. The two classical instruments used for trade liberalization are the so-called most-favoured-nation treatment (MFN) and the principle of reciprocity. Both instruments can be and have actually been embodied in bilateral, regional and multilateral trade treaties. Nevertheless, although reciprocity is strived for on the plurilateral and multilateral level as well, equivalent trade concessions are more likely to be agreed upon in bilateral negotiations. Similarly, though MFN has frequently been inserted in bilateral treaties, its liberalization effect increases with the number of participants. Therefore, MFN is typically associated with multilateral trade regimes.<sup>5</sup>

It is useful to discuss first MFN on the multilateral level and then bilateral reciprocity as two models for trade liberalization. This is followed by an evaluation of the existing world trade order in GATT, which tries to integrate different policy regimes and liberalization instruments.

### The Multilateral Approach

The underlying objective of the MFN principle<sup>6</sup> is to abolish discrimination between foreign suppliers in international trade. It states that country A is to treat country B under equal conditions as favourably as any other third state. Hence, MFN implies that country B has a right to receive all trade concessions that country A grants to third countries. In addition, country A is obliged to avoid any governmental or administrative means that prejudice country B compared to third countries.

<sup>5</sup> For a historical survey cf. W. Diebold, Jr.: The History and the Issues, in: W. Diebold, Jr. (ed.): *Bilateralism, Multilateralism and Canada in U. S. Trade Policy*, Council of Foreign Relations 1988, pp. 1-36.

<sup>6</sup> For a profound analysis of MFN cf. G. Jaenicke: *Meistbegünstigungsklausel*, in: K. Strupp, H.-J. Schlochauer (eds.): *Wörterbuch des Völkerrechts*, Berlin 1961, Vol. 2, pp. 497-503; R. Senti: *GATT – Allgemeines Zoll- und Handelsabkommen als System der Welthandelsordnung*, Zurich 1986, pp. 100 et seq.

MFN can assume various shapes: it may be granted unilaterally or mutually between governments. It may be given on a de facto basis, but usually it is embodied as a legal clause in an international treaty. MFN can be universal in character, but normally it is restricted with respect to territory, content or time. Foremost is the distinction between conditional and unconditional MFN. The former version sets requirements for MFN and hence bears reciprocal elements. The latter may be considered the pure form of MFN and states that contracting parties are obliged to extend all trade concessions granted to one country immediately and without any conditions to all other signatories. The following paragraphs will analyze the effects of unconditional MFN as a legal rule in a multilateral trade treaty.

In general, the implementation of unconditional MFN fosters the efficient allocation of resources by improving competition and leads to more stable and predictable conditions in international trade. In particular, unconditional MFN tends<sup>7</sup>

- to prevent the distortion of world markets, since contracting parties offer equal conditions to their trading partners;
- to lessen inefficient government interference in international markets;
- to make states more reluctant to create new trade obstacles, because barriers cannot be erected selectively and will cause retaliation by all trading partners affected;
- to reduce control costs for duties settlements for imports at national borders;
- to reduce information costs for governments and economic entities for future trade transactions, since signatories subscribe to non-discriminatory trade policy;
- to reduce for the same reason trade disputes and the abuse of economic power by wealthy nations against less developed countries with little bargaining power.

However, unconditional MFN does not necessarily imply that trade obstacles will actually be removed: "A country following multilateral principles can treat all with perfect equality by reducing no trade barriers at all."<sup>8</sup> In fact, the multilateral strategy including MFN faces

<sup>7</sup> Cf. H. Klodt, *op. cit.*, p. 184; H. Hesse: *Unbedingte oder bedingte Meistbegünstigung als gestaltendes Prinzip einer Welthandelsordnung*, in: *Jahrbuch für Sozialwissenschaften*, Vol. 39 (1988), pp. 235-244 (235 et seq.); U. Müller: *Die Gefährdung der GATT-Ordnung*, in: *Wirtschaftsdienst*, Vol. 62 (1982), No. 5, pp. 254-260 (256 et seq.).

<sup>8</sup> W. Diebold, Jr., *op. cit.*, p. 1.

difficulties in initiating substantial trade liberalization: first, the dynamic extension of concessions might have unpredictable and severe short-term impacts on national economies, which in turn give rise to protectionist policies;<sup>9</sup> second, since multilateral negotiations usually involve a huge number of participants with various and divergent interests, results come up only after long bargaining and generally reflect the smallest common denominator with few liberalization effects; finally, the unconditional extension of concessions allows protectionist countries a free ride. They can benefit from the liberalization efforts of other parties without giving any concessions of their own. Consequently, even countries committed to free trade are cautious to take the first step to liberalization within a multilateral MFN regime.<sup>10</sup>

However, the spill-over effects of unconditional MFN for trade liberalization should be stressed:<sup>11</sup> once the liberalization process is started, concessions are immediately extended to all other signatories. In principle, only one bilateral agreement on the reduction of trade barriers may be sufficient to cause a significant liberalization of world trade. Hence, presuming the will of governments to reduce trade barriers, MFN can be considered the most effective instrument to promote global trade.

### The Bilateral Approach: Reciprocity

The bilateral liberalization approach, on the other hand, relies on reciprocity as the guiding negotiating principle. Accordingly, two interested governments agree on the mutual reduction of trade barriers with the intended effect that both parties benefit in like manner from the arrangement. These mutual concessions may be negotiated informally but usually they are embodied as rights and obligations in a bilateral trade treaty. Reciprocity may imply the mutual reduction of identical trade barriers. However, it usually suggests that signatories grant each other equivalent trade concessions in order to exploit inter-sectoral liberalization. Each bilateral treaty usually differs with respect to the level of trade concessions depending on the interests of the relevant parties. Therefore, the difference between a world trade order based on bilateral treaties and a multilateral trade regime based on unconditional MFN is that the former allows preferential treatment between foreign suppliers, which the latter tries to abolish.

<sup>9</sup> Cf. G. Feketekuty, *op. cit.*, pp. 223 et seq.

<sup>10</sup> Cf. G. Klepper: The Next GATT Round: Bilateralism versus Multilateralism, in: *INTERECONOMICS*, Vol. 21, (1986), No. 5, pp. 232-238 (here p. 238).

Bilateral reciprocity certainly tends to overcome some of the typical problems related to unconditional MFN and multilateral negotiations:<sup>12</sup> first, since the focus lies on equivalent concessions, free-riding is inhibited; second, reciprocity presents an opportune instrument for governments to pursue their short-term political interests. Short-term effects of free trade that harm a government's reputation among voters and interest groups, like structural unemployment or an unfavourable balance of payments, may be kept under control or justified if trade barriers are reduced mutually. What follows is that for political considerations, governments are more inclined to commit themselves to profound liberalization on the basis of reciprocity. In addition, since only two parties are involved, each bilateral trade treaty is concluded readily and can be tailored to the specific trade conditions between the participating countries. Mainly when sensitive trade issues – e. g. national regulation – need to be resolved, bilateral negotiations are valid liberalization strategies. The results may then also serve as models for multilateral negotiations.

Does this suggest that a network of bilateral treaties may be an alternative to a multilateral trade regime? From an economist's point of view, the answer may be no.

Concerning implementation, a network of bilateral treaties causes high if not prohibitive transaction costs.<sup>13</sup> Furthermore each bilateral treaty represents a fragile political equilibrium between signatories. Every new bilateral agreement tends to destroy the equilibrium of former treaties that the two parties have concluded with other trading partners. The latter – if they are affected negatively by the new arrangement – will certainly ask for additional concessions. Hence, multiple trade conflicts and legal uncertainties are typical for a network of bilateral arrangements.<sup>14</sup>

In addition, trade creation may come to a standstill and be limited to trade relations between those countries that have sufficient resources to offer equivalent trade concessions. Only the "happy few" may benefit while less developed countries would be left

<sup>11</sup> Cf. K. Dam: The GATT: Law and the International Economic Organization, Chicago 1970, pp. 62 et seq.; U. Müller, *op. cit.*, p. 256.

<sup>12</sup> H. Hesse, *op. cit.*, pp. 238 et seq.; H. Klodt, *op. cit.*, pp. 184 et seq.; W. Diebold, Jr.: The New Bilateralism?, in: W. Diebold, Jr. (ed.): *Bilateralism...* *op. cit.*, pp. 128-188 (p. 152 et seq.).

<sup>13</sup> For example: in 1981 GATT rules were followed by more than 120 states. Consequently, MFN treatment could only be substituted by more than 6900 bilateral treaties. Cf. U. Müller, *op. cit.*, p. 256.

<sup>14</sup> For historical examples see W. Diebold, Jr.: The History and the Issues, *op. cit.*, pp. 1 et seq.

out. These limitations may cause significant diversion of trade, which in turn leads to a suboptimal allocation of resources. The crucial question then is whether the welfare gains of trade creation attributed to bilateralism are higher than welfare losses of trade diversion likely to occur. There are no easy answers available. Results will depend on various factors, such as the level of preferential treatment, existing cost differences between economies and consumer preferences.<sup>15</sup>

There are further problems related to a bilateral trade regime: governments are less reluctant to establish new trade obstacles, since they can be erected selectively and retaliation is predictable.<sup>16</sup> Finally, it should be noted that there have been several cases in economic history where wealthy nations abused their economic power in bilateral trade negotiations against less developed countries.<sup>17</sup>

To summarize the previous sections, the bilateral approach focusing on reciprocity may be an alternative for initiating liberalization if multilateral negotiations fail. However, one has to keep in mind that it bears the danger of distorting and destabilizing world trade. The multilateral strategy on the other hand faces difficulties in initiating substantial liberalization, especially when complex and sensitive trade issues are concerned. However, from a normative point of view it should be considered the foundation for a world trade order, since it prevents an inefficient distortion of world markets and stabilizes free trade once in existence.

### A Mixed Approach

It was shown above that both models have important strengths as well as serious defects. It is understandable that policy-makers have tried to create

<sup>15</sup> For a more profound analysis of the trade effects of bilateral and regional arrangements cf. H. Siebert: Zölle IV: Zollunionen und Präferenzzonen, in: Handwörterbuch der Wirtschaftswissenschaft, Vol. 9, 1982, pp. 666-678; J. Viner: The Customs Union Issue, New York 1950.

<sup>16</sup> Cf. F. Liebig: Das GATT als Zentrum der Welthandelsordnung, Baden-Baden 1971, pp. 20 et seq.

<sup>17</sup> For example cf. R. Senti, op. cit., pp. 57 et seq.; W. Diebold, Jr.: The History and the Issues, op. cit., pp. 1 et seq.

mixed regimes. The current international order in trade in goods as embodied in GATT follows this line: reciprocity and MFN are both basic principles in GATT law. The GATT intends to integrate bilateral, plurilateral and multilateral policy regimes towards a global free trade order. This mixed approach can be identified in several areas. Foremost for our purpose are those rules and common practices in GATT that deal with trade negotiations and the relationship between MFN on the one hand and customs unions and free trade areas on the other hand. Finally, the so-called "liberalization clubs" will be analyzed as a rather new liberalization strategy within GATT.

### Multilateral Trade Negotiations

The preamble and Art. XXVIII, 1 of GATT state that multilateral trade negotiations should be based on reciprocity. However, in Art. I of GATT, contracting parties commit themselves to unconditional MFN, and hence trade concessions granted to one country must be extended immediately and unconditionally to all other signatories.<sup>18</sup> In practice, trade negotiations in GATT have been ruled by the so-called "principal supplier" procedure. Accordingly, at first the most important trading powers bilaterally agree upon reciprocal removal of trade barriers. These concessions in turn must be extended multilaterally to all other signatories.<sup>19</sup> Indeed, the combination of reciprocity and unconditional MFN in GATT had been quite successful in the fifties and sixties in reducing tariffs.<sup>20</sup> However, as critics have stressed, these achievements are mainly to be attributed to US commitment to free trade at that time and to the fact that tariff negotiations are relatively transparent and involve little transaction costs. When

<sup>18</sup> Cf. J. Jackson: World Trade and the Law of GATT, Indianapolis 1969, pp. 240 et seq.

<sup>19</sup> The principal supplier rule was a common practice in US trade policy before World War II and dominated tariff negotiations in GATT until the Kennedy Round. Even when linear tariff reduction was introduced during the Kennedy Round, bilateral negotiations between principal suppliers were still the rule in many sectors. And still today trade liberalization in GATT is hardly possible without prior bilateral or plurilateral agreements between the three trading blocks (USA, European Community, Japan). Cf. R. Senti, op. cit., pp. 57-60.

<sup>20</sup> Cf. G. Klepper, op. cit., p. 236; R. Senti, op. cit., pp. 70-81.

PUBLICATION OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

Annual subscription rate  
DM 120,-  
ISSN 0023-3439

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The short report on domestic and world business trends and raw materials markets published every fortnight by HWWA-Institut für Wirtschaftsforschung-Hamburg

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US leadership diminished in the seventies and negotiations turned to complex issues such as non-tariff trade barriers, multilateral negotiating hardly led to any significant liberalization.<sup>21</sup>

### Bilateral and Regional Economic Integration

Though GATT founders obviously judged multilateral trade liberalization to be fundamental, they also intended to capture the trade-creating benefits of bilateral and regional liberalization efforts. At the same time, however, clauses were inserted in GATT to control and minimize trade diversion likely to result from those arrangements. Consequently, Art. XXIV of GATT allows for the establishment of free trade areas and customs unions only if specific conditions are met.

First, duties and restrictive regulations must be removed on all or "substantially" all trade between the constituent territories (paras. 4, 8 (a), (b)). Second, trade barriers maintained by a customs union or by the constituent members of a free trade area vis-à-vis non-members shall not on the whole be higher than before the arrangement (para. 5 (a), (b)). Third, liberalization is to be completed in a reasonable period of time (para. 5 (c)).<sup>22</sup>

For several reasons the original concept has been turned almost upside down. Due to political considerations, customs unions (e. g. the EC) and free trade areas (e. g. EFTA) have been permitted or tolerated by GATT members, although they did not fully meet the conditions required by Art. XXIV of GATT.<sup>23</sup> In

<sup>21</sup> Cf. R. Senti, *op. cit.*, pp. 88-93; H. Hesse, *op. cit.*, pp. 238 et seq.; G. Klepper, *op. cit.*, p. 238.

<sup>22</sup> It should be noted here that GATT also grants exception to the MFN rule for historical arrangements such as the Commonwealth. For a more profound analysis of Art. XXIV of GATT cf. J. Jackson, *op. cit.*, pp. 575 et seq.; K. Dam, *op. cit.*, pp. 42 et seq.

<sup>23</sup> For details cf. K. Dam, *op. cit.*, pp. 274 et seq.; R. Senti, *op. cit.*, pp. 117 et seq. For a more comprehensive analysis cf. M. Hilf, F. Jacobs, E.-U. Petersmann (eds.): *The European Community and GATT*, Deventer 1986.

<sup>24</sup> Preferential treatment for developing countries is justified with the "infant industry" argument. It suggests that developing countries might have comparative advantages in some industries but do not have resources or time to build them up. In order to avoid inefficient allocation of resources, these industries need to be protected temporarily against established industries in developed countries. Although most economists in general subscribe to this point of view, implementation is difficult, since the distinction between infant and inefficient industries is almost impossible. For a profound analysis cf. R. Senti, *op. cit.*, pp. 270 et seq.; K. Rose: *Theorie der Außenwirtschaft*, 9th ed., Munich 1986, pp. 485 et seq.

<sup>25</sup> For further reasons cf. H. Hesse, *op. cit.*, pp. 236 et seq.

<sup>26</sup> See for example the US proposal in Atlantic Council of the United States, Trade Committee, Special Advisory Panel: *GATT Plus: A Proposal for Trade Reform*, New York 1976; M. Camps, W. Diebold, Jr.: *The New Multilateralism*, Council on Foreign Relations, New York 1986; H. Giersch: *Perspectives on the World Economy*, in: *Weltwirtschaftliches Archiv*, Vol. 121 (1985), No. 3, pp. 409-426 (here p. 424).

addition, preferential treatment between and for developing countries has become an accepted norm in GATT law.<sup>24</sup> The renaissance of protectionism and the complexity of current trade issues added further to the erosion of MFN and to the shift towards bilateral and regional arrangements.<sup>25</sup>

### Liberalization Clubs

Due to the problems of multilateral trade negotiations and to the renaissance of bilateralism, the idea of "liberalization clubs" has recently gained considerable importance in GATT and reputation among scholars.<sup>26</sup> Examples of liberalization clubs are the several codes for the reduction of non-tariff trade barriers that were concluded in the Tokyo Round.<sup>27</sup> Liberalization clubs consist of interested countries that agree on more profound liberalization rules on a conditional MFN basis: trade concessions do not have to be extended to all trading partners but are limited to those countries that are willing to accept these far-reaching liberalization steps.<sup>28</sup> Hence, every club will discriminate against non-members and bears the danger of trade diversion. However, by definition every liberalization club must be open to newcomers. Their openness distinguishes them from customs unions and free trade areas, which in principle represent closed arrangements.

The underlying objectives are obvious: a smaller number of countries with similar economic development or common political interest will come to a significant removal of trade obstacles within a short period of time. "If intra-club relations produce positive results, dynamic as well as static ones, they induce others to join, which involves paying the price of liberalization."<sup>29</sup>

The crucial question is to what extent liberalization clubs are and should be open to countries willing to adhere to them. "Obviously, there is a trade-off between substance and coverage. If the agreement ... is to be signed only by a limited number of countries, it could include liberalization steps that are not acceptable to others."<sup>30</sup> In addition, rules may be tailored too much to the specific trade conditions between the original parties, so that expansion of membership is restricted from the very beginning.<sup>31</sup> Liberalization clubs designed

<sup>27</sup> Cf. H. Hesse, *op. cit.*, p. 241; R. Senti, *op. cit.*, pp. 81 et seq.

<sup>28</sup> Cf. H. Klodt, *op. cit.*, p. 185. GATT might also be called a liberalization club: MFN is limited to GATT members, and the Treaty is open to newcomers willing to pay a price for entrance. But because of wide participation, low entrance price and the absence of far-reaching liberalization rules, GATT should be distinguished from club arrangements.

<sup>29</sup> H. Giersch, *op. cit.*, p. 424.

<sup>30</sup> H. Klodt, *op. cit.*, p. 188.

like this are de facto closed and may in effect create similar problems to those known from bilateralism. On the other hand, low price for entrance may increase membership but will limit trade creation. The typical problems bound with multilateralism would come to surface again.

Nevertheless, liberalization clubs have the unique potential to combine the advantages of bilateral and multilateral liberalization strategies. Therefore, they can be regarded as the crucial means to overcome current trade problems.

After having discussed alternative liberalization instruments, how then might a regime for free trade in services look? It was argued above that multilateral application of unconditional MFN should be a basic requirement for a free trade regime. At the same time, experiences in trade in goods suggest that bilateral and plurilateral arrangements may also be needed to initiate and enlarge trade. It is shown below that the special characteristics of services argue even more for a mixed policy. Negotiations on trade in services have turned out to be extremely difficult and complicated. These difficulties are partly caused by the very nature of existing barriers to trade in services and partly by conflicting interests between the participating governments.

### Barriers to Trade in Services

Trade in services differs in some respects from trade in goods. "By definition, a good is a physical object that can be transferred between economic units. A service, by contrast, is an intangible change in the condition of a person or a good resulting from the economic activity of

some other economic unit."<sup>32</sup> Therefore, for most trade in services a physical contact between the service provider and the customer is a necessity to carry through the transaction: either the customer travels to the service provider (e. g. tourism) or, more commonly, the service supplier moves to the customer. The latter transaction usually requires investments in the country of destination. These services may be termed factor-embodied services. Even if services are disembodied in the sense that they do not require physical presence for exportation (e. g. data base services), they do require the transborder movement of information. What follows is that for both factor-embodied and disembodied services the unhindered movement of factors (capital, labour, information) is a prerequisite for free trade in services.

The crucial obstacles to the movement of factors and hence to trade in services are national regulations.<sup>33</sup> These regulations may in effect deny market access for, or impose operating restrictions on, foreign service suppliers.<sup>34</sup>

The telecommunications sector is an important example in which market access for foreign service providers is prohibited. Until recently in most countries national telecommunications monopolies (PTTs) had the exclusive right to offer public telecommunications services within their respective territories. International communications services could only be provided through the cooperation of two or more PTTs. Although some countries have deregulated their telecommunications sector and allow for competition between national suppliers, foreign providers of communications services are rarely granted market access. Similar restrictions on market access exist in banking and especially in insurance services.<sup>35</sup>

Operating restrictions on the other hand can take various forms:<sup>36</sup> national immigration and investment laws frequently hinder the movement of labour and capital, which in turn imposes restrictions on trade in factor-embodied services. Other typical operating restrictions include differential reserve requirements in banking and insurance, discriminatory taxation or

<sup>31</sup> The free trade agreement between the USA and Canada illustrates the problem. The adherence of third countries was a central issue during negotiations. Finally it was decided that the agreement should not be open to third countries since it could destroy the equilibrium in the treaty, which had required long and intensive bargaining. For a detailed analysis cf. W. Diebold, Jr.: *The New Bilateralism*, op. cit., pp. 156 et seq. In addition, from a Mexican point of view, the agreement is too much shaped for trade between the USA and Canada, so that adherence to the treaty is almost impossible. Cf. G. Bueno: *A Mexican View*, in: W. Diebold, Jr.: *Bilateralism ...* op. cit., pp. 105-127.

<sup>32</sup> H. Klotz, op. cit., p. 186.

<sup>33</sup> Tariffs hardly exist as barriers to trade in services, because they do not present practical means of influencing the movements of factors. For example: a government could put tariffs on the export of raw data in order to support its domestic data processing industry. However, this would imply the intensive governmental control of transborder information flows, which would cause prohibitive administrative costs. In addition, in many countries fundamental human rights would be violated. For more details on the characteristics of trade in services, see G. Feketekuty, op. cit., pp. 75 et seq.; H. Klotz, op. cit., pp. 186 et seq.

<sup>34</sup> In practice, a clear distinction between denial of market access and operational restrictions is frequently impossible. For a discussion of those barriers cf. H. Klotz, op. cit., p. 187.

<sup>35</sup> For a sectoral discussion of telecommunications, insurance and banking see the contributions by R. Ellger, D. Witt: *International Free Trade in Telecommunications*; W.-H. Roth: *International Free Trade in Insurance Services*; W. Möschel: *International Free Trade in Banking Services*, in: E.-J. Meistmäcker (ed.): *Rules for Free International Trade in Services*, Schriftenreihe Wirtschaftsrecht und Wirtschaftspolitik, Vol. 107 (forthcoming 1990). In general cf. V. N. Balasubramanyam: *International Trade in Services: The Issue of Market Presence and Right of Establishment*, in: P. Robinson, K. Sauvart, V. Govitrikar: *Electronic Highways For World Trade*, San Francisco, London 1989, pp. 131-153.

<sup>36</sup> Cf. G. Feketekuty, op. cit., pp. 129 et seq.

restrictions on the type of services that can be offered. More indirectly, service providers that heavily depend on access to national telecommunications networks (banking, insurance, information services) complain about discriminatory technical standards, unreasonable tariffs and unfavourable conditions for leased lines in some countries. Data protection laws are often mentioned as barriers that hinder trade in information services.

The removal of these regulations is a difficult task, since they frequently reflect sensitive national policy goals. Differential reserve requirements in banking and insurance are justified as necessary rules for consumer protection. National security considerations are often put forward by governments as reasons for obstacles to transborder data flow. National telecommunications monopolies have been defended by reason of economic and social welfare policies.

These examples already indicate the core problem for efforts to liberalize trade in services: a proper distinction between appropriate and unreasonable regulation is a highly political task and frequently impossible.<sup>37</sup> Service negotiations involve high information costs and require intense and long bargaining. Not surprisingly, multilateral trade talks on services that bring together a huge number of governments with divergent interests are complex undertakings, whereas ready agreements and effective liberalization rules cannot be expected. These circumstances already suggest that in addition to multilateral strategies, bilateral and plurilateral instruments may be needed for effective liberalization.

### Politics of Trade in Services

Depending on their own economic development and competitive position in world service markets,

governments pursue different strategies and have chosen different forums for trade in services.

The USA, which enjoys comparative advantages in many services, initiated the debate and presses for timely and effective liberalization to exploit new business opportunities for US service providers abroad. In general, the USA supports multilateral negotiations in GATT. At the same time, it calls for bilateral agreements with its most important trading partners in order to come to quicker and more profound results. The free trade arrangements with Israel and Canada constitute the first results of this policy.<sup>38</sup> Sectoral bilateral negotiations on the basis of reciprocity are other developments in US trade policy with respect to services.<sup>39</sup>

The European Community may follow a similar line. It backs current talks in GATT but may well extend its bilateral agreements with Israel or EFTA members to trade in services or may conclude other bilateral treaties. Foremost for EC members, however, is the creation of a common service market in Europe as an important part of a single European market after 1992.<sup>40</sup>

Less developed countries perceive liberalization in trade in services as a threat to their development prospects. Hence they strive for preferential treatment by developed countries in order to build up their "infant industries" in services. Since their bargaining power is limited in bilateral negotiations, they prefer multilateral talks in GATT where they can act as a political bloc and push decisions more effectively in their direction.<sup>41</sup>

Due to divergence of interests, simultaneous negotiations on the bilateral, regional and multilateral levels are a political reality. The difficult task ahead will be to integrate these different efforts into a harmonious policy regime that fosters desirable trade creation and minimizes inefficient trade diversion.

Proposals are presented below for a regime for free trade in services.<sup>42</sup> They take into account theoretical

<sup>37</sup> Cf. P. Nicolaidis: *The Problem of Regulation in Traded Services: The Implications for Reciprocal Liberalization*, in: *Außenwirtschaft*, Vol. 44 (1989), No. 1, pp. 29-57.

<sup>38</sup> For a profound analysis of the US policy cf. G. Fekete kuty, *op. cit.*, pp. 295 et seq.

<sup>39</sup> The most recent and controversial example of this strategy is the US Telecommunications Trade Act of 1988. The act provides that the US president is obliged to enter into negotiations with those countries that pursue a protectionist trade policy in telecommunications and that have been identified as "priority countries" through investigations by the US trade representative. If negotiations for a liberalization of telecommunications markets in those countries fail, then the US president is authorized to take retaliatory action. The congressional action stems partly from the growing importance of trade in telecommunications equipment and services for the US industry and partly from the perceived imbalance of a relatively liberalized and open telecommunications market in the USA compared to the relatively regulated and closed markets in other countries. For a comprehensive analysis cf. J. Duane, W. Edgar: *Sectoral Reciprocity in Telecommunications: The Telecommunications Trade Act of 1988*, in: *The George Washington Journal of International Law and Economics*, Vol. 22, No. 1 (1988), pp. 175-214.

<sup>40</sup> Cf. the EC Commission's White Paper on completing the internal market (1985); cf. also the contribution by C. Engel: *Trade in Services between the European Communities and Third Countries - Its Regulation by Community Law*, in: E. J. Mestmäcker: *Rules for Free International Trade in Services*, *Schriftenreihe Wirtschaftsrecht und Wirtschaftspolitik*, Vol. 107 (forthcoming 1990).

<sup>41</sup> It should be noted that developing countries at first opposed the inclusion of services as a trade issue for the Uruguay Round at all. See M. Gibbs, M. Mashayekhi: *Services: Cooperation for Development*, in: *Journal of World Trade*, Vol. 22 (1988), No. 2, pp. 81-107 (here pp. 90 et seq.)

<sup>42</sup> As with the former sections the following paragraphs focus on the inclusion of MFN and reciprocity in a service regime. For other basic elements of a constitution for trade in services like national treatment, transparency, procedures for dispute settlement, etc., see J. Jackson: *Constructing a Constitution for Trade in Services*, in: *The World Economy*, Vol. 11 (1988), No. 2, pp. 187-202 (here pp. 189 et seq.)



findings, lessons in trade in goods and the special characteristics of trade in services that have been analyzed previously.

Among policy-makers a consensus emerged that initial negotiations should focus on developing an umbrella agreement that sets forth basic principles to be applied to all traded services. Following terms in trade in goods, this treaty may be called a "General Agreement on Trade in Services" (GATS). It is commonly understood that GATS should strive for the widest possible adherence of countries. Global membership, however, implies that the treaty will contain only vague principles not qualified for initiating effective liberalization. The main objective of a general agreement should rather be to provide for an institutional platform for progressive liberalization, to promote the integration of world service markets and to stabilize trade in services.<sup>43</sup>

It was suggested above that unconditional MFN – on the premise that countries are willing to reduce trade barriers – contributes to these goals. In GATS as well, privileges and obligations should be extended immediately and unconditionally to all members of the treaty, but not necessarily to non-members.<sup>44</sup> In particular, as the Canadian delegation stressed, "there should be a requirement that bilateral concessions between a party to the Agreement and a non-party to the Agreement be extended automatically to all parties to the Agreement. This would ensure that the Agreement was the 'best deal' available to each party and would encourage wide participation."<sup>45</sup>

However, the final impact of an MFN clause will on the one hand depend on the level of liberalization steps governments are willing to accept in GATS. On the other hand, crucial will be what kind of exceptions will be allowed by provisions in the general agreement.

### A Strategy for Sector Codes

Given the divergence of interests and the complexity of issues, it is important that an MFN clause in the

general agreement should not preclude the subsequent conclusion of sector codes that contain higher levels of commitments between interested parties.<sup>46</sup> The fact that the overwhelming amount of world trade in services is currently conducted between a small number of countries (OECD members) already suggests that club arrangements will probably come into existence.<sup>47</sup>

It is widely understood that these additional agreements are to be concluded for important service sectors, such as telecommunications, banking or insurance. These sector codes would reflect the specific regulatory environment in each sector and even address such sensitive issues as market access or direct investment in order to achieve effective liberalization.<sup>48</sup> Because most countries will likely not accept these far-reaching liberalization steps, in the beginning probably only a small proportion of the parties to the general agreement will sign the sector codes. In order to prevent free riders, the codes should rely on conditional MFN: the extension of concessions should be limited to countries that are willing to pay the price of liberalization and adhere to the sector treaties. Similarly, further negotiations for the reduction of trade barriers within the framework of the codes should be based on reciprocity. However, these arrangements must be open to all countries willing to fulfil the obligations laid down in the codes. Thus, they could also be termed sectoral liberalization clubs.

Though there should be no doubt about the necessity of these clubs, one has to keep in mind that club arrangements tend to distort world trade. Therefore, sector codes need to be carefully coordinated and controlled under the general agreement. The umbrella agreement must define conditions and procedures for the establishment of sectoral clubs. In order to guarantee openness and foster participation, these rules should prevent unjustified discrimination by original members of the code against newcomers. In addition, they should coordinate liberalization efforts to preclude the simultaneous existence of several bilateral or plurilateral arrangements in one sector that pursue rather protectionist goals. For example, the establishment of a bilateral sectoral treaty should only

<sup>43</sup> For details on GATS see the proposal issued by the OECD, Working Party of the Trade Committee: Trade in Services, Summary of certain elements of a conceptual framework for an agreement on trade in services, Doc. Nr. TC/WP (88) 72, Paris 1988; G. F e k e t e k u t y, op. cit., pp. 191 et seq.

<sup>44</sup> It should be noted that the Group of Negotiations on Services (GNS) so far could only agree that a form of MFN clause should be embodied in a general agreement, and as yet no consensus has been reached on whether MFN should be granted unconditionally or on a conditional basis. Cf. "Montreal Ministerial Statement on Trade in Services", in: Transnational Data and Communications Report, May 1989, pp. 26 et seq. For a summary of proposals cf. OECD, Working Party ..., op. cit., p. 7.

<sup>45</sup> Communication from Canada, Negotiation of a Multilateral Agreement on Trade in Services: A Working Hypothesis, GATT Secretariat, Doc. UR-88-0189, May 1988, p. 5.

<sup>46</sup> Cf. J. A c k s o n, Constructing a Constitution ..., op. cit., p. 196.

<sup>47</sup> For a statistical overview cf. A. H e r r m a n n, W. O c h e l: Der internationale Handel mit Dienstleistungen, in: Ifo-Institut für Wirtschaftsforschung – Schnelldienst, Vol. 40 (1987), No. 14-15, pp. 55-65 (here p. 56).

<sup>48</sup> For details on sector codes cf. G. F e k e t e k u t y, op. cit., pp. 241 et seq.

be permitted if it contains a considerably higher level of concessions than an existing plurilateral code.

If sector codes comply with these requirements, they will be an effective and crucial means for progressive liberalization in trade in services.

### Economic Integration

Political reality already implies that a general agreement on trade in services will include exceptions to the rule of MFN for free trade areas and customs unions. Neither the USA nor Canada will accept the unconditional extension of concessions agreed upon bilaterally to all members of a general agreement. Similarly, the EC made it clear that it will "liberalize regulations faster among its Member States than with respect to third countries".<sup>49</sup> And indeed, the potential of customs unions and free trade areas to create trade in services that would otherwise not exist should be exploited as long as multilateral instruments for trade in services are not available or fail. However, from a long-term perspective, one cannot overlook the danger of undesired trade distortion that is likely to occur and that – as experiences in trade in goods indicate – is difficult to remove subsequently. In fact the control and integration of bilateral and regional agreements into a global order for trade in services will probably be the most difficult challenge ahead.

It should be stressed that – given the economic potency of the EC and trade flows between Canada and the USA – existing free trade areas or customs unions should not be "grandfathered" without further examination. Instead, all existing and future bilateral or regional economic arrangements should fulfil conditions similar to those in Art. XXIV of GATT: first, a general agreement should call for a significant removal of barriers on a wide range of services in a reasonable period of time; second, trade barriers with respect to third countries maintained by the new arrangement should on the whole not be higher than before its establishment. In any case, the level of concessions among constituent territories should in general be higher than those concluded in sector codes mentioned

<sup>49</sup> Communication from the European Communities, Discussion Paper: A Possible Conceptual Structure for a Service Agreement, GATT Secretariat, Doc. UR-87-0439, December 1987, p. 7.

<sup>50</sup> An example is the book printing industry. Recently the typesetting stage of book production has been increasingly performed by developing countries because typesetting is labour intensive and does not require high labour skills. Due to low wages developing countries have comparative cost advantages in those services. In principle, these findings can be extended to any services requiring keyboard input functions on a routine basis. Cf. B. Hindley, A. Smith, *op. cit.*, pp. 387 et seq.; cf. also G. Fekete, *op. cit.*, pp. 116 et seq.

above. Considering the lack of transparency in trade in services and the fact that bilateral and regional services regimes have already been erected, these rules may be even more difficult to enforce than with trade in goods.

### Preferential Treatment for LDCs

Developing countries may enjoy comparative cost advantages in some service sectors, especially in labour-intensive services.<sup>50</sup> If these cost advantages actually or potentially exist, then they should be exploited in order to improve the allocation of resources for the world economy. In many cases, however, service industries have still to be built up in the Third World. In the event of immediate liberalization, developing countries might not have the time to erect those "infant service industries", because their domestic markets will be dominated soon by well-established service providers from developed countries.<sup>51</sup> Thus, a general agreement should contain provisions that except temporarily preferential treatment for developing countries from the rule of MFN. However, it should be stressed that these provisions might well be abused by countries to pursue protectionist goals. Much more research is needed to distinguish between infant service industries and those that are and will be just inefficient.

### Conclusion

From a theoretical point of view, the multilateral approach should be considered the desirable long-term policy for trade in services. In reality, due to complexity of issues and divergence of interests, a multilateral regime containing profound rules for liberalization is hard to achieve. In fact there is a risk that an uncoordinated network of bilateral and regional arrangements might develop. A further distortion of world service markets can be suspected as the harmful result of such a policy.

However, as Charles Kindleberger put it when reflecting on international trade in general, "Instinct seems to suggest that there is room for a position between the idealistic attempt to re-establish a bygone multilateralism and cynicism which would suggest that bilateralism is the inescapable road of the future."<sup>52</sup> From our point of view, at least for free trade in services, a mixed policy with an emphasis on liberalization clubs to be coordinated under a multilateral umbrella could be the second best solution.

<sup>51</sup> Cf. D. Nayyar: Some Reflections on the Uruguay Round and Trade in Services, in: *Journal of World Trade*, Vol. 22 (1988), No. 5, pp. 35-47 (here pp. 40 et seq.).

<sup>52</sup> C. Kindleberger: *Marshall Plan Days*, Boston 1987, p. 59.