

Trading Blocs and the Trading System: The Services Dimension

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Abstract

This paper explores the relationship between regional and multilateral agreements to liberalize trade in services. Following a conceptual discussion of the political economy of regional as opposed to multilateral negotiations, existing data on trade and investment flows are analyzed with a view to gaining some insight into the likely interest group preferences regarding alternative institutional arrangements to liberalize trade in services. Conceptual considerations and available data suggest a preference for regional liberalization. But available data and a comparison of the content of the major existing agreements also suggests that regional and multilateral approaches are more likely to be considered by service industries and regulators to be complements than substitutes. (JEL: F13)

I. Introduction

Regional agreements to liberalize international transactions in services

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have been prominent in the late 1980s and early 1990s. Examples include the Canada-United States Free Trade Agreement (CUSFTA), the Australia-New Zealand Closer Economic Relations trade agreement (CER), the EC-1992 program, and the recently concluded European Economic Area (EEA) agreement and the North American Free Trade Agreement (NAFTA). All of these agreements are recent, the oldest having been negotiated in the mid-to late-1980s, the most recent yet to be implemented. At the same time regional agreements to liberalize trade in services were pursued by OECD countries, services were also introduced on the agenda of a multilateral trade negotiation, the Uruguay Round. The focus of this paper is on the relationship between regional agreements and the General Agreement on Trade in Services (GATS) that was negotiated under auspices of the Uruguay Round. The question of whether regional and multilateral approaches are complements or substitutes has been hotly debated, especially in the early 1990s. Although this is obviously an issue that pertains to both goods *and* services, this paper is restricted to services, as this dimension has attracted much less attention.¹ As services liberalization is a central element of all the recent regionally focused agreements, an understanding of the political economy forces underlying this trend are important in answering the complement-substitute question.

The plan of the paper is as follows. Section II provides a conceptual discussion of interest group preferences and activity with respect to services liberalization in both the regional and multilateral context. Section III presents some data on trade and direct investment flows for major service industries in the United States and the EC, using recent information on the origin and destination of such flows. These data are helpful in understanding both negotiating positions and outcomes *ex post*, and are suggestive regarding the likely outcomes *ex ante*. Section IV compares the regional agreements and the GATS, focusing on differences in sectoral coverage and the extent of liberalization that was achieved. Section V concludes.

1. For general discussions of the pros and cons of RTAs and why they are pursued, see the recent conference volumes edited by Anderson and Blackhurst [1993] and De Melo, Panagariya and Rodrik [1993]. Neither volume devotes much attention to the role of services.

II. Political Economy and Conceptual Issues

The political economy of liberalization of trade in services is analogous to merchandise trade liberalization in that export-oriented industries and consumers of importables will tend to support it, while import-competing firms can be expected to oppose it. Notwithstanding this basic similarity, there are a number of important differences.

First, because services tend to be nonstorable, service transactions often require that the provider and demander/consumer of the service interact, *i.e.*, be at the same place at the same time. Many services are not tradable in the standard sense of the term, in that natural barriers to trade are prohibitive. In such instances foreign service providers that desire to contest a market must be able to establish a physical presence in that market – be it temporarily or on a longer-term basis. Liberalization then requires the reduction/elimination of both barriers to cross-border trade flows *and* to the movement of foreign service providers or consumers. To the extent that such movement must be longer-term, this implies that establishment or foreign direct investment (FDI) appears on the negotiating agenda. The introduction of FDI has consequences for the political economy of liberalization. In particular, if this mode of contesting markets can be kept off the table, domestic incumbents producing nontradable services will remain unaffected by liberalization, and little effective market opening will occur. To the extent that such industries are not “export-oriented” in the sense of seeking the freedom to establish in other markets, they may focus their lobbying efforts to prevent the liberalization of FDI, and attempt to form explicit or implicit coalitions with other industries/interest groups in this position. Possible examples of such industries are professions such as providers of legal and medical services (where there are often regulatory barriers to entry) and retail banking. If barriers to trade are not natural but government-made – *i.e.*, the service is in principle tradable – import-competing, relatively high-cost industries can be expected to oppose the liberalization of both trade *and* investment (establishment). An example here is the air transport industry in many countries.

The need for addressing multiple modes of contesting markets in services negotiations not only increases the potential number of affected

groups in participating countries but may also change standard predictions of lobbying interests (Hoekman, 1992). In the short run, it is generally assumed that sector-specific factors of production employed in inefficient protected industries will oppose liberalization of market access. In the services-context this may not be the case. To the extent that establishment is the most efficient mode of contesting a service market, sector-specific labor may be less opposed to liberalization, insofar as it is expected that net employment in the sector concerned will not change much upon liberalization due to the establishment of foreign-owned firms. This is likely to be the case in particular when natural barriers to trade are prohibitive, as establishment is then the only feasible mode.²

Second, in the merchandise trade setting some government agencies may oppose liberalization if trade taxes constitute an important source of revenue. This will not arise in the services context as tariffs are rarely employed (this frequently not being feasible). Indeed, barriers to trade in services often will take the form of regulations. Industries and final consumers that desire access to cheaper and/or higher quality services – be they of domestic or foreign origin – therefore must seek changes in regulatory structures. This implies that regulatory agencies enter into the picture as players. Compared to the merchandise setting there is likely to be a different mix of government agencies involved in liberalization efforts, with possible opposition on the basis of revenue concerns (if any) being supplanted by opposition by regulatory agencies. Again, much may depend on the mode of supply being considered. If the focus of liberalization efforts is only on cross-border trade, regulators may have greater objections to liberalization, as it is generally more difficult to control industries that are located in foreign jurisdictions. Indeed, regulators may prefer that establishment is *required* as a mode, as this ensures that they will maintain their control of the activity involved (insurance is an example).

Third, the fact that in the services-context regulatory regimes constitute

2. This may occur even if net employment is expected to decline. As long as a substantial part of the workforce can reasonably expect to continue being employed in the sectors involved, there will be less opposition to liberalization than if the products had been tradable and production was expected to move to another country.

the primary barriers to market access makes it more difficult to pursue the negotiation techniques that have been used in the merchandise setting. Traditional GATT trade negotiating rounds were based on the reciprocal reduction of tariffs and other trade restrictions, which mobilized export-oriented firms in each participating country to offset the political pressure exerted by import-competing firms favoring continued protection. Moreover, the incremental and gradual nature of GATT liberalization reduced adjustment costs at any point in time and facilitated liberalization. While the political economy of services trade talks is similar in this dimension, the incremental reduction of market access restrictions is more difficult to achieve, given that discussions must center on regulations. If existing regulatory regimes are perceived to be in the national interest, governments will be opposed to changing them, especially if such change is 'discrete'. Although similar constraints increasingly apply to negotiations on policies affecting trade in goods as well, the problem is more binding in the services context.

At any point in time the political 'market' of a country will determine an equilibrium level of intervention (market access restrictions). This equilibrium changes continuously, as reflected in the successful deregulation efforts undertaken in the United States and the U.K. in the 1980s, and the unilateral liberalization-cum-deregulation pursued recently by major Latin American countries. Why such efforts prove politically feasible is an interesting and important question that will not be addressed here.³ As the focus of this paper is on the relationship between different reciprocal approaches, the equilibrium that emerges from the domestic interaction of relevant interest groups – industries and government agencies – is taken as given. Given an initial domestic *status quo*, interest groups will have a choice between pursuing regional and multilateral trade agreements.⁴ The preferences of various lobbies for alternative institutional approaches are difficult to determine *ex ante*, given the large number of possible policy packages that may be associated with either a regional or a multilateral agreement. In order to gain

3. See Derthick and Quirk [1985] for a study of the U.S. experience that addresses this question.

4. Clearly the objective of interest groups seeking such agreements may be to affect the domestic *status quo* as much as to obtain greater access to foreign markets.

greater understanding of the problems involved, it is helpful to describe the problem facing a representative lobby more formally.⁵

Leidy and Hoekman [1993] suggest that for analytical purposes, any negotiation can be split into three stages: a pre-negotiation phase where the set of possible agendas is narrowed down; a negotiation stage, where a specific policy package is chosen; and an implementation phase during which the package is implemented. Lobbies may have an incentive to attempt to influence decisions at all three stages. For simplicity, it is assumed here that interest groups only play a role during the negotiation stage, take the agenda for negotiations as given, and expect governments to implement agreements as negotiated.⁶ In practice such lobbies will consist largely of well-organized industries (those that have solved the free rider problem) and regulatory agencies.

The objective of interest groups is to shape the *effective* preferences of negotiators over alternative policy packages. Let the vector of such possible packages be $x_i = x_i^* + \varepsilon$, ($i = 1, \dots, P$), where ε is a random vector with finite variance and an expected value $E(\varepsilon | \Theta) = 0$, where Θ represents various exogenous parameters affecting the distribution of ε . Given a representative interest group j 's *ex ante* beliefs about the vector of possible outcomes (x_i^*, Θ) , its negotiation problem is to:

$$\max -l_j + \beta \left\{ \sum_{i=1}^P \rho_{ij}(L | v^N) V_j(x_i^*, \theta) + [1 - \sum_{i=1}^P \rho_{ij}(L | v^N)] \cdot V_j^s(x_s, \theta) \right\} \quad (1)$$

subject to $l_j \geq 0$, where l_j , an element in the lobbying vector L , is j 's lobbying

5. What follows is a substantially simplified version of a model developed in Leidy and Hoekman [1993].

6. Both these assumptions are unrealistic and unnecessary. Leidy and Hoekman [1993] allow for lobbying at all three stages, thus recognizing that lobbies may influence both the agenda and the implementation of negotiated agreements. The scope lobbies have to influence outcomes at the implementation stage is a function of the government and the institutional environment they face. For example, if international agreements have direct effect and automatically supersede national legislation, there will be little if any scope to influence implementation. Conversely, if implementation occurs through administrative procedures, or requires the passing of domestic implementing legislation, lobbies may have substantial scope to influence outcomes at this stage.

expenditure during negotiations, $V_j(x_i^*, \Theta)$ is the expected future value of package x_i for group j ($j = 1, \dots, N$), and $\rho_{ij}(L | v^N)$ is the j th group's perception of the relationship between the probability of a possible policy package being selected and total lobbying under the structure implied by the set of possible policy packages that could emerge from negotiations, $v^N = \{x_1, \dots, x_p\}$. The term $V_j^s(x_s, \Theta)$ is the interest group's perceived income under the status quo policy package, x_s (implying negotiations breakdown). The term $1 - \sum \rho_{ij}(\bullet)$ is group j 's perception of a breakdown of negotiations, and β is the discount factor corresponding to the future implementation of what is negotiated.

This is obviously a rather complex problem, the solution to which will depend, among other things, on how each group's expectations are formed regarding the behavior (strategy) of other groups. If, for simplicity, Cournot conjectures are assumed, the solution to (1) implicitly yields an indirect value function of the form

$$V_j = V_j(v^N, x^*, x_s, L_{-j}, \beta, \Theta) \quad \forall j = 1, \dots, N, \quad (2)$$

where x^* is the vector of possible policy packages (x_1^*, \dots, x_p^*) .⁷ The value of the marginal product of a unit of lobbying for an interest group is the discounted sum of its effect on the perceived probability of each possible policy package being adopted, weighted by the conjectural value of each package relative to the *status quo*.

This structure is helpful in understanding some of the key determinants of interest group preferences regarding regional as opposed to multilateral negotiations. A regional trade agreement (RTA) by definition involves substantially fewer countries than a multilateral trade negotiation (MTN); indeed, some RTAs involve only two countries. The fundamental market access constraint in the services-context is regulatory in nature. In regional talks, it is more likely that the governments involved will be relatively like-minded with respect to the general objectives underlying at least a subset of the regulatory regimes applying to service industries, especially if – as is often the case – the countries involved have similar cultures and *per capita* incomes and are in geographic proximity. As a result it may be easier to

7. For a much more detailed treatment, see Leidy and Hoekman [1993].

negotiate liberalization of access to service markets in a regional context. Tradeoffs across issues may be more feasible as well, as the countries involved may have concerns in areas such as foreign or environmental policy that may be linked to market access. The general implication is that the set of possible policy packages (x^*) is likely to differ across RTAs and MTNs, and may well be larger under the former, including issues that could not even appear on the negotiating agenda of a MTN. And issue linkage or "sidepayments" may be more feasible, facilitating agreement.

In a regional setting there is likely to be less uncertainty confronting interest groups regarding the valuation of the set of policy packages. The closer are the regulatory objectives and specific regimes of countries for individual sectors, the smaller may be concerns regarding free riding of competitors in potential partner countries. The smaller the required changes in regulatory regimes and the greater the confidence that regulations will be enforced in all jurisdictions, the more certain are the conditions of competition *ex post*. If geographic proximity entails that firms have more information on existing and potential competitors located in neighboring countries, making monitoring less costly, regional integration may again be less uncertain than multilateral efforts. Such uncertainty reducing factors will be reflected in the parameter Θ .

One implication of the foregoing is that the benefits of regional services integration may be more easily internalized. Such internalization might also be achieved through the raising of external barriers against non-member countries (see below). More interestingly, a number of service activities may generate network externalities, or be associated with agglomeration and other scale effects. If these effects are regional in scope this will strengthen preferences for regional liberalization efforts. There is some reason to think this may be the case in practice. For example, various distribution-related activities are subject to scale economies (*e.g.*, multi-modal transport, warehousing, marketing), and, for small countries in particular, these may be regional. Agglomeration externalities may be important for tradable services that are not highly tied to specific manufacturing activities (*e.g.*, financial intermediation or consulting). Network externalities are important for telecommunications and information services. Producers of nontradable services that are intermediate inputs into manufacturing activities must be

able to locate in the same area as their (potential) clients. As manufacturing activities tend to be geographically concentrated, such establishment by service providers will also take a regional focus. Incentives for centralization/concentration of service activities may well be demand driven as well, raising the support for regional liberalization. Users of services will benefit from regional integration of service markets as greater competition lowers unit costs and increases the quality and variety of services on offer. The various factors underlying a likely preference for regional integration will be reflected in the valuations attached to policy packages by interest groups. The effect may be that the difference between a given policy package (x^*) and the status quo (x_s) that obtains in the regional context may be greater than under a multilateral format, or alternatively, that regional liberalization will result in most of the possible gains.

As important as the possible economic rationales for a regional focus on the part of service providers and users is the constraint that will generally be imposed by regulators. As mentioned earlier, in the services context interest groups must seek (lobby for) the abolition of regulatory differences across jurisdictions that prevent the provision by non-residents of regulated services. Even if the regulatory regimes in question are applied in a nondiscriminatory manner to both domestic and foreign firms, this will often be enough to effectively restrict access to service markets. Examples where this is often the case are distribution-related activities such as marketing or transportation, services that satisfy final demand (*e.g.*, retail distribution), and/or services that are subject to prudential supervision and 'minimum quality' standards (*e.g.*, retail financial services, or medical and education services). If 'nondiscriminatory' regulations restrict market access, what is required is either the mutual recognition of regulatory regimes/standards, or harmonization. Consequently, a preference is likely to exist for RTAs on the part of regulators. Regulatory convergence and mutual recognition is in principle more feasible in a small numbers setting than in a multilateral context.

To the extent that the foregoing considerations are valid, interest groups may devote their resources to pressure governments to pursue the effective reduction of service market access restrictions in a regional context. This 'bias' will be augmented by the preferences of regulatory bodies and con-

sumers concerned with service quality. Service industries will, of course, have different preferences regarding regional liberalization, some opposing it, others in favor, depending on competitive advantage, etc. For any given distribution of preferences, the point is that the existence of externalities, scale and regulatory effects may imply that regional efforts are preferred to multilateral ones.

Up to this point the discussion has centered largely on service-specific issues, which have been neglected in the literature on regional integration. The more general arguments that have been made in the merchandise trade setting to explain the rise of regionalism will, of course, also apply. Thus, the more similar are countries in their endowments and income levels, the likelier it is that intra-industry trade will be significant. Consequently the aggregate adjustment costs associated with a RTA are likely to be much lower than under a multilateral agreement,⁸ facilitating the negotiation of the former. Globally-oriented exporting firms may be indifferent between the status quo and a RTA as long as external trade barriers are not raised, and may actively support it if it is perceived that negotiating power of the regional entity enhances the probability of negotiating greater access to third markets. The extent of intra-industry trade can also be regarded as a proxy for the regulatory 'closeness' of countries as regards tradable services, trade not being feasible at all if the regulatory regimes differ too much. The next section investigates what available data reveal on this issue as far as trade in services is concerned.

Another element determining the choice between RTAs or MTNs concerns the enforcement of commitments made under alternative agreements. RTAs may allow more credible commitments to be made, for a variety of reasons. First, in a regional arrangement it may be easier to monitor the implementation of the agreement as there are fewer countries involved, and the similarity (and proximity) of the member countries is likely to imply that industries are better informed regarding actions by rivals or foreign governments that are deemed to violate the negotiated agreement. Second, a RTA may allow for greater supranational enforcement mechanisms, as well as

8. This hypothesis is often postulated in the literature and has been supported by empirical studies. See Greenaway and Hine [1991] for a recent survey of the theory and evidence in the EC context.

speedier and less uncertain implementation. The European Court of Justice and the bi-national panel process in the Canada-U.S. trade agreement provide examples. Third, a RTA may come closer to satisfying the necessary conditions for a self-enforcing agreement than a MTN can because the set of issues it deals with is likely to be greater, increasing the costs of breakdown.⁹ In terms of the formal framework, there will be less uncertainty regarding the implementation of an agreement. This will again be reflected in the vector Θ .

Finally, as noted earlier, the policy stance of an RTA vis-à-vis outsiders may be important in determining the extent to which interest groups can internalize the gains from regional liberalization of markets. Theoretical arguments can be advanced to support arguments that the formation of an RTA will result in external trade policies that are either more or less liberal on average.¹⁰ The issue of the external policy implications of RTA formation is an empirical one, as it depends on the relative power of – and pay-offs accruing to – those industries who would gain and lose from regional market closure. Even if no change occurs, once an RTA exists it may create vested interests that will oppose further liberalization via the MTN process. As noted by Bhagwati [1993], interest groups may argue that the RTA ‘is our market,’ and that ‘our markets are large enough.’ Conversely, a RTA may facilitate multilateral liberalization if import-competing firms perceive the additional threat from this to be low, especially when compensated by greater access to foreign markets. Regional liberalization of service markets will result in reducing the costs of intra-area exchange as service providers are induced to specialize and differentiate their products. The associated cost reductions will enhance the competitiveness of all firms located within the region. Moreover, the associated income gains increases the attractiveness of the region as a market, and creates pressures on other regulatory jurisdictions to follow suit. Firms located outside the region will perceive themselves to be placed at a competitive disadvantage. Such firms face various options, one being to seek to establish within the region, another being to extend the liberalization through either accession to the regional bloc

9. See Yarbrough and Yarbrough [1992] for a detailed analysis.

10. See the contributions in Anderson and Blackhurst [1993] and de Melo and Panagariya [1993].

and/or through multilateral negotiations.¹¹

Summing up, although *a priori* the number of countries in the RTA context is smaller, the number of issues and interest groups may be as large, if not larger, as under a MTN. Notwithstanding the fact that the complexity of the two types of liberalization approaches is therefore similar, a number of arguments can be made why in the services context regional agreements may be preferred. What matters from the perspective of the global trading system is not only why RTAs involving services are being pursued, but the implications for multilateral liberalization efforts. Although some of the service-specific variables that have been identified are difficult to measure, in the following two sections attention will center on: (1) what available data suggest regarding the likely preference of specific governments and service industries for regional versus multilateral liberalization; and (2) the degree of overlap between the regional services trade agreements and the GATS. As regards the latter, it can be hypothesized that the more similar are the regional agreements to the GATS in terms of sectoral coverage and rules/principles, the more likely that the two approaches are complementary.

III. Preferences for Alternative Fora: What Do the Data Suggest?

The stance of potentially affected interest groups (primarily sector-specific factors and industry regulators)¹² in the short to medium run depends on numerous factors. National endowments, factor-intensity of production, the trade orientation of specific industries (export-oriented or import-competing), and the likely magnitude of adjustment pressure subsequent to liberalization of market access are among the more important. The degree to which political support for regional arrangements is driven by trade diversion and the possibilities for industries to determine the external trade policy stance of a regional entity are additional factors that may be influential. In this section the focus is on what available data reveal about the likely preference of OECD producers of tradable and nontradable services.

11. Baldwin [1993] has explored the incentive effects of regional integration for 'outside' firms.

12. Consumers and users of intermediate service inputs should always prefer multilateral over regional liberalization.

Trade specialization or 'revealed comparative advantage' indices have been used extensively in the literature as a proxy for determining the pattern of comparative advantage across countries. While only loosely consistent with the theoretical literature on comparative advantage – which relates trade patterns to differences in technology and factor endowments that are reflected in relative costs of goods and services – these indices are nonetheless useful for descriptive purposes, *e.g.*, determining the export orientation of industries. Trade specialization or 'revealed comparative advantage' (RCA) indices are defined as the ratio of exports of a "product" category to a country's total exports, divided by the same ratio for the sum of all the countries in the sample (*i.e.*, $[X_{ij}/Y_j]/[X_{it}/Y_t]$, where X_{ij} are exports of product i by country j , Y_j are total exports of goods and services by country j , and t stands for the group total: the sum of all countries). The value of this index may range from zero to a very large number. If the index is greater than one this implies that the country is relatively specialized in the product concerned. RCA indices may provide some information on the possible preference of different countries for multilateral liberalization. The more specialized is a country in exporting services relative to the world, the more likely it is to favor multilateral liberalization. Conversely, countries that are not specialized in services can be expected to prefer a regional approach, assuming any liberalization is feasible at all.

Balance-of-payments statistics are currently the only source of information on trade in services available on a global basis. "Commercial services" transactions are considered to comprise the sum of "transport" (largely freight and passenger transport by sea and air), "travel" (expenditures by nonresidents – mostly tourists – while staying in a foreign country), and "other services." The last category includes items such as brokerage, insurance, communications, leasing and rental of equipment, technical and professional services, income generated by the temporary movement of labor, as well as property income (royalties).¹³ While country coverage for aggre-

13. Thus, official transactions and investment income are excluded from commercial services. Labor and property income are included because some countries include these items indistinguishably in the aggregate category "other services and income." It should be noted that labor income does not include worker remittances or migrant's transfers.

Table 1
Revealed Comparative Advantage Indices for Trade in Services, 1989

Country/Region	Goods	All Services	Transport	Travel	Other Services
Developed countries	98.5	106.5	105.2	98.9	111.3
Developing countries	104.4	81.0	79.1	111.5	67.0
Canada	110.2	55.5	14.5	76.2	68.8
Denmark	92.6	132.3	178.8	103.3	117.7
Finland	104.2	81.7	104.5	64.3	76.6
France	90.0	143.7	138.9	118.8	163.9
Germany	107.7	66.6	62.2	39.3	89.8
Italy	96.8	113.9	91.2	114.8	127.9
Netherlands	98.2	107.6	165.0	41.2	114.7
Norway	88.5	150.0	345.4	61.1	70.8
Portugal	93.7	127.2	72.4	275.3	49.5
Spain	77.9	196.1	138.7	405.7	70.5
USA	95.5	119.5	120.1	129.4	108.9

Source: IMF, Balance of Payments Yearbook [1992], and national sources.

gate categories such as "transport," "travel," and "other services" is relatively comprehensive, only OECD countries provide more disaggregated data.

Table 1 reports RCA indices for the developing and industrialized country groups and for the United States, Canada, and the major EC countries.¹⁴ For ease of reading, all indices have been multiplied by 100. Developing countries as a group tend to be relatively specialized in merchandise, while industrialized countries are specialized in services. Of the OECD countries, Norway, Denmark and the Netherlands are highly specialized in transport, Portugal and Spain in travel (tourism), while France, Italy, the Netherlands, and the United States are relatively specialized in "other" services (*i.e.*, non-transport, non-travel-related services). Some care is necessary in interpreting these indices, given that the number of products over which they are

14. The choice of EC countries was determined by availability of comparable disaggregated data on trade in services.

calculated is small and the difference between the relative importance of merchandise compared to services is large. The indices reported in Table 1 relate to exports on a balance of payments basis at a high level of aggregation, reflecting the nonavailability of detailed trade statistics for services. It should be noted that merchandise accounts for about 80% of world trade. Thus, if a country exports no commercial services at all, the merchandise index will be about 1.2. The upper bound for the commercial services ratio is much higher at 5.6, as their share in world exports is only 18%. Given that "transport," "travel," and "other services and income" account for 6%, 5%, and 7% of world trade, respectively (GATT, 1989), upper bounds for their specialization ratios are 16.7, 20.0, and 14.3. This should be kept in mind when interpreting the reported figures.

Table 2 reports relative specialization indices for a number of OECD countries that report more disaggregated data on the category "other services," where the denominator of the ratio is now the average of this group of countries. The services involved are transport, tourism, banking, insurance,

Table 2
Revealed Comparative Advantage Indices for Trade in Services,
Selected OECD Countries, 1989

Country	Commercial Services	Transport	Tourism	Banking	Insurance	Communications	Construction
Canada	47.3	49.2	48.8	43.6	114.4	121.2	48.2
Denmark	129.5	207.3	76.4	21.5	63.4	134.0	n.a.
Finland	69.6	76.9	49.9	1.7	354.3	77.3	260.8
France	110.0	80.4	94.7	289.0	142.2	62.3	94.9
Germany	52.9	42.4	31.3	31.6	1.0	105.4	119.3
Italy	97.6	61.9	89.1	128.5	92.1	40.8	193.9
Netherlands	90.6	118.3	31.6	30.4	1.6	93.6	114.4
Norway	127.7	239.4	47.2	n.a.	27.7	97.8	88.8
Portugal	109.2	49.0	213.9	n.a.	13.4	n.a.	n.a.
Spain	164.8	93.2	318.2	79.5	121.5	48.0	33.3
U.S.A.	100.8	82.0	98.8	176.1	69.9	219.7	40.4

Note: For definitions, see Table 1.

Source: EUROSTAT [1990] and OECD [1992].

ance, communications and construction. Data were drawn from EUROSTAT [1991] for the EC countries, complemented by OECD [1991a] for the non-EC countries.¹⁵ The six sectors were chosen on the basis of being relatively comparable across countries. The data in Table 2 illustrate that there appear to be wide differences in specialization across countries. Norway and Denmark are highly specialized in transport, the U.S. and France in banking, Finland in insurance and construction, and the U.S. in communications. The main implication of these data is that OECD producers of tradable services should favor both multilateral and regional liberalization, the former because they have a RCA in services in comparison to the rest of the world, the latter because various OECD countries are relatively specialized in different services.

The relative importance of intra-industry trade (IIT) is often regarded as an indicator of the extent to which significant adjustment pressures are likely to arise as a result of liberalization, and can be seen as a proxy for the regulatory 'closeness' of countries. The higher is IIT among a given set of countries, the more likely is a preference for a RTA. Two measures of intra-industry trade in services are reported in Tables 3 and 4. The first, reported in Table 3, is the Grubel-Lloyd index, defined as

$$GL = \frac{\sum_i (X_i + M_i) - \sum_i |X_i - M_i|}{\sum_i (X_i + M_i)}$$

where X_i and M_i are a country's exports and imports of industry i , respectively. Because the Grubel-Lloyd index is biased downwards by an overall trade imbalance, the Michaely index of similarity of exports and imports is reported in Table 4. It is defined as:

$$M = 1 - \sum_i \left| \frac{X_i}{\sum X_i} - \frac{M_i}{\sum M_i} \right|$$

15. It should be noted that Italian construction trade data are estimates based on information on international contracts awarded published in *Engineering News Record*, various issues. Furthermore, volume data for countries reporting the value of trade in communications was used to estimate Danish trade in communications using the volume (minutes) of international calls reported in Siemens, *International Telecom Statistics*, Munich: Siemens, 1991.

Table 3
Grubel-Lloyd Intra-Industry Services Trade Indices

	Services					Merchandise	
	1980	1983	1985	1987	1989	1980	1985
Belgium-Lux	84.2	86.3	87.1	84.4	83.8	84.1	86.7
Denmark	77.5	73.9	80.2	82.3	79.3	67.4	72.6
France	85.0	82.3	81.1	85.6	85.7	86.1	85.5
Germany	71.0	76.4	76.6	73.6	74.6	55.4	68.2
Italy	62.0	59.3	64.0	71.2	79.5	69.6	69.5
Netherlands	69.2	72.0	68.3	68.9	68.8	77.9	76.3
Spain	52.0	49.6	47.6	45.2	51.8	50.4	68.2
United Kingdom	80.8	85.3	82.9	83.5	80.9	80.8	84.3
Canada	88.2	81.4	85.6	83.8	85.3	64.5	76.4
United States	78.3	70.6	69.0	73.9	77.7	68.2	66.5

Source: Services trade data are drawn from EUROSTAT [1990] and OECD [1992]; merchandise intra-industry indices are from Greenaway and Hine [1991].

Table 4
Michaely Index of Intra-Industry Trade in Services

	Services					Merchandise	
	1980	1983	1985	1987	1989	1980	1985
Belgium-Lux	69.0	71.5	73.0	70.8	69.0	83.3	86.5
Denmark	44.1	47.9	59.2	65.7	53.6	67.5	72.5
France	69.5	65.9	65.2	73.8	73.9	85.9	85.4
Germany	50.9	59.0	61.6	59.2	60.7	72.6	76.1
Italy	16.6	12.2	21.1	40.8	58.7	68.3	68.9
Netherlands	39.0	44.5	36.8	37.7	38.2	77.4	76.4
Spain	18.9	5.7	6.7	4.3	12.6	57.9	69.8
United Kingdom	66.1	68.8	69.9	65.9	61.7	81.5	84.5
Canada	80.4	64.6	76.2	78.8	77.7	64.9	76.4
United States	54.3	39.6	42.4	46.8	50.7	68.0	75.4

Source: Services trade data are drawn from EUROSTAT [1990] and OECD [1992]; merchandise intra-industry indices are from Greenaway and Hine [1991].

Both indices range between 0 and 1, intra-industry trade being greater the closer they are to 1. For convenience all indices have again been multiplied by 100 in the tables. The number of disaggregated service categories reported by countries varies. The EC countries report 14 such categories, Canada 15, and the United States 21.¹⁶ It can be seen from Tables 3 and 4 that IIT is quite high on the basis of either index for all countries except Spain. The tables include intra-industry trade indices for merchandise, drawn from Greenaway and Hine [1991], which are based on data for 28 goods-producing sectors.

On average, it appears that the magnitude of intra-industry trade in services is very similar to that in merchandise for the countries reported. Intra-industry trade is significantly greater than for merchandise in Canada, Denmark, and Germany, while the opposite holds only for Spain. It is well known that intra-industry trade in merchandise has grown substantially over the last two decades. The mean Grubel-Lloyd index for merchandise trade of the OECD countries for which services data are available was 67.4 in 1970, 70.4 in 1980 and 75.4 in 1985. The average index for services also demonstrates an upward trend, but increases are smaller. The average of the services indices increased from 72 in 1979 (the first year for which EC data are available) to 74.2 in 1985 to 76.7 in 1989. In interpreting these numbers it should be kept in mind that the smaller number of service categories as compared to merchandise items may bias the service indices upward. However, the difference between the number of service and merchandise sectors for the most recent years is relatively small, so that even though both IIT indices are likely to be biased upward, the goods and services indices should be comparable.

The significance of intra-regional trade has been considered as another criterion for both the appropriateness and likelihood of countries forming an RTA. The relative importance of intra-regional trade can be regarded as one indicator of the extent to which benefits of an RTA are already 'internalized.' For the EC as a whole the share of intra-regional trade flows in services in total trade flows was 45 percent on average in the 1979-82 period, rising to

16. However, for the United States this coverage is only available for recent years. Up to 1985 the United States reports only 10 categories.

Table 5
Intra-Regional, Intra-Industry Trade in Services

	1979	1980	1983	1985	1987	1989
Belgium-Lux	76.2	80.0	81.6	82.1	81.9	83.4
Denmark	57.8	77.8	73.5	68.9	67.5	70.2
France	89.1	90.9	86.8	85.6	87.1	86.0
Germany	64.1	65.4	66.8	69.4	69.4	70.6
Italy	41.9	44.3	50.3	56.8	65.4	78.4
Netherlands	69.5	72.8	72.3	68.9	72.8	73.7
Spain	39.7	43.2	41.7	38.6	39.4	45.9
United Kingdom	78.8	78.1	68.3	66.5	64.5	65.0
Canada-U.S.	n.a.	n.a.	n.a.	n.a.	77.9	78.0

Source: Data are drawn from EUROSTAT (1990) and OECD (1992).

47 percent in the 1986-88 period. This compares to 53.5 and 58.5 percent for merchandise (EUROSTAT [1990]). Virtually all of the increase in intra-regional trade in services occurred for the category "other" commercial services, which increased from 38.5 percent to 42.5 percent over this period. For Canada, trade with the United States in the late 1980s accounted for 60 percent of total trade in commercial services. However, for the United States trade with Canada accounted for only 9 percent of total services trade.

Data on the importance of intra-regional, intra-industry trade using the Grubel-Lloyd measure is contained in Table 5. Contrary to what might be expected a priori, in 1989 the intra-industry index for intra-regional trade in services was lower than the index for trade with the world.¹⁷ However, intra-regional, intra-industry trade appears to have been growing faster than intra-industry trade more generally. In the eleven-year period for which data are available, the intra-EC intra-industry trade index rose by some seven

17. This is not due to the influence of travel, in which certain EC countries are specialized. Recalculating the indices without travel only has a significant impact on the index for Germany (a major 'importer') and Spain (a major exporter) increasing by 10 and 25 percentage points respectively in 1989 (not reported).

percentage points, as compared to an increase of four percentage points for the general index. Intra-regional, intra-industry trade for the United States and Canada is somewhat higher than for the EC (78 in 1988 vs. 71.6 for the sample of EC countries).

RCA and IIT indices are only relevant for tradable services. As noted earlier, many services are not tradable. If so, FDI will be the only mode through which markets can be contested, and the service industries affected will only be concerned with establishment. While existing data are inadequate to be able to identify which services are in this category, commercial services currently account for only 22 percent of total trade of the OECD countries in the sample (about 20 percent for the world as a whole). In turn transport and travel account for most of this services trade. "Other services" represent about 6.5 percent of total trade of these countries, of which services such as banking, insurance and communications account for between one-sixth and one-third. The relative importance of trade in these services is therefore limited.

Producers of non-tradable services will generally have to contest foreign markets through foreign direct investment (FDI). Not surprisingly, FDI flows in services varies between 25 and 80 percent of the total stock of inward FDI in most host countries. As of the late-1980s, over 40 percent of the world stock of FDI was in services activities, and this share has been expanding. A large proportion of such investment is in the financial services sector. Financial services accounted for some 50 percent or more of total inward FDI in services in many OECD countries. In conjunction with the relatively low volume of trade in financial services, this suggests that many of these services are not readily tradable.¹⁸

As demonstrated in Table 6, by far the largest share of FDI flows originate in the major OECD countries and go to other industrialized nations. While the general shift in Japanese FDI away from developing countries is particularly striking, all major source countries display a shift towards services FDI and towards other OECD countries. The FDI data illustrate a revealed preference for regional integration, both on the part of the indus-

18. There are, of course, very large capital and foreign exchange flows between countries on a daily basis. But this does not constitute trade in services.

Table 6
Stocks of FDI by Source Country and Host Region, Various Years

(percentage of total and US \$ billion)

Country	Period	Developed Countries			Developing Countries			Total (US \$bn)
		Primary	Manufac.	Services	Primary	Manufac.	Services	
Canada	1975	16.1	46.2	14.3	4.9	4.2	14.1	10.7
	1989	11.0	42.4	32.8	2.6	2.5	9.4	66.9
Germany, Fed. Rep.	1975	1.5	35.3	37.1	2.6	13.0	4.7	20.0
	1990	1.2	33.6	49.7	1.1	9.6	4.8	143.4
Japan	1975	10.9	8.8	26.5	17.2	23.6	13.0	16.0
	1990	2.5	17.7	48.5	3.5	8.5	19.3	310.8
Nether- lands	1973	40.4	33.7	9.5	7.1	5.5	3.7	15.8
	1990	28.9	19.7	39.9	3.5	4.3	3.7	100.0
United Kingdom	1974	7.0	49.3	22.4	4.3	11.5	8.0	23.6
	1984	27.5	27.3	26.9	5.9	4.5	8.0	101.1
United States	1975	19.9	36.6	14.4	3.8	8.4	7.0	124.2
	1990	7.5	24.5	24.7	4.3	6.4	10.9	550.5

Source: United Nations and World Bank [1993].

tries involved and the governments that allow it. This should facilitate a RTA approach, given that integration is to some degree already a *fait accompli*. It cannot be inferred from the data what the stance of producers of non-tradable services is likely to be with respect to multilateral liberalization. Intra-OECD flows are already large, and high growth rates of services FDI in the last decade suggest barriers to such FDI are relatively low. Insofar as the large extent of intra-OECD cross-hauling of FDI implies that significant adjustment costs (scale effects) already have been – or will be – incurred (realized) in the regional context, the incremental costs of multilateral liberalization may be low.

Summing up, this review of available data on trade and investment in services reveals that: (1) intra-industry trade is high for those OECD countries that report disaggregated trade data; (2) the relative importance of intra-regional trade in services is significant, but is smaller than for merchandise

trade flows; (3) many – but certainly not all – OECD countries have a ‘revealed comparative advantage’ in services; and (4) FDI in services accounts for half or more of total FDI in many countries, with most investment concentrated in financial and distribution services, has been growing rapidly, and is mostly an intra-OECD affair. Although the data that are reported in the tables should be interpreted with care, given the general weakness of service statistics and the small magnitude of the absolute value of the trade flows involved, the relatively high level of intra-industry and intra-regional trade in services, as well as the intensity of intra-OECD FDI flows in services, suggests a revealed preference for RTAs. However, RCA and FDI data also suggest that outward-oriented service industries may support multilateral liberalization as well. The magnitude of intra-OECD FDI and trade in services suggests that most new opportunities will lie in third countries. Insofar as import-competing firms will already have adjusted to substantially more external competition (or the threat thereof), the marginal cost of multilateralization of regional liberalization may be perceived as being low, especially if the quid pro quo is greater access to third country markets.

IV. Comparing the regional and multilateral arrangements

Both the conceptual and the data-based discussions of the foregoing sections lead to ambiguous conclusions regarding the preferences of interest groups for alternative fora. However, they do suggest that: (1) because market access barriers take the form of regulatory regimes, a regional approach may be preferred by many industries and regulators; (2) such preferences may be augmented insofar as there are scale effects and externalities that are regional in scope; (3) regional liberalization between OECD members may be more feasible insofar as intra-industry trade and intra-regional trade and investment flows are significant; and (4) multilateral liberalization may well be supported wherever regional liberalization has already occurred. Whether regional and multilateral approaches are complements ultimately can only be answered by the agreements themselves. The problem here, of course, is that both approaches are in a state of flux. Indeed, the sectoral coverage of the multilateral treaty on trade in services

remains under negotiation at the time of writing. Nonetheless, enough information exists to allow a preliminary analysis. In what follows the focus is only on RTAs involving OECD members and the GATS.

Clearly the EC is unique among regional agreements. The provisions of the Single European Act go far beyond those of the other agreements. The EC illustrates that far-reaching liberalization of service markets is feasible in a regional setting. In the context of this paper, the relevance of the EC is that it provides a benchmark for purposes of comparing the other RTAs — the Canada-U.S. FTA, the NAFTA and the Australia-New Zealand Closer Economic Relations (CER) trade agreement — with each other and with the GATS. All these agreements are limited to inter-governmental cooperation, liberalizing access to markets without involving any significant degree of supranationality. Four dimensions for comparison purposes are suggested by the EC experience: (1) sectoral coverage; (2) the magnitude of exceptions to nondiscrimination; (3) the impact on reducing licensing and certification related barriers to trade; and (4) the treatment of nondiscriminatory measures that restrict the contestability of service markets.¹⁹

1. The CER and NAFTA take a negative list approach to coverage (that is, all sectors covered except those listed in annexes); GATS and CUSFTA a positive list (*i.e.*, only those sectors explicitly mentioned in annexes are covered). While either approach can lead to the same outcome, a negative list is more transparent. It forces parties to list all nonconforming measures and excluded sectors, whereas a positive list approach does not. Aside from this major difference, superficially the four agreements appear to be rather similar with respect to coverage. The same sectors tend to be excluded: basic telecommunications, air and water transport, social services, government procurement. These have also been the sectors where the EC has encountered difficulties in liberalizing market access. This suggests that industries that favor or oppose liberalization display similar preferences in both regional and multilateral fora. NAFTA goes further than the GATS on road transport, but does not open up air or maritime transport (cabotage). Although

19. See Hoekman and Sauvé [1993] for a detailed discussion of the provisions of the various agreements and a comparison based on a somewhat different set of criteria. Hindley [1987] and Pelkmans [1990] review the EC, Whalley [1991] the Canada-U.S. FTA, Lloyd [1991] the CER, and Hoekman [1992] the GATS.

transport is formally covered by the EC-92 liberalization program, even in that context it is proving difficult to make significant changes (Messerlin, 1990). Before '1992' transport was effectively excluded from the scope of liberalization, and it remained excluded in CUSFTA and may well be excluded from the GATS.²⁰

Conversely, financial services providers in the United States and the EC have recently become more interested in obtaining greater market access opportunities in each other's markets and in third markets (*e.g.*, ASEAN). In part this desire was driven by recent advances in information and telecommunication technologies that increased the tradability of many financial services – both at the retail and the wholesale level. American financial services firms – banks and insurance companies – have been especially active in *both* regional and multilateral services negotiations. They were prime movers behind the formation of the Coalition of Service Industries, and created a Financial Services Group in mid-1989 to lobby American negotiators. The industry was influential in opposing attempts by the United States Treasury to have financial services excluded from a multilateral agreement on trade in services (Westlake, 1990) and was able to induce the American government to oppose the reciprocity provisions of the EC Commissions first draft of the Second Banking Directive. The CUSFTA, the NAFTA and the GATS all contain separate but similar language on financial services that goes a bit beyond the general provisions of each agreement in terms of liberalizing access to service markets.

Although the sectors that are excluded altogether are similar under the various agreements, the GATS makes a distinction between general obligations and specific commitments. This has important implications for the sectoral coverage of the GATS, as it reduces the effective coverage of the agreement (see below).

2. Under the EC, NAFTA and CER national treatment is a general obligation and no distinction is made between modes of contesting service markets. Under the GATS national treatment is a "specific commitment" that

20. Air transport has been taken out of the GATS through the sectoral annex. With the exception of certain ancillary services, other transport services are unlikely to be scheduled by many countries.

applies only to scheduled services. The GATS is therefore the least far-reaching agreement by far. Agreement was reached in the GATS context to supplement national treatment commitments with market access commitments. Six measures restricting market access are in principle prohibited. Both national treatment and market access are specific commitments that apply only to service sectors that are listed by Member states, and then only to the extent that sector-specific qualifications, conditions and limitations are not maintained. Any or all of the six types of measures that are prohibited in the market access article may continue to be applied to a sector that is listed by a country as long as these measures are also listed. The effective sectoral coverage of the GATS therefore depends both on the service sectors that are subjected to the two specific commitments by individual countries, and on the extent to which measures violating these commitments are maintained. Developing countries have tended to schedule relatively few service sectors. OECD countries have done more in terms of scheduling service sectors, but generally maintain numerous measures that violate either national treatment or the market access article.

While the GATS is the only agreement where national treatment is not a general obligation, both NAFTA and the GATS allow for derogations to MFN, whereas the EC and CER do not. In both the former cases the need for a derogation arose in large part because of potential concerns of the telecommunications industry regarding market access opportunities in other countries. In the final days of the Uruguay Round it became clear that a number of participants were ready to invoke exceptions to MFN for financial services, basic telecommunications, maritime transport, and/or audiovisual services. Rather than allow a situation to develop where countries would withdraw conditional offers in these areas and exempt them from the MFN obligation, a compromise solution was reached under which negotiations could continue without endangering the establishment of the GATS. Negotiations on financial services are to be concluded within six months of the entry into force of the agreement establishing the WTO. Talks on basic telecommunications and maritime transport are to be concluded by end-April and end-June 1996, respectively.

3. With the exception of the EC, under all the agreements there are no or limited provisions for harmonization or mutual recognition of regulatory

regimes pertaining to licensing and certification of professional services providers. NAFTA comes second to the EC in that there is an obligation to abolish nationality or permanent residency requirements for licensing of professional service providers. Furthermore, a mechanism is created for mutual recognition of licenses and certifications. However, there is no obligation to recognize credentials of service providers from another country.²¹ Both CER and GATS encourage the negotiation of recognition arrangements, but do not require it.

4. Nondiscriminatory regulations often effectively constrain the contestability of service markets. This is explicitly recognized in the NAFTA and the GATS. The approach taken towards such measures is very similar under both agreements, as countries remain unconstrained to impose such regulations. The main difference arises because of the top down, negative list approach of NAFTA, which implies that parties must list all such measures in an annex. This is not the case under the GATS. However, both agreements consider such regulations as subject to liberalization negotiations. The EC is the sole agreement to impose significant disciplines on subsidization of service industries. CER only prohibits *new* export subsidies or measures with a direct distorting effect on trade. NAFTA and GATS do not impose any disciplines at all in this connection.

Summing up, do the RTAs go much beyond the GATS? Abstracting from the EC-92 program – which clearly goes far beyond the GATS – the answer is yes, but less than might be expected. The CUSFTA grandfathered all existing measures affecting the provision of services, immediate liberalization effectively being restricted to the financial services sector. The NAFTA goes substantially further than the CUSFTA, especially in terms of transparency. It is much ‘cleaner’ than the GATS in that a negative list approach to coverage was taken, no distinctions are made regarding modes of supply and national treatment is a general obligation. The NAFTA is undoubtedly superior to the GATS in terms of structure and substantive obligations. Specific commitments by countries in the GATS context fall far short of equivalence with NAFTA. However, it is noteworthy that the countries that are

21. NAFTA allows for MFN derogations; *i.e.*, there is no a priori obligation to extend the benefits of recognition agreements (Hoekman and Sauvé, [1993]).

member of RTAs (EC, US, Canada, Australia and New Zealand) did make large offers in the MTN. Thus, not only do excluded sectors tend to be similar across agreements, so are the sectors that are subjected to liberalization.

This suggests that regional and multilateral agreements are seen as complements, not substitutes, by those industries in favor of market access liberalization. Why this is so cannot be answered unambiguously, but two factors are arguably significant. First, and most obviously, the industries that are able to exclude themselves from liberalization are politically powerful. Second, even in the regional context it has proven to be difficult to go much beyond acceptance of the rules of nondiscrimination and national treatment. This is enough to ensure that some markets become contestable, but many will effectively remain closed. The required harmonization or mutual recognition of standards that is necessary to allow cross-border trade in many regulated services is difficult to agree to, even if the willingness exists in principle. For example, even if a convincing case can be made that network externalities in telecommunications are great enough to motivate harmonization, agreement must be reached on the standard to be adopted. Countries will have different interests in this respect, each preferring local standards as the adjustment costs of switching regimes may be large.

The stance of the major service industries that were players in the negotiation of the various agreements is consistent with the available – admittedly limited – data on trade and relative specialization. As illustrated in Tables 1 and 2, the United States has a revealed comparative advantage (disadvantage) in financial services and communications (construction and transportation). Financial services and telecommunications providers were strong supporters of multilateral liberalization, whereas the transportation industry – both air and maritime – was strongly opposed to liberalization in both regional and multilateral context. The EC as a whole is relatively specialized in exporting services and not surprisingly became a vocal supporter of a multilateral agreement on trade in services with universal coverage of commercial services.²²

Progress towards multilateral liberalization was driven by firms desiring

22. See Feketekuty [1988] and Woodrow [1990] for more detailed discussions of the preferences and concerns of various service industries.

greater access to foreign markets, complemented by users of service inputs (producer services) seeking to lower their production costs. For some industries – *e.g.*, financial services – pushing for multilateral liberalization was part of a strategy of seeking changes in the domestic regulatory structure. Such changes were considered to be more likely to occur in the *quid pro quo* context of multilateral negotiations. While export-oriented service industries such as financial services were somewhat successful in achieving their objectives, this does not imply that they dominated opposition on the part of industries seeking to keep ‘their’ home market to themselves. Users played an major role as well in convincing regulators and policymakers that changes were required. Indeed, a perception that greater competitiveness required that average service input costs (quality) be reduced (increased) was an important factor explaining regulatory changes in general, and the willingness to allow greater access to service markets in particular. The financial service industry (as a major user of information technology and telecommunications) was again an influential lobby in this connection (Hoekman [1992]).

V. Concluding Remarks

Although theory cannot provide an unambiguous prediction regarding the relationship between regional and multilateral agreements to liberalize trade in services, both conceptual considerations and the available data on trade and investment flows suggests that RTAs should be easier to negotiate and be more far-reaching than a multilateral agreement. This does not imply that the two approaches are substitutes. The review of the agreements illustrates that sectors that are (included) excluded from regional liberalization are also (included) excluded from multilateral liberalization. This suggests that the GATS is likely to be seen as being complementary to the regional arrangements by major service industries in OECD countries. The very existence of RTAs may lead service industries in member countries to perceive the marginal costs of liberalization *vis-a-vis* outsiders to be low. Thus, in the EC context incumbent industries were already confronted with (the threat of) entry by other EC firms; the additional impact of third-party competition may not have been considered to be a major additional threat.

Moreover, given that FDI into the EC was already subject to a liberal regime, and those foreign firms that establish in an EC country benefit from EC-92 rules and principles, liberalization in the MTN context may be redundant for services that require establishment.²³

Explicit recognition of the services dimension underlying recent regional integration arrangements strengthens the viewpoint that regionalism is more likely to support than hinder multilateral liberalization. The effect of regional liberalization of service markets is to enhance the competitiveness of the firms – whether producers of goods or services – located within the region. The costs of intra-area exchange are reduced as service providers are induced to specialize and differentiate their products. The associated cost reductions and income gains increases the attractiveness of the region as a market, and creates pressures on other regulatory jurisdictions to follow suit as firms located outside the region perceive themselves to be placed at a competitive disadvantage.²⁴ Both demonstration and domino effects may therefore be set into motion, the former consisting of emulation, the latter referring to the incentive that is created for non-member countries to seek accession to a regional arrangement. Both responses will foster further integration of the global economy, as it implies that further opportunities for specialization are created.

Of course, this does not have to be the case. The existence of a sufficiently large RTA may also lead firms to believe that the marginal cost of non-agreement in the multilateral setting is low. Thus, some European firms may believe that the Single European Market offers more than enough scope for expansion and consolidation.²⁵ However, the RTAs do not reveal much in the way of actions to keep regional markets closed to third parties. In part this may be because the RTAs did not achieve much up to the late-1980s. But in principle the treatment of non-EC service providers will improve somewhat upon implementation of EC-92 (Pelkmans [1990]). This non-raising of external barriers is another indication that many EC service indus-

23. But not unimportant, of course. One thing the GATS will do is lock in (bind) policies, ensuring that market access conditions cannot be changed costlessly.

24. See Baldwin [1993] for a discussion of this issue.

25. This is less likely to be the case for U.S. firms, as the Canadian and Mexican markets are not that large relative to the rest of the world.

tries and/or regulators/policymakers sought a more competitive environment for service markets. And, the scope for private actions to restrict competition is limited by the EC's competition policy. Similarly, while NAFTA may give rise to some trade and investment diversion, external barriers in the services area do not appear to have increased.

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