Do Economic Integration Agreements lead to Deeper Integration of Services Markets?

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Abstract

Economic Integration Agreements (EIAs) covering services are proliferating against a backdrop of profound changes in services production and trade. After reviewing the basic economics of services trade, and the main features of EIAs in services, the paper provides an initial quantitative estimate of the effect of these agreements on bilateral trade in services, using the standard gravity model. At the same time, the paper estimates the effects of other – not institutionally or politically motivated – determinants of services trade "in the standard gravity tradition." The paper shows that services trade between two countries is positively related to their size and negatively related to the distance between them. In fact, there is evidence of a "home market effect" in services. Most importantly for the sake of this paper and this volume, PTAs appear to have positive effects on bilateral services trade, in the order of 12% to 15%. It has not been possible to find however a significant difference – in terms of

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Preferential liberalization of trade in services is not a new phenomenon, but has become a more common and prominent feature of the latest generation of bilateral preferential trade agreements (PTAs) negotiated in this decade. As of 1 September 2009, 73 economic integration agreements (EIAs) have been notified to the WTO under Article V of the GATS. This list includes all types of EIAs, including *inter alia* the successive European Union enlargements, the European Economic Area, EFTA, NAFTA, MERCOSUR; ASEAN, and more recent bilateral or plurilateral preferential trade agreements covering services. Most of those notifications arrived before the year 2000 – 61 compared to 12 before that year.[3] And many more agreements are currently being negotiated.

One might expect that countries entering these PTAs do so with the objective of eliminating barriers to trade in services, but more importantly, in the hope that the agreements will actually increase bilateral services trade between the parties. Lack of reliable data on trade in services (especially of bilateral flows) has made it almost impossible to carry out empirical studies of the determinants of bilateral services trade flows and – in particular – of the effects of PTAs on trade flows in services. However, the availability of statistics on trade in services has improved over the last year, particularly among OECD countries. Taking those developments in the statistical field into account, the main purpose of this paper is to provide an initial quantitative estimate of the effect of PTAs on bilateral trade in services, using the standard gravity model. At the same time, the paper will provide an opportunity to look into other – not institutionally or politically motivated – determinants of services trade "in the standard gravity tradition." It will be then a way of gauging how well the gravity model

between suppliers and consumers is often seen as necessary to build trust, to complete the transactions, and to remove information asymmetries between suppliers and clients.

The interaction between producers and consumers implies that a definition of trade in services must go beyond our traditional understanding of trade, to encompass provider and consumer mobility across national borders. We will see in subsequent sections of this paper that agreements dealing with services trade (both at the bilateral and multilateral levels) have taken account of this specific feature.

The nature of services has critical implications for what we understand as trade policy in services. Border measures, particularly tariffs, are almost impossible to apply to trade in services for the simple reason that customs agents will not bembouembou.r andelituc3ae trt61ygageners (s)-5.gnse decades. After five years of stagnation in the early 1980s, global exports of services grew regularly, reaching US$ 3,371 billion in 2008, a nine-fold value increase compared to 1980. Exports of services grew on average at around 8.61% a year in value terms over the period 1980-2008, faster than goods exports (7.96%), and definitely much faster than world GDP (6.39%). As a result, the share of commercial services exports in total world exports (goods and services) rose from 15.2% in 1980 to 18.8% in 2008, after reaching an all-time high of 19.7% in 2002 (Figure 1).

Secondly, reflecting new trends in services trade, between 1980 and 2008, the share of *travel* and *transport* in total *commercial services* decreased, to the benefit of *other commercial services.* Indeed, the share of transport in total commercial services declined steadily from 37% in 1980 to 23% in 2008. Exports of travel services expanded vigorously in the 1980s and mid-1990s, going from 28% to 34% of world services trade between 1980 and 1995; but then slowed down, representing "only" 25% of world services trade in 2008. On the other hand, the share of *other commercial services* rose from 35% to 51% of world services trade between 1980 and 2008. These *other commercial services*, which include many services prone to global outsourcing, such as business and computer-related services, have proven to be the most dynamic segment of world trade in the last decades (Table 1).[7]

And thirdly, developing countries' share in world trade in services has grown significantly in the last two decades. For example, if we compare OECD with non-OECD countries, we see that the latter's share in world services exports increased from 22.73% in 1980 to 29.80% in 2008. The share of non-high income countries (both OECD and non-OECD) has grown from 13.87% in 1980 to 20.73% in 2008.[8] Technological advances increasingly allow the spatial fragmentation of goods and services production, and off-shoring to operational units abroad and even outsourcing to a foreign third party service supplier has become common practice among multinational corporations. Developing countries are indeed becoming exporters of so-called Business Process Outsourcing (BPO) services. Low-labour costs, the availability of a well-educated pool of workers, and the improvement in the quality and price of international telecommunications, have allowed several developing countries, most notably India, to take the lead in this field (Marchetti, 2007).

Having said that, it is worth clarifying that these statistics, which are based on Balance-of-Payments (BOP) information, greatly underestimat

Safe for a few exceptions (e.g. sectoral exclusions in the PTA between Australia and Thailand, or the exclusion of financial services from the PTA between EFTA countries and Chile), the sectoral coverage of these agreements is the widest possible – all services are covered, except for the bulk of air transport services and "services supplied in the exercise of governmental authority", which are those supplied neither in competition nor on a commercial basis.[14]

As indicated in the first section of this paper, protectionist measures in services usually take the form of regulations. As explained elsewhere (Marchetti and Mavroidis, 2004) regulations are very heterogeneous, and while some may have been designed as protectionist devices others may be necessary to achieve legitimate economic or social objectives. The GATS, and all the bilateral PTAs including trade in services, deal with the question by distinguishing between trade restrictions and "domestic regulations". The disciplines on market access and national treatment are meant to capture the most outrageous or explicit forms of protection of national service industries, i.e. discriminatory measures or specifically identified limitations on market access; while the disciplines on "domestic regulation" deal with more implicit forms of barriers to trade in services stemming from licensing and qualification requirements and procedures, and technical standards.

Market access and national treatment are thus central obligations in PTAs. Market access provisions are aimed at prohibiting a specific set of governmental measures restricting the supply of services. In GATS-type agreements, six types of market access limitations are contemplated: a) limitations on the total number of suppliers; b) limitations on the total number of transactions or assets; c) limitations on the total value of operations or output; d) limitations on the total number of employees; e) restrictions on the type of legal entity required to supply services; and f) restrictions on foreign equity participation. These corresponds to the measures listed in Article XVI:2(a)-(f) of the GATS. The national treatment obligation is usually defined in GATS-type agreements as in Article XVII:1 of the GATS, as the obligation to "accord to services and service suppliers of [the other party], in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers." Unlike the market access obligation, the national treatment obligation does not identify specific limitations and hence any measure applied to the detriment of like foreign service and service suppliers, either *de jure* or *de facto*, would qualify as a departure from national treatment.

Market access and national treatment are not general and unconditional obligations in GATS-type agreements. In other words, these agreements do not contain any obligation to grant access to, or avoid discrimination of, foreign services and services suppliers. Rather, under these agreements the freedom to access the market through any of those modes of supply, as well as the extent of national treatment, are subject to negotiations, and the resulting commitments are entered into national schedules. As a consequence of this approach, unless the agreement provides for periodic rounds of negotiations, such as MERCOSUR and ASEAN, liberalization of services trade (understood as the granting of access and national treatment to foreign services and services suppliers) may be quite incomplete or, rather, cover a limited number of sectors.

[14] For a discussion on "services supplied in the exercise of governmental authority", see Marchetti and Mavroidis (2004).

A critical element of any trade agreement covering services is its negotiating modality, which determines the sectoral coverage of those liberalization commitments, i.e., the sectors that will be subject to market access and national treatment obligations, and the extent to which these obligations will apply. GATS-type agreements adopt a so-called "positive-list" or "bottom up" modality whereby the liberalization obligations (market access and national treatment) only apply to the sectors listed, and subject to any limitations or conditions inscribed in the schedule of commitments. Limitations may be inscribed with respect to any of the six market access measures described above, and with respect to any discriminatory measure.[15] Under a positive list approach, limitations may be introduced for existing non-conforming measures or for future measures. Moreover, since only "measures" are bound, no indication is given of the relevant laws/regulations on which these are based, which accentuates the lack of transparency of this scheduling mechanism.

Agreements generally adopting a GATS-type approach include MERCOSUR, ASEAN, Thailand-Australia, Singapore-Australia, Singapore-Japan, New Zealand-Singapore, the PTAs signed by the EC, and the PTAs subscribed by EFTA countries.

b) NAFTA-type agreements

These agreements have both a services chapter ("cross-border trade in services") and an investment chapter. The services chapter applies then to measures affecting "cross-border trade in services", which is defined as including the equivalent to GATS modes 1, 2, and 4; but does not cover the supply of a service through foreign direct investment (FDI), which is instead covered by a specific chapter on investment.[16] Further provisions on the movement of some categories of natural persons are also typically found in an additional chapter. And some mode 4-related elements (e.g.,national

Older PTAs, such as NAFTA and Canada-Chile

This category includes basically the set of legislation providing for the European internal market. The central principles governing the internal market for services are set out in the EC Treaty. This guarantees to EC services suppliers the freedom to establish themselves in other Member States, and the freedom to provide services on the territory of another EC Member State other than the one in which they are established. The free movement of services (complemented by the freedom of establishment) is one of the four fundamental freedoms on which the EC internal market is founded. [18]

Any discrimination concerning the provision of services on the basis of nationality is prohibited directly by the EC Treaty, without the need of specific Community legislation. Services covered under this "freedom" include all activities of an industrial or commercial character or of craftsmen and the activities of the professions. "Services" do not include transport, banking and insurance, which have their own liberalization frameworks.[19]

The EC Treaty provisions have direct effect. This means, in practice, that Member States must modify those national laws that restrict the freedom of establishment, or the freedom to provide services; and that the treaty provisions are directly enforceable via the European Court of Justice. EC Member States may only maintain restrictions if they are justified by reasons of general interest (e.g. on grounds of public policy, public security or public health), and provided they are proportionate.

Although the Treaty refers to the freedom to provide services, the European Court of Justice has held that the freedom established by the Treaty includes the freedom, for the recipient of services (such as tourists, persons seeking medical treatment, people travelling for business or study purposes) to go to another Member State in order to receive the service there. So this freedom is not just the freedom to provide (akin to mode 1 of the GATS) but also the freedom to consume services anywhere across the EU (akin to mode 2 of the GATS).

The principles of freedom of establishment and free movement of services have been clarified and developed over the years through the case law of the European Court of Justice. In addition, important developments and progress in the field of services have been brought about through specific legislation in fields such as financial services, telecommunications, broadcasting and the recognition of professional qualifications

Home-country regulation and mutual recognition – within a common framework of minimum requirements – are essential to this approach. In other words, if a service is lawfully authorised in one EC Member State it must be open to users in the other Member States without having to comply with every detail of the legislation of the host country, except those concerning consumer protection. Over the years however, numerous and diverse national regulations were found to prevent the full development of the internal market, and made it necessary to take specific actions to remove the barriers affecting both the freedom of establishment for providers in Member States and the free movement of services between Member States. This was the initial aim of the Services Directive adopted in 2006 that

[18] The other freedoms include the free movement of goods, the free movement of persons, and the free movement of capital.

[19]

sought to establish a general legal framework facilitating the exercise of the freedom of establishment for service providers and the free movement of services.[20]

In the case of the freedom of establishment, the Directive provides for a new framework for authorisation schemes including conditions for the granting of authorisation, duration, procedures, etc. Member States will be able to establish or maintain authorisation schemes only if certain conditions are met and these schemes will have to be non-discriminatory, necessary and proportionate. The Directive also provides for the creation of single points of contact in each EC (in fact EEA) Member State through which providers can complete all procedures and formalities.

In the case of freedom to provide services, Member States shall no longer be able to prevent a foreign service provider from offering his/her services on their territory. Member States may still stipulate their own national requirements, but only for reasons of public policy, public security, public health or protection of the environment. Such national requirements must also respect common Internal Market principles of non-discrimination, proportionality and necessity. In order to make it easier to monitor such requirements, and to give service providers better and easier access to information on national requirements, all Member States are obliged to report and justify their national requirements to the Commission.

The sectoral coverage of the Directive is limited though. Services covered by the Directive are only business-related services, such as management consultancy services; testing and certification services; advertising and marketing services; distribution services; recruitment

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4. An introduction to the gravity equation in international trade

Tinbergen (1962) pioneered the use of the gravity equation in international trade. Since then, Additionally, several authors have discussed the econometric specification of the gravity equation, contributing to the improvement of its performance (e.g. Cheng and Wall (1999), Egger (2000), Feenstra (2004), and Baldwin and Taglioni (2006)).

5. The gravity equation and trade in services

Only a few studies using the gravity equation has been devoted to services, mainly due to the lack of reliable and consistent data on bilateral trade. Grunfeld and Moxnes (2003) apply a gravity equation to bilateral export of services and FDI flows for 1999. Data for services trade comes from the OECD, and covers 22 OECD members and their trading partners, including non-OECD countries. Their regressors (or explanatory variables) include the level of GDP and GDP per capita in the importing and exporting countries, the distance between them, a dummy variable if they are both memb and a common language are found to be the most important determinants of trade between two countries. However, adjacency and membership of the European Union are not found to increase services trade. Walsh's results also show that distance is not a significant services for export, while a higher level of inco

Secondly, in order to assign the date of entry into force to the different agreements, I used the following rule: the agreement that entered into force before end-June of a given year will carry as a date of entry into force that same year, while the agreement that entered into force as of 1 July of a given year will carry as the date of entry into force the following year. For example, if the agreement entered into force on 1 February 2003, the date of entry into force will be 2003; and if the agreement entered into force on 1 December 2003, the date of entry into force will be 2004. The date of entry into force is the one that prompts the value "1" for the dummy variable.

Thirdly, in the case of European countries, I have used data on individual countries' services exports, which allows to capture the effect of both intra-EC trade and extra-EC trade. Intra-european trade among the 25 EC member states will be captured by the EC dummy, which will for example, take the value 1 for the period 1999-2006 for France's exports to Germany, and the value 1 as of 2004 for France's exports to the Czech Republic. Extra-EC trade (e.g. France's or Czech Republic's exports to Chile) will be captured by the PTA dummy.

Some clarifications with regard to the estimation are also in order. Firstly, to be closely aligned with theories surrounding the gravity equation, I focus on unidirectional trade in services, and not on total trade. In particular, I focus on services from country i to country j as the dependent variable. The reason for this is that, as explained by Baldwin and Taglioni (2006) and Subramanian and Wei (2007), the basic theory tells us that the gravity equation is a modified expenditure function; it explains the value of spending by one nation on the goods produced by another nation. In other words, the gravity equation explains unidirectional bilateral trade. In this case, the choice of exports of services, instead of imports, has been on purpose. Indeed, contrary to trade in goods, where import figures are generally more reliable than export figures, in the case of services, the contrary is true –export figures are more reliable than import figures, because surveys of domestic exporters in specific sectors are generally more reliable than survey of importing entities throughout the whole economy.[22]

Secondly, I use country (importer and exporter) fixed effects, to cater for the so-called "multilateral resistance" term. As explained by Anderson and van Wincoop (2003), many omitted factors can influence trade between pairs of countries. The most important of these omitted factors is the so-called “multilateral resistance term". Trade between any two countries depends negatively on the trade barriers of each country relative to the average barrier of the two countries with all trade partners. In other words, when multilateral trading costs (the barriers *vis-à-vis* the "rest of the world) rise relative to bilateral costs (the barriers *vis-à-vis* the bilateral trading partners), trade flows rise between the country pair i and j; and vice versa. Anderson and van Wincoop argue that multilateral resistance cannot be measured using remoteness variables based on measures of distance as these do not capture border effects, rather the gravity equation must be solved by taking into account the impact of barriers on prices. Anderson and van Wincoop show that the estimation of the gravity equation can be greatly improved by incorporating what they refer to as multilateral resistance measures. The importance of Anderson's and van Wincoop's (2003) contribution is acknowledged in the literature. However, as Feenstra (2004) and others have noted, it has not been widely adopted in empirical research given the difficulties in its implementation (a customised programme is needed as the endogenous nature of the price terms requires a non-

[22] I thank Andreas Maurer and Joscelyn Magdeleine, from the WTO, for pointing this out to me.

linear solution). Feenstra (2004) shows that the inclusion of country-specific fixed effects generates the same results as Anderson and van Wincoop (2003) with little loss of efficiency. Since trade between any two countries depends on the multilateral resistance of both importers and exporters, I will use time-varying fixed effects for both importers and exporters, to account for factors specific to each countries, such as the level of barriers (see Subramanian and Wei (2006) for a similar approach).

Thirdly, following Baldwin's and Taglioni's (2006) recommendation, I use (undeflated) nominal trade and GDP data combined with time (year) dummies. As explained by these authors, the usual procedure of deflating trade and GDP figures back to a common year using for example the US price index can introduce important biases. They therefore recommend the use of time fixed effects (or time dummies) to cater for variations in inflation. These time fixed effects would also cater for other changing factors, such as the value of the dollar, the global business cycle, and so forth.

While data on total services trade, as well as trade in selected Balance-of-Payments (BoP) categories such as transport, travel and other commercial services, have been generally available for a long time, only a few countries had offered a breakdown of these data (at least for total services) by trading partner. This explains the fact that previous gravity studies on services trade were only able to focus on very short periods of time – one, two, or three years at most. However, data availability has improved markedly over the last few years, prompted by initiatives at the international level to improve services data collection with a view to *inter alia* match the GATS definitions of trade and the sectoral classification used in negotiations.[23] There are currently three main sources of Balance-of-Payments services trade data at the international level: Eurostat, OECD, and the UN. The country and time coverage offered by these sources are not identical, however.

In a nutshell, the Eurostat Cr7 tr

Data on GDP were taken from the World Bank World Development Indicators. Data on distance, contiguity, and common language were taken from the geographical datagbase compiled by CEPII (Centre d'Etudes ProspectivesData on G[(Data onJ0 two countries con(c)8ke(e)92(nc)8kc

and most importantly for the sake of this paper and this volume, PTAs appear to have positive effects on bilateral services trade, in the order of 12% to 15%.

It has not been possible to find however a significant difference – in terms of their effect on services trade – between PTAs and deep integration initiatives like the European internal market. This may be due to the inherent limitations of the methodology followed in this paper – the gravity equation – which can only give a partial indication of the effect of agreements on bilateral services trade. But it can also point to more fundamental differences between these two types of economic integration schemes. In fact, while the relative openness of the EC to the rest of the world may imply a smaller internal preference margin than in other PTAs, where trading parties maintain more restrictions towards the rest of the world; the results may also be an indication that intra-EC services trade flows are still below their potential, and0i4gnt of thth787 Tw[(openn)-6.4(e(rk)-5.634t)6.1(.explo-4.1(84)]T.4(o)0(4gnt)-d-4.1(4 TD-6.6

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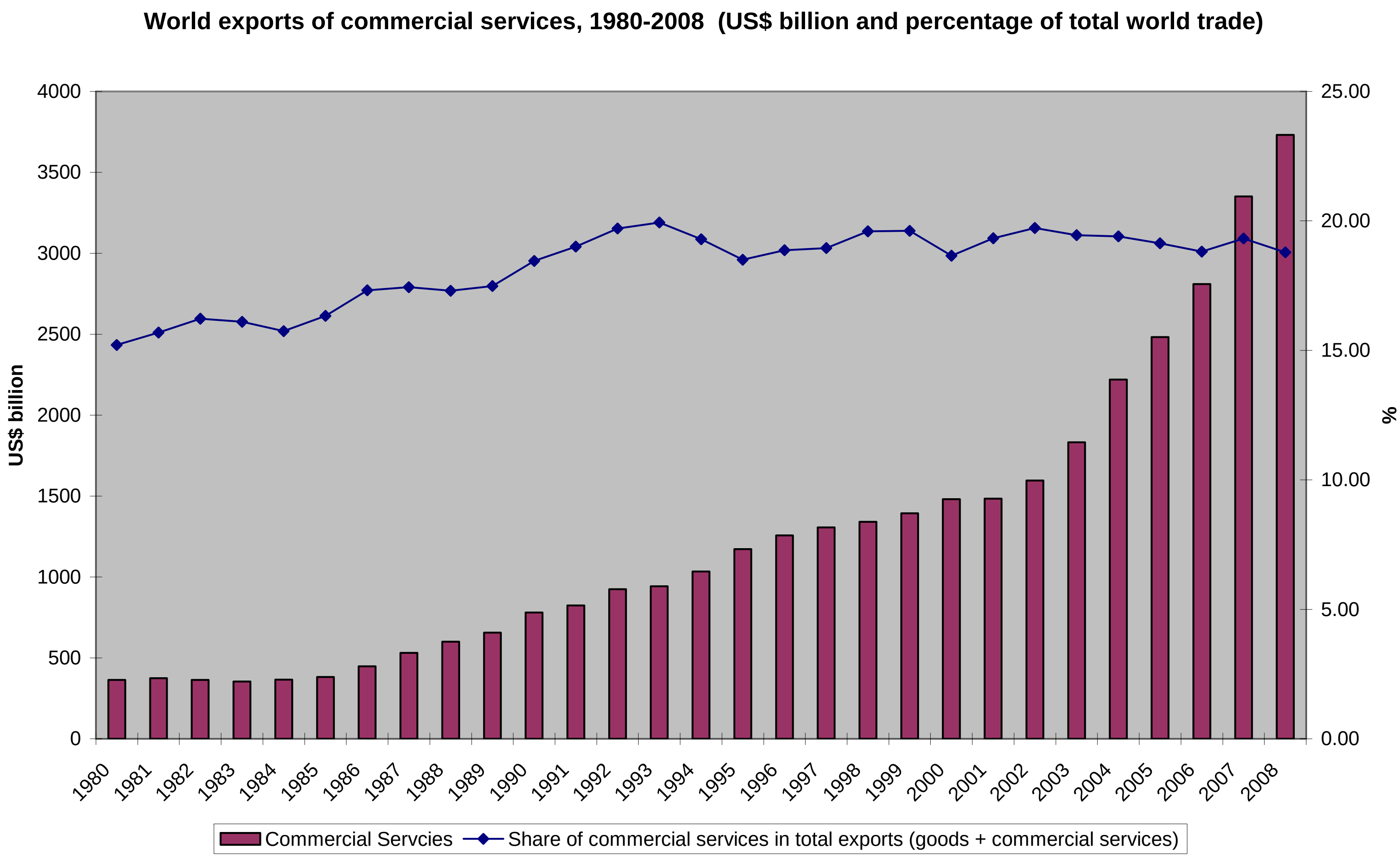
World exports of commercial services, 1980-2008 (US$ billion and percentage of total world trade)
US$ billion
%
4000
3500
3000
2500
2000
1500
1000
500
0
25.00
20.00
15.00
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1980
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Commercial Servcies
Share of commercial services in total exports (goods + commercial services)

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Table 1.Changing patterns of trade in services (in % of total world trade)

	1980	1995	2008
Transport	37	26	23
Travel	28	34	25
Other Commercial Services	35	40	51

Source: WTO statistics database.

Table 2. Economic Integration Agreements covered by the study (and direction of trade flow).

Agreement	Date of entry into

Note: The first trading partner mentioned is the exporter. In some cases, two-way flows were available, such as between Australia and the US, Canada and the US, and the trade between individual EC member states.