

The General Agreement on Trade in Services: Doomed to Fail? Does it Matter?*

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Abstract: Little progress has been made to date in using the GATS framework to lock-in already implemented unilateral reforms, let alone in inducing new liberalization. A number of potential explanations for this limited performance are identified and assessed. These include limited feasibility of using the reciprocity mechanism to mobilize domestic export interests; weaknesses in domestic (complementary) regulatory capacity; uncertainty regarding the magnitude and distribution of costs and benefits of policy reforms; and a preference for bilateral or regional cooperation. All these factors play a role in reducing the ability of the GATS to be an effective instrument to internalize terms of trade externalities and to act as a credible commitment device for policy reform. Changes in negotiating modalities and focus could help strengthen the relevance of the GATS as an instrument of multilateral cooperation.

Keywords: Trade in services, GATS, WTO, trade negotiations

JEL classification: F13, F15

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Introduction

One of the major results of the Uruguay Round was the General Agreement on Trade in Services (GATS). Part of the new World Trade Organization that entered into force in 1995, the GATS greatly extended the coverage of the multilateral trading system by establishing rules and disciplines on policies affecting access to service markets.¹ The GATS was negotiated during a period of far-reaching unilateral reforms of service sector policies, as “natural monopoly” arguments for State-provision or control of major service industries were eroded, and large-scale privatization programs were pursued in many parts of the world, developed and developing. These reforms were driven by technological changes as well as increasing recognition that the cost and quality of services is important for the growth performance of the economy.

An efficient, competitive financial sector is critical in ensuring that capital is deployed where it has the highest returns. Low cost and high quality telecommunications will generate economy-wide benefits, as the communications network is a transport mechanism for information services and other products that can be digitized. Similarly, transport services affect the cost of shipping goods and movement of workers within and between countries. Business services such as accounting, engineering, consulting and legal services reduce transaction costs associated with the operation of financial markets and the enforcement of contracts, and are a channel through which business process innovations are transmitted across firms in an industry or across industries. Retail and wholesale distribution services are a vital link between producers and consumers, with the margins that apply in the provision of such services influencing the competitiveness of firms on both the local and international market. Health and education services are key inputs into – determinants of – the stock and growth of human capital.

Services are very heterogeneous, and span a wide range of economic activities. This diversity masks a fundamental function of many services: they are inputs into production. This function of many services offsets a long-standing concern in the economic literature that a steadily expanding service sector may (must) be associated with a declining growth rate of the economy. These concerns reflect a presumption that limited potential for productivity improvements in services implies that over time the real costs of – and employment in – services must rise relative to other sectors, reducing the growth potential of the economy to

¹ The original GATT-1947 did not cover services because when the GATT was negotiated services were mostly nontradable and GATT did not cover investment. It is only relatively recently that technological change and regulatory reforms allowed an increasing number of services to be traded internationally through telecommunications networks.

that of the “stagnant” services sectors (Baumol, 1967). Once it is recognized that services are often inputs, an expansion of the service sector can increase growth.²

Liberalizing access to service markets (enhancing contestability) will reduce what Konan and Maskus (2006) call the cartel effect—the markup of price over marginal cost that incumbents are able to charge due to restricted entry; and attenuate what they call the cost inefficiency effect—the fact that in an environment with limited competition, the marginal costs of incumbents are likely to be higher than if entry was open. These effects can have significant impacts on all sectors and households in an economy.³

There is an emerging body of econometric evidence that policy reforms to increase competition in services industries, including through international liberalization, can help boost growth prospects and enhance welfare. Mattoo, Rathindran and Subramanian (2006) find that countries that fully liberalized the telecommunications and financial services sectors grew, on average, about 1.5 percentage point faster than other countries. Eschenbach and Hoekman (2006a) find that financial and infrastructure services policy reforms had an important, statistically significant positive impact on per-capita growth of transition economies during the 1990-2004 period. An expanding number of country-specific analyses have found a positive relationship between services liberalization, services sector performance and total factor productivity growth at the level of firms that use the services concerned relatively intensively. These studies tend to find that FDI in services is an important mechanism through which “good practices” and knowledge is diffused to host countries.⁴

In principle, trade agreements can provide a focal point for both liberalization of access to service markets and for policy reforms (“good regulatory practices”), in part by offering a mechanism through which commitments can be enforced. The stylized fact that looms large here, and that motivates this paper, is that very little progress has been made to date in using the WTO to negotiate liberalization of services trade and investment. Indeed,

² This may occur even if there is limited scope for productivity growth in the services concerned, as assumed by Baumol. Oulton (2001) has shown that an expansion in stagnant services inputs may increase overall growth, because greater outsourcing of services by (productive) firms in non-stagnant sectors entails a reallocation of factors that increase overall output and aggregate productivity.

³ Rutherford, Tarr and Shepotylo (forthcoming), for example, develop a model where services FDI is a source of new knowledge and competitive pressure, and helps host countries to produce and export more advanced products. As barriers to trade in producer services fall, costs of imported services drop, and imports (including through FDI) rise and displace domestic firms. However, the additional varieties available to the economy generate positive externalities for final goods production, raising TFP and welfare disproportionately.

⁴ For example, in firm-level analyses of the Czech Republic and India, Arnold, Javorcik and Mattoo (2006) and Arnold et al. (2007) find a positive relationship between services liberalization, FDI in services and the TFP performance of domestic firms in manufacturing. The presence of services FDI is the most robust variable affecting TFP in user firms. See Hoekman (2006) for a survey of the literature.

WTO members are not using the GATS framework to lock-in unilateral reforms that have already been implemented. It is fair to say that to date the GATS has been a disappointment. At the same time, the number of countries that are negotiating preferential liberalization of trade and investment in services is expanding rapidly.

This paper explores alternative explanations for why this is the case. Section 1 summarizes recent services trade and trade policy trends and the status quo in the GATS. Section 2 discusses a number of hypotheses why the GATS is not delivering, and reviews the extent to which preferential trade agreements do a better job in addressing the objectives of the various interest groups concerned. Section 3 makes several suggestions regarding what might be done to enhance the relevance of the GATS. Section 4 concludes.

1. Global Trends: Trade, Policies, and the GATS

Services have unique characteristics that affect their tradability. Typical characteristics include: (i) intangibility – so that international transactions in services are often difficult to monitor, measure and tax; (ii) nonstorability – so that production and consumption often must occur at the same place and time; (iii) differentiation – services are often tailored to the needs of customers; and (iv) joint production, with customers having to participate in the production process.

As the conventional definition of international trade – where a product crosses the frontier – would miss out on a whole range of international transactions, GATS negotiators took an unusually wide view of trade, which was defined to span four modes of supply:

- *Mode 1 – Cross-border*: services supplied from the territory of one Member into the territory of another.
- *Mode 2 – Consumption abroad*: services supplied in the territory of one Member to the consumers of another.
- *Mode 3 – Commercial presence*: services supplied through any type of business or professional establishment of one Member in the territory of another (i.e., FDI).
- *Mode 4 – Presence of natural persons*: services supplied by nationals of one Member in the territory of another. This mode includes both independent service suppliers, and employees of the services supplier of another Member.⁵

Data on the magnitude of the transactions associated with each of these modes are notoriously weak. The primary source is the balance of payments, where measured flows correspond mainly to modes 1 and 2. Data for modes 3 and 4 is very limited. Services trade as defined by modes 1 and 2 roughly tripled over the decade from 1994 to 2004. For the 178

⁵ The GATS does not apply either to measures affecting natural persons seeking access to the employment market of a Member, or to measures regarding citizenship, residence or employment on a permanent basis.

countries for which the IMF reports data the median value of imports of services in 1994 was some US\$550 million. As of 2004, this had increased to US\$1.5 billion. For the world's largest services trader, the US, total reported imports rose from almost US\$200 billion to US\$340 billion.

Table 1: Service imports as a share of GDP, 1994 and 2004

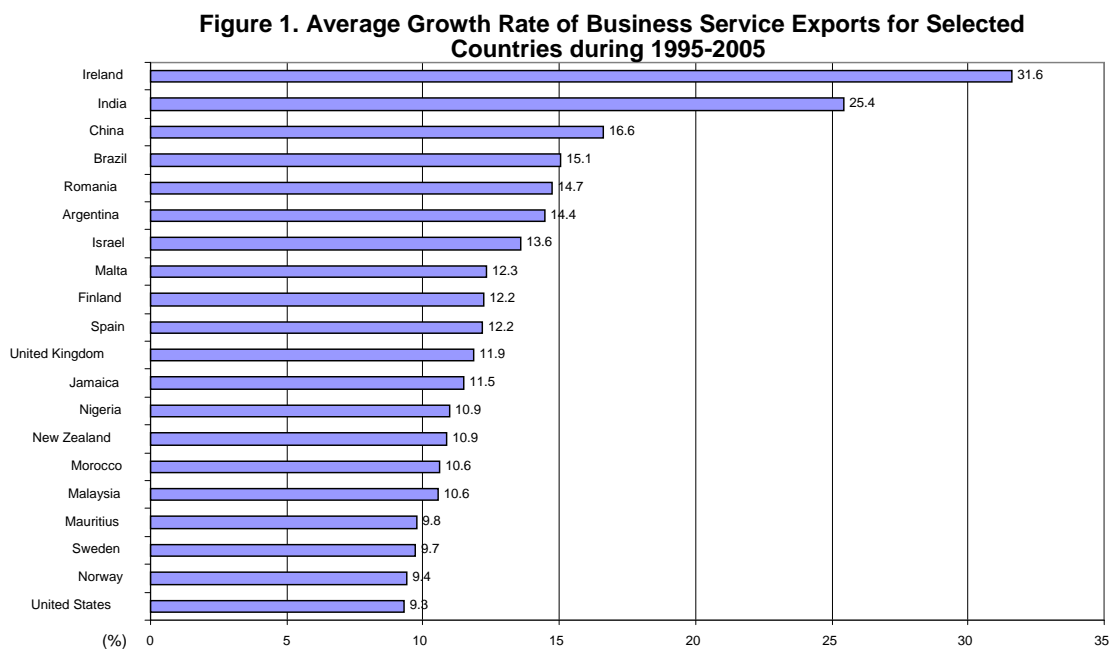
Total services		
	1994	2004
All countries (n=178)	11.0	12.0
High income	8.0	12.7
Upper middle income	11.4	12.8
Middle income	10.3	11.6
Lower middle income	13.6	11.4
Low income	11.7	11.2
Non-transport, non-travel services		
	1994	2004
All countries	4.6	5.1
High income	3.3	6.7
Upper middle income	4.5	5.3
Middle income	4.2	4.6
Lower middle income	6.5	4.9
Low income	4.4	3.8

Source: Francois, Hoekman and Wörz (2007), based on IMF statistics

Notwithstanding the growth in the absolute value of mode 1-2 services trade, if measured as a percentage of GDP it only rose slightly: from 11 percent in 1994 to 12 percent of GDP in 2004 (Table 1). The rising importance of overall trade in services occurring through these two modes stems mainly from growth in imports by high-income countries (from 8 to 12.7 percent), driven by strong growth in producer and business services (for which the import to GDP ratio doubled, rising from 3.3 to 6.7 percent). Imports of financial, insurance, computer, and communication services, and royalties and license fees all increased substantially. As a result, there has been a shift away from travel (tourism) and transport services towards producer and business services.

In contrast to high-income countries, a strong increase in producer related service imports is observed in only a few developing countries. Financial services are an exception, with the median import for developing countries rising from around 0.1% of GDP to roughly 1% of GDP (Hoekman, Francois and Wörz, 2007). Recent technological changes have supported rapid growth in international exchange of business services. The business services exports of developing countries have grown nearly four-fold in the last decade. The average

annual growth rate of business service exports for Brazil and China during 1995-2005 was 15 percent, for India it was 25 percent (Figure 1). In large part this reflects growth in so-called business process outsourcing (BPO) services. Within BPO activities, the more advanced developing countries, such as India, are moving from providing only low-end back-office services (data entry, etc.) to more integrated and higher-end service bundles in fields such as customer care, human resource management, and product development. This move is creating space for other developing countries to enter the more standardized segments of the market.



The high business service export growth rates for developing countries have resulted in their share of global trade rising to 22 percent. Most of this increase reflects expanding exports of Asian countries, which doubled their global market share to reach 14.8 percent in 2005. However, trade in business services continues to be dominated by the high-income countries,⁶ whose global market share in 2005 was 78 percent, down from 86 percent in 1995 (Figure 2).

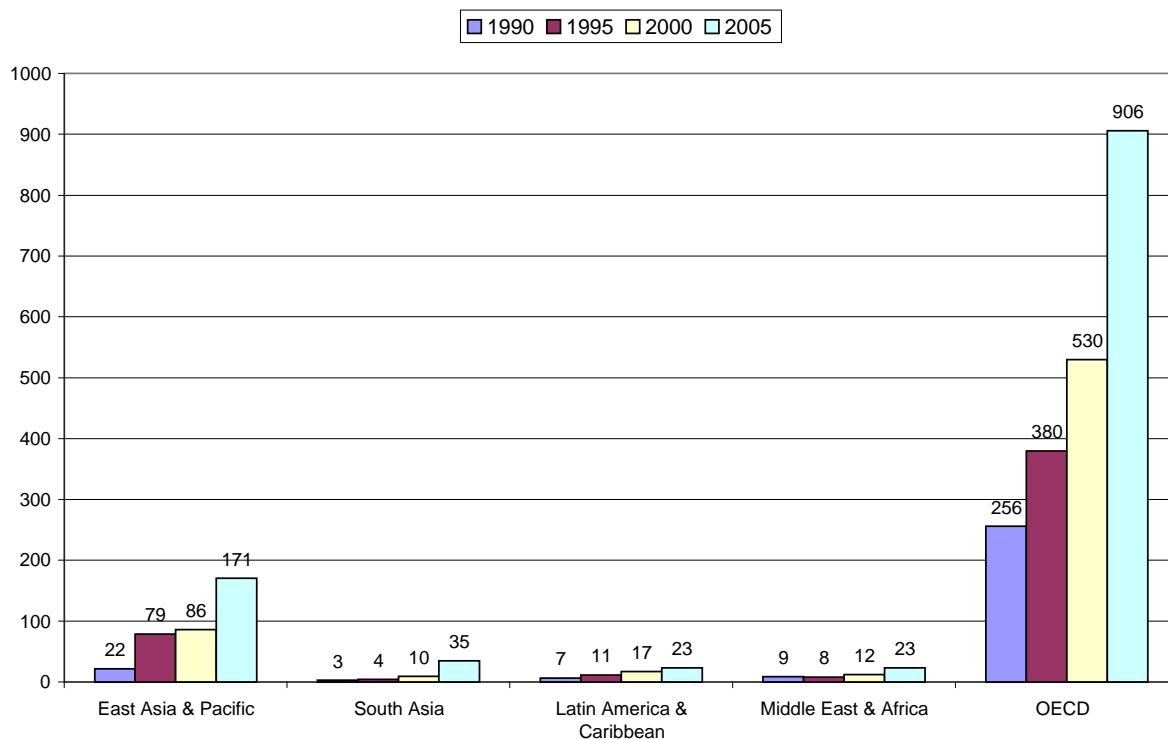
The characteristics of services make FDI a major channel for foreign providers to contest services markets. It may well be that increased use of services outsourcing will result in cross-border trade in services coming to dominate the value of sales of services by affiliates of foreign-owned firms at some point in the future, but this is not the case today.⁷

⁶ Note from Figure 1 that the country with the highest annual rate of business services export growth during 1995-2005 was Ireland, at 31.6 percent.

⁷ See, e.g., Jensen and Kletzer (2005).

For the United States, sales of services by foreign affiliates of US firms (i.e., through outward FDI) has grown more rapidly than cross border trade in services since the mid 1990s. The global stock of FDI stood at some \$10 trillion in 2004, of which about 60 percent was in service industries, up from only 25% in 1970.⁸

Figure 2: Regional Distribution of Business Services Exports (US\$ bn)



There has also been a marked shift in the composition of global services FDI flows. UNCTAD (2005) reports that in 1970 finance and trade (distribution) accounted for 65 percent of the total stock; this dropped to 45 percent in 2003. Conversely, the share of telecoms, energy, and business services has risen from 17 to 44 percent. There are significant differences in the composition of FDI inflows into developed and developing countries. Business services accounted for 40 percent of the total inward FDI stock in developing countries in 2003, compared to only 20 percent in the OECD.⁹

National Policies and the GATS Status Quo

Policy reforms, mostly implemented by governments autonomously, as well as changes in technology have underpinned the expansion of trade and investment in services discussed above. Many countries have taken action to increase competition on services markets by

⁸ See <http://www.unctad.org/Templates/Page.asp?intItemID=1923&lang=1>.

⁹ Non-equity FDI (franchising, management contracts, leasing) is not captured in the forgoing statistics.

liberalizing FDI, opening access to foreign competition in backbone sectors such as transport and telecommunications, and privatizing state-owned or controlled service providers. The extent of the unilateral reforms in policies, and the continuing technological developments that are allowing ever more services to be traded internationally suggest that one reason why multilateral negotiations to liberalize services are not progressing is that they are redundant – governments are implementing liberalization autonomously. Existing and ongoing reforms in conjunction with booming world trade and investment in services clearly will reduce the incentives of firms to invest resources in supporting multilateral efforts to further open markets (Hoekman and Vines, 2007).

This factor undoubtedly plays a role in explaining the limited traction of the GATS and is discussed further below. However, it is important to recognize that it is not the case that most markets are fully open to foreign competition. A plethora of restrictive policies often continue to prevail on many services markets. A recent survey undertaken by the World Bank of the extent of discriminatory policies restricting entry by foreign firms in specific services markets in 30 developing countries finds that there is significant heterogeneity (Gootiz and Mattoo, 2007). Many sectors are open, especially for FDI. However, in many sectors various restrictions continue to be imposed, and some sectors are completely closed. The consensus view is that the tariff equivalents of prevailing restrictions are a multiple of those that restrict merchandise trade.¹⁰ “Sensitive” sectors vary by country reflecting differences in comparative advantage and the legacy of past policies. Many countries maintain foreign equity or entry restrictions for certain services markets.¹¹ Moreover, barriers to entry in a number of services sectors, ranging from telecommunications to professional services, are maintained not only against foreign suppliers but also against new domestic suppliers. Liberalization can, therefore, lead to enhanced competition from both domestic and foreign suppliers.

As is the case for the GATT it is also important to recognize that a key function of the GATS is to “lock-in” policies by establishing an upper bound on the level of restrictiveness of permitted policies. GATS rules operate at two levels. First, there is a set of general rules that apply across the board to measures affecting trade in services, of which the most important are transparency and the most-favored-nation (MFN) principle. Second, there are so-called specific commitments by Members on market access and national treatment. Article

¹⁰ Hoekman (2006). No comprehensive, cross-country, comparable datasets exist that allow a summary assessment of the prevailing levels of services trade and investment barriers.

¹¹ In India, for example, professional services like accountancy, legal, and retail distribution, postal and rail transport services are formally closed to foreign participation.

XVI (market access) lists a set of measures that restrict *market access* and that a WTO Member may not maintain or adopt, unless this is specified in its schedule.¹² Article XVII (national treatment) covers both *de jure* and *de facto* discrimination against foreign services or service suppliers.

In the case of both market access and national treatment, the scope of the commitments of WTO members is determined by what they put in their schedules. These schedules of specific commitments are made on a sector-by-sector and mode-of-supply basis, with countries having the option of making no commitments at all (“unbound”), a partial commitment, or a full commitment (“none”) – i.e., specifying that no limitations are maintained on market access (as defined by Art. XVI) or on national treatment (Table 2). The associated complexity of the schedules makes it difficult to “quantify” the coverage of GATS. Most efforts to do so have tended to use either a simple count of sectors/modes where commitments are made or employ a weighting scheme that is a function of the type of commitment made. Although arbitrary, one simple and transparent way of weighting is to give a weight of zero to “unbound” type commitments; a weight of 1 to full commitments (i.e., “none” is scheduled in a specific cell of the matrix in Table 2), and a weight of 0.5 to commitments where restrictions are specified.

Table 2: Example of a schedule of specific commitments

Country X, Sector Y	Conditions and limitations on market access	Conditions and qualifications on national treatment	Additional commitments
1. Cross-border	Commercial presence required	Unbound	
2. Consumption abroad	None	None	
3. Commercial presence (FDI)	25% of management to be nationals	Unbound	Independent regulator
4. Temporary entry of natural persons	Unbound, except as indicated in Horizontal Commitments	Unbound, except as indicated in Horizontal Commitments	

Notes: ‘None’ implies no exceptions are maintained– that is, a bound commitment not to apply any measures that are inconsistent with market access or national treatment. ‘Unbound’ implies no commitment of any kind has been made.

Analyses of commitments made in the Uruguay Round suggest that these were of a (partial) standstill nature, that is, a promise not to become more restrictive than already was the case for scheduled sectors (Hoekman, 1996). No WTO member came even close to locking in all unilateral reforms that had already been implemented – the (weighted average)

¹² These include limitations on: (a) the number of service suppliers; (b) the total value of services transactions or assets; (c) the total number of services operations or the total quantity of service output; (d) the total number of natural persons that may be employed in a particular sector; (e) specific types of legal entity through which a service can be supplied; and (f) foreign equity participation (e.g. maximum equity participation).

coverage of specific commitments as of 1995 did not exceed 50 percent for most countries. For high-income members such as the EU that made among the most far-reaching commitments, the pre-Doha coverage of mode 1 was only 50 percent, while that for mode 4 was only 3.5 percent (Table 3). Most developing countries have commitments that are well below 50 percent of all services and modes of supply.

Table 3. EU-15 commitment index in services (percent)

Mode of supply	Pre-Doha	April 2003 offer	Difference (% points)
Mode 1	50.5	57.2	6.7
Mode 2	66.9	88.2	21.3
Mode 3	63.0	82.9	19.9
Mode 4	3.5	4.5	1.0
Total	46.0	58.2	12.2

Source: Hoekman, Mattoo and Sapir (2007).

In many WTO members actual policies are much more liberal than what is committed to in the GATS. For example, in a recent paper, Barth, Marchetti, Nolle and Sawangngoenyuan (2006) combine data on specific GATS commitments on financial services with measures of actual policy in this sector for 123 countries drawn from Barth, Caprio and Levine (2006). They conclude that in practice applied policy is much more liberal than what was committed to in the GATS. Eschenbach and Hoekman (2006b) come to the same conclusion for the set of transition economies that were EU accession candidates.

2. Why Such Limited Traction in the GATS?

Expanding the coverage of the GATS should be beneficial to WTO members individually and collectively. First, the potential direct gains from reform of services trade for most WTO members are likely to be large, given the evidence that barriers to trade and investment in many markets are still high, in particular for mode 4-trade. Second, services reform is needed to enable developing countries to take advantage of the new opportunities that arise from goods trade liberalization. Many poor countries lack trade capacity and competitiveness, reducing the ability of their firms to benefit from access to export markets or to compete with imports. Improving competitiveness is largely a service agenda: better access to efficient and competitively priced transport, distribution and many other services. Third, the WTO negotiating process requires countries that seek market access concessions to offer concessions in turn. Thus, greater ambition in terms of liberalization of agriculture is likely to

require greater opening in services, an area of export interest to many of the OECD countries that protect their agriculture sectors.

While some progress has been made to date in using the GATS framework to lock-in unilateral reforms that have already been implemented, the GATS has played virtually no role in inducing new liberalization. Indeed, it is fair to say that to date the GATS has been a disappointment. Adlung and Roy (2005) have assessed both the current coverage of specific commitments of WTO members in the GATS and the offers that were on the table as of 2006, when negotiations were suspended. For many countries the coverage of specific commitments is well below 50 percent of all services and modes of supply. Adlung and Roy conclude that not only do the requests and offers made in the 6 years following the launch of negotiations on services in 2000 imply little if any liberalization of policies; most countries were not even willing to use the GATS as a vehicle to “lock in” existing levels of openness.¹³ Even for the EU, which is actively pursuing the realization of a single internal services market, the initial offers made during the Doha round were most limited in the areas that were of greatest interest to developing countries – modes 1 and 4 (see Table 3) – reflecting the difficulties the EU members have in liberalizing these modes within the EU context (Hoekman, Mattoo and Sapir, 2007).

Why so little movement? Is there a fundamental problem that is specific to services/GATS? Or is it the case that governments are still in “learning mode” and thus understandably risk averse? While the services agenda is more complex than goods trade, the arguments that are sometimes offered that the GATS is “new” and Members are still feeling their way forward are not compelling. It has been more than ten years since the GATS entered into force, and policymakers have been dealing with services in a trade-negotiating context now for over 20 years. The characteristics of services make it more difficult to negotiate liberalization than in the case for goods trade, but complexity can only be part of the explanation.

The key factor is that there is simply too little private sector engagement and lobbying in support of the GATS process to overcome resistance from those that perceive GATS commitments as being (potentially) costly. What follows analyzes the constellation of forces that (should) favor expanded coverage of the GATS and that (may) oppose this, and discusses

¹³ A number of studies have shown that there is often a major gap between the actual level of openness of sectors and the level of commitments in the GATS. For example, Barth et al. (2006) compare data on specific GATS commitments for financial services with measures of actual policy in this sector for 123 countries. They conclude that in practice applied policy is much more liberal than what was committed to in the GATS.

the extent to which preferential trade agreements provide a better vehicle through which the objectives of these various groups can be pursued.

2.1 Pro-liberalization forces

There are two major groups that in principle should support an expansion in the coverage of multilateral liberalization disciplines and GATS commitments: exporters and users/consumers of services.

Export interests: limits to reciprocity?

The basic mechanism that makes trade negotiations “work” is that exporters are induced to take on import-competing interests in each of the countries participating in a multilateral negotiation process. The negotiation alters the prevailing political economy equilibrium that has generated/supports the status quo set of policies in each country by giving exporters a carrot (better access to foreign markets) that induces them to mobilize political support for domestic reforms. Insofar as the services agenda revolves around market access, standard reciprocity dynamics should work as well or badly as they do in the case of trade in goods, i.e., resistance to welfare-improving reforms by those currently benefiting from restrictive policies can be overcome by offering export interests better access to foreign markets. In practice, however, the lack of progress in expanding the coverage of the GATS suggests that reciprocity is not working its magic for services. One potential reason is that the export side of the mechanism may be weaker than in the case of goods.

In the case of developing countries – the majority of the WTO membership – most are small and therefore not of great interest to the large players in the WTO, constraining their prospects of negotiating significant additional access to major markets.¹⁴ Moreover, many developing countries are not or do not perceive themselves to be (potential) services exporters. While many poor countries are significant exporters of services, in that services generate a substantial share of their total foreign exchange earnings, often this is derived from activities where the relevant policies are under the control of the exporting government, not the importer. The most important such “service” is tourism, where the export revenue generated depends primarily on measures that the tourism destination country puts in place itself.

¹⁴ Note that in contrast to goods, developing countries do not have nonreciprocal preferential access to OECD service markets. That is, there is no GSP for services.

As far as mode 1 services trade is concerned, developing countries are exporters, but this is often not constrained at all, with the exception of services such as gambling where importing countries may reserves the activity to the State or ban it altogether. But most of the business process outsourcing, call centers, etc. that are growth areas for many countries are not constrained by trade policy measures in the destination or importing country. While there is certainly increasing opposition against such trade in high-income countries, outside of government contracts there is little that is currently done to restrict such activities from being “offshored.” Turning to mode 3, most developing countries do not have significant “offensive” interests, in contrast to high-income economies.

The one mode where all developing countries do confront particularly high barriers and that is therefore of great relevance to potential exporters is mode 4. It is unlikely however that much can be achieved on mode 4 access to high-income country markets, especially for less skilled services activities. Mode 4 is very politically sensitive and in practice, insofar as importing countries are willing to consider relaxing barriers, experience suggests they will do so only on a bilateral basis in a bilateral setting. However, the lack of serious prospects for mode 4 liberalization in the GATS framework effectively removes many potential export interests in many poor developing countries from the process.

A related factor that may help explain the very limited progress that has been made to date is that the GATS has a strong sectoral focus (Sapir, 1999). Its coverage is determined by a positive list, with governments scheduling commitments on a sector-by-sector basis. Given that most countries will not be significant (potential) net exporters in most sectors, reciprocity requires that countries find the required balanced of concessions across different services sectors, or, if countries do not have strong export interests in any services, in other WTO areas. Even if one abstracts from the latter set of countries, crafting a series of bilateral deals on services among the subset of countries with services interests may be difficult.

These considerations imply that a key dimension of the reciprocity mechanism – services exporters – is either missing or much weaker in many WTO members than is true for goods. The exception are large service firms that are based in high-income economies, which have clear interests in selling more services to both OECD and to (large) developing countries. This is mostly a mode 3 agenda. The result is a rather unbalanced picture as far as export interests are concerned – in effect, if exchanges of “concessions” are to be restricted within the services arena, it would have to involve deals that are limited to mode 3 exchanges (largely an intra-OECD/large emerging markets affair) or that involve access to developing nations for mode 4 in the OECD in return for mode 1 and 3 liberalization by developing

countries. As mode 4 liberalization on an MFN basis is currently a non-starter, this implies that large services firms from OECD countries must be willing to throw their weight behind efforts to reduce agricultural and manufactures protection in order to obtain better access to developing countries. To date, there has been little evidence of such a dynamic emerging in OECD countries with high protection of the farm sector.

Incentives for unilateral liberalization: the role of downstream interests

In contrast to the situation that generally prevails in the goods trade context, where users/consumers are diffuse and rarely significantly affected by the cost-raising effects of protection at the individual or household level, the incentives for users to organize and support unilateral liberalization are stronger for many services. Because inefficient service industries generate costs for downstream users in many sectors, unilateral reform incentives may be larger than for trade in goods and be less susceptible to roll-back, reducing the perceived need to use international commitment mechanisms such as the GATS to lock in reforms. Allowing high cost, low quality services to dominate on a market will be detrimental to almost everyone in an economy, with large users having strong incentives to push for measures – such as deregulation, privatization, and liberalization – that generate more competition in the provision of these upstream suppliers of inputs (Hoekman and Messerlin, 2000). With the exception of EU members in their pursuit of the realization of a single European market for services, most reforms implemented by countries since the 1980s have been autonomous. Although for much of this period multilateral commitment mechanisms did not exist and thus were not an option, the extent of unilateral reform that has been observed suggests such mechanisms may not be needed as much as in the case of goods trade.

Even if one accepts the premise that unilateral liberalization forces are strong, it must be recognized that many restrictive policies continue to prevail. Thus, this is more an argument that at the margin the incentives for firms to engage are not strong enough: costs exceed expected benefits. The same applies to the implied assessment of firms regarding the value of engaging their governments (negotiators) to push for using the GATS as a mechanism to lock in current levels of openness. Exporters and downstream entities may regard the status quo as ‘stable’ in that they perceive a low probability of governments backsliding (raising protection again). Although this may be a correct perception, it may also discount too much the probability of ‘backsliding’. The example of Indonesia is illustrative: in July 2007 the government announced a variety of more restrictive conditions on inward

FDI. Given that the prevailing more liberal situation had not been locked in through the GATS, the government was unconstrained in taking this action (Aglionby, 2007).¹⁵

2.2 Anti-GATS forces

There are two groups that may oppose an expansion of the GATS. The first is familiar from the goods context: import-competing firms/incumbents, workers, unions – those who stand to lose from liberalization. Second, distinct from the goods context, sectoral regulators may resist international cooperation on regulatory measures that is anchored in a binding trade agreement or is motivated by trade concerns.

Import-competing interests and adjustment concerns

In both OECD and developing countries there are incumbent firms and workers with firm-specific skills that may lose from liberalization. The offers that have been tabled in the Doha round reveal that OECD countries are most willing to make concessions in modes 2 and 3, where the levels of commitment were already fairly substantial prior to Doha. OECD markets tend to be relatively open, helping to explain the fact that these countries account for some 75 percent of global trade in services – both cross-border and FATS. Although there is political resistance to mode 1 trade driven by worries about the employment impacts of offshoring and greater use of business process outsourcing to locations in developing countries, policies that restrict such trade are primarily regulatory in nature, and not affected by the WTO talks. The mode that is most affected by outright barriers, mode 4, and that is of great interest to many developing countries, is the mode OECD countries are least willing to open.

Resistance to liberalization in developing countries varies across sectors and modes. Differences in policy stance across sectors are driven by the differential impacts of technology and the legacy of past structures. In telecommunications, many countries have exploited new technological possibilities by directly introducing competition, especially in mobile communications. Adjustments by public sector incumbents were facilitated by the fact that telecom markets have been growing rapidly, with overall sectoral employment expanding. Other technology dependent sectors such as IT-enabled business services never confronted pressure for protection of the domestic market – there were no incumbents. In other sectors where restrictions continue to prevail this is often driven by the legacies of past

¹⁵ Indonesia announced a 49 percent foreign ownership cap in sectors such as multimedia, ports, airports, and education. Equity ownership caps were reduced for mobile phone companies (from 95 to 65 percent) and set at 80 percent for insurance, 65 percent for hospitals and 55 percent for most construction activities.

policies that limit the ability of domestic firms to confront competition. For example, in countries dominated by public sector banks with excessive staffing levels and weak balance sheets as a result of directed lending at non-market rates, large displacements will result from full liberalization. Adjustment and employment concerns therefore may be an important factor impeding liberalization.

Regulators, consumer interests and equity concerns

The intangible nature of most services makes it hard for buyers of services to investigate or test their quality prior to purchase. The extent of asymmetric information often creates a necessity to regulate services in order to protect consumers. Regulating services may also be desirable in order to remedy other types of market failures, including imperfect competition, which is often present in network services such as telecommunications where the number of providers is limited. Externalities may cause a problem if there is also imperfect information – e.g., in the case of financial services, where the failure of one institution may cause problems to the entire sector. For all these reasons, activities tend to be highly regulated.

Although consumers should in principle favor reforms that increase the number of suppliers and, in principle, lower prices and/or increase the range of services offered, they may in fact oppose them for fear that reforms will lower service quality and/or increase the market power of (foreign) firms. Regulators may be concerned that trade liberalization will impede their ability to enforce domestic regulatory standards. Trade will bring with it regulatory competition if services suppliers are only subject to the norms and standards that apply in their home markets.¹⁶ Thus, if trade is permitted to occur on the basis of the qualifications and certifications obtained in the home country of providers, there may be concerns regarding whether host country norms are met.

Hoekman and Messerlin (2000) note that the scope for traditional reciprocity-driven negotiations in services is inherently more limited than for goods because of concerns relating to regulatory autonomy. The prevalence of regulation complicates and constrains use of the reciprocity mechanism for services because it is very difficult to design multilateral rules and national commitments in a way that clearly separates or distinguishes between measures that are protectionist and measures that have a good domestic efficiency or social

¹⁶ A case in point was the dispute between Antigua and Barbuda and the US on gambling services. The WTO Panel and Appellate Body ruled that the US prohibition of internet gambling was inconsistent with the specific commitments the US had made on market access, even though the US prohibition applied *equally* to foreign and US providers. The inconsistency arose because specific commitments on market access preclude even non-discriminatory (regulatory) prohibitions.

equity rationale. A critical challenge then is how to differentiate between legitimate concerns relating to quality and performance, and regulatory requirements that simply constitute barriers to entry, creating rents for incumbents by raising prices. Marginal “quid pro quo” changes to domestic regulatory policies may not enhance welfare – indeed, they could easily lower it. Regulators may therefore be concerned that market access negotiating dynamics could adversely affect their ability to design and implement regulatory norms that maximize national welfare.

An additional regulation-related complicating factor is that successful liberalization in developing countries will often require substantial strengthening of domestic regulatory institutions and related infrastructure. The impacts of more competitive market structures following liberalization on access to services by poorer households in developing countries have been mixed. In cases like mobile telecommunications, a positive relationship has been observed in many developing countries because initial conditions were bad – few households had access. However, in other areas, like financial services, unless improved regulatory measures are put in place, liberalization may have an adverse effect on access to credit for rural areas and the poor. Putting in place mechanisms to ensure better access to services post-liberalization is important from an equity perspective. It is also important from a political economy perspective to bolster support for implementing efficiency enhancing policy reforms and sustaining them over time. Absent actions to address regulatory weaknesses, countries may not be in a position to fully realize the potential benefits of trade reforms in services (*or* goods) (Hoekman and Mattoo, 2007).

2.3 Preferential trade agreements: revealed preferred, but do they do much?

Agreements to liberalize international transactions in services on a bilateral or regional basis have become increasingly prominent. The spread of such agreements may be a factor explaining the limited traction of the GATS insofar as the factors impeding multilateral liberalization of services trade are easier to address in a small numbers setting.

Although many early agreements did not go much beyond the GATS in terms of coverage, more recent vintage agreements often do (Table 4). Roy, Marchetti and Lim (2007) conclude that PTAs that involve the US have the most comprehensive coverage and deepest levels of commitments. Many agreements generally do entail some additional liberalization and commitments. Thus, the EU-Chile agreement goes further than the GATS by locking in some liberalization of telecommunications and maritime services (Ullrich, 2004), and the DR-CAFTA requires Costa Rica to open its telecommunications and insurance industries.

Table 4: Post-2000 Preferential Trade Agreements that include Services

PTA	Entry into Force	Date of Signature	WTO Notification	Negative or Positive List?	GATS-type Market Access Obligation for Mode 3?
New Zealand – Singapore	Jan. 2001	Nov. 2000	Sept. 2001	Positive List	Yes
EFTA – Mexico	Jul. 2001	Nov. 2000	Aug. 2001	Positive List	Yes
EC – Mexico	Mar. 2001	Oct. 2000	June 2002	Positive List	Yes
Chile – Costa Rica	Feb. 2002	Oct. 1999	May 2002	Negative List	No (nor for mode 1)
Japan – Singapore	Nov. 2002	Jan. 2002	Nov. 2002	Positive List (Japan used negative list for mode 3 NT).	Yes
Singapore – Australia	Jul. 2003	Feb. 2003	Oct. 2003	Negative List	Yes
US – Chile	Jan. 2004	June 2003	Dec. 2003	Negative List	Yes
US – Singapore	Jan. 2004	May 2003	Dec. 2003	Negative List	Yes
Chile – El Salvador	June 2002	Oct. 1999	Mar. 2004	Negative List	No (nor for mode 1)
Republic of Korea – Chile	April 2004	Feb. 2003	April 2004	Negative List	No (nor for mode 1)
EC-Chile	Mar. 2005	Nov. 2002	Nov. 2005	Positive List	Yes
EFTA – Singapore	Jan. 2003	June 2002	Jan. 2003	Positive List	Yes
China – HKC	Jan. 2004	Sep. 2003	Jan. 2004	Positive List (for China)	Yes
China – Macao China	Jan. 2004	Oct. 2003	Jan. 2004	Positive List (for China)	Yes
EFTA – Chile	Dec. 2004	June 2003	Dec. 2004	Positive List	Yes
US – Australia	Jan. 2005	Aug. 2004	Dec. 2004	Negative List	Yes
Thailand – Australia	Jan. 2005	Jul. 2004	Jan. 2005	Positive List	Yes
Panama – El Salvador	April 2003	March 2002	April 2005	Negative List	No (neither for mode 1)
Japan – Mexico	April 2005	Sep. 2004	April 2005	Negative List	No (neither for mode 1)
US – Bahrain	Aug. 2006	Sep. 2004	-----	Negative List	Yes
US – Oman	-----	Jan. 2006	-----	Negative List	Yes
US – CA + DR	Mar. 2006	Aug. 2005	Mar. 2006	Negative List	Yes
US – Morocco	Jan. 2006	June 2004	Jan. 2006	Negative List	Yes
US – Peru	-----	April 2006	-----	Negative List	Yes
Japan – Malaysia	-----	Dec. 2005	-----	Positive List	Yes
Korea – Singapore	Mar. 2006	Aug. 2005	Feb. 2006	Negative List	No
US – Colombia	-----	Feb. 2006 (conclusion of negotiations)	-----	Negative List	Yes
Singapore – India	-----	June 2005	-----	Positive List	Yes

Source: Roy, Marchetti and Lim (2007).

An in-depth analysis of services liberalization in PTAs in Asia by Fink and Molinuevo (2007) concludes that there is great variance in coverage of services and the depth of commitments, with more commitments made in sectors where countries have also made more extensive commitments in the GATS. Sensitive sectors such as health, transport and financial services as well as the movement of service suppliers (mode 4) tend to be subject to the fewest commitments. In areas where there are no WTO disciplines, there also tend to be no PTA rules—e.g., on safeguards, subsidies, or procurement. The same is true as regards domestic regulation, with only one PTA establishing an across-the-board necessity test.¹⁷

Fink and Molinuevo (2007) conclude that the rules of origin that are contained in the Asian PTAs are mostly liberal, in that PTA benefits extend to nonmember firms that are established (have a commercial presence) and substantial business operations in any PTA member. The same is true for many other recent PTAs in other parts of the world (Fink and Jansen, 2007). Given that most multinational services firms have a commercial presence in the major markets, this implies that any PTA-based liberalization may be nondiscriminatory on a *de facto* basis. While this would be good news from a global welfare perspective, it leaves open the question why export industries in PTA countries would support PTA negotiations when they do not support the GATS process. One possible explanation is that much of what is contained in the PTAs reflects unilateral policy reforms – i.e., they do not change the status quo. Another is that in practice a distinction is made between firms based on where they originate (have their headquarters or do most of their business). That is, insofar as liberalization does occur it is not MFN.

Very little information exists on implementation of PTAs and the extent to which market structures change over time. This makes it impossible to assess to what extent PTAs have been able to overcome the constellation of forces that have been impeding more rapid and deeper progress in the GATS.¹⁸ With the exception of the EU and a small number of agreements between high-income countries (e.g., Australia-New Zealand),

¹⁷ This is contained in the Trans-Pacific Economic Partnership Agreement, between Brunei, Chile, New Zealand and Singapore.

¹⁸ The incentives to seek preferential access will be significant if the PTA removes previously binding barriers to entry in a sector. The US-DR-CAFTA is an example. It requires Costa Rica to open access to previously monopolized telecommunications and insurance markets. While CAFTA requires Costa Rica to open these markets to firms originating in signatory countries, whether it will do so on a discriminatory basis remains to be seen (the agreement has yet to be implemented by Costa Rica at the time of writing).

most PTAs have not achieved much in terms of actual *additional* liberalization. The difficulty experienced by the EU to fully liberalize intra-EU services trade and create a single market for services illustrates that achieving liberalization through regional cooperation is difficult. Progress towards a single market in services across the EU encountered strong opposition when attempting to remove limitations on cross-border trade (mode 1) and the temporary movement of personnel (mode 4). All other PTAs have achieved far less than the EU.

It is also noteworthy that there are no instances – beyond the EU itself – of major economies opening up access to each other’s services markets. There is no US-EU PTA for example, and the US and EU do not have PTAs with other major economies. Instead, the pattern is one of South-South agreements and North-South agreements where the Southern countries are small. The quid pro quos in the latter type of agreements revolve around preferential access to the goods markets, and specific liberalization commitments in service sectors characterized by monopoly or highly restrictive entry barriers.

The failure of the FTAA, the fact that PTAs have not been very successful in addressing disputes in services (a noteworthy example being the Telmex case, which went to the WTO even though the parties were both NAFTA members), the resistance inside the EU to fully liberalizing intra-EU services trade, all illustrate that the challenges to services liberalization may not be that much easier to address regionally than multilaterally. It continues to be the case that most services policy reforms tend to be implemented unilaterally.

3. Bolstering Prospects for Multilateral Cooperation

The foregoing suggests that while somewhat more appears to be happening through PTAs, there is not much compelling evidence that PTAs are going significantly beyond already applied services policies, except possibly in areas where there are significant incentives for partner countries to seek access to protected markets and share the rents created by restrictive entry policies. The one area where PTAs, especially those modeled on NAFTA and that take a negative list approach to coverage, are superior to the GATS is in transparency. This because they require signatories to specify all non-complying policies in Annexes, so that at least it is clear what the applicable policies are.

Three changes in approach towards services negotiations in the WTO might improve the prospects of greater progress in the WTO. First, limit negotiations on binding disciplines to the large players. Second, limit the focus of negotiations to overt market access barriers. Third, pursue “soft law” forms of cooperation on regulatory matters as opposed to seeking binding, enforceable commitments. To a greater or lesser extent WTO members have already begun to move in these directions.

Plurilateral approaches to negotiations

The WTO has 151 members, the majority of which have only a very limited stake in negotiating better access to service export markets. Limiting talks to a critical mass of countries is an obvious way to reduce transactions costs while still ensuring that most of the gains from agreement would be internalized among those participating. The pursuit of what Schelling (1978) has called a “k-group strategy” – the minimum number of countries (“K”) out of a larger set (“N”) that internalizes enough of the total potential gains from cooperation to make free riding by the remaining N-K players feasible – was adopted by WTO members at the end of 2005 at the Hong Kong ministerial meeting.

Annex C of the Hong Kong WTO ministerial declaration endorsed a shift towards plurilateral or collective negotiations among subsets of members. A plurilateral approach to negotiations for services is easier to implement in the services context than for goods because of the way the GATS is structured.¹⁹ The positive list approach to define the country coverage of specific commitments on a sector-by-sector basis allows significant flexibility as regards which countries need to make commitments.

Plurilateral talks were pursued among some 30-40 countries starting in early 2006.²⁰ Requests were tabled for legal; architecture/ engineering; computer-related; postal/courier; telecommunications; audiovisual; construction; distribution; education; environmental; financial; maritime; air transport; and energy services, as well as cross-border trade (modes 1/2); mode 3; mode 4; and MFN Exemptions (general, financial and audiovisual) (Chaudhuri, 2006). The negotiations involved mostly OECD members and large emerging economies. Requests were generally less ambitious than those made

¹⁹ Article XIX GATS mentions plurilateral negotiations as modality that could be used by Members.

²⁰ Past practice suggests that for sectoral liberalization agreements to be applied on a MFN basis the “internalization” ratio needs to be on the order of 90 percent of total trade. This was the figure used in the negotiations on the Information Technology Agreement.

bilaterally, which often called for full market access and national treatment in sectors of export interest to the demandeur. Two rounds of talks were held before the Doha round was suspended in July 2006. Additional rounds of meetings occurred in the spring and fall of 2007, after negotiations resumed. News reports suggest that although progress was made as a result of the shift to the new negotiating modalities, the inability to move forward on agriculture and nonagricultural market access dominated the efforts of negotiators. At the time of writing it is not possible to assess what the ultimate outcome of the plurilateral approach will be (might have been).

The “free riding” that is implied by plurilateral negotiations will of course not necessarily be beneficial to poor or small countries. However, the rationale for a critical mass approach to market access negotiations is not to let poor country governments “off the hook” but to recognize that there is little they can do to influence the outcome of market access negotiations. That is, they have few incentives to play this game, and will find it hard therefore to argue domestically that the quid pro quo received justifies potentially painful domestic reforms. As discussed further below, a more à la carte approach that stresses assistance and cooperation may be more appropriate to the needs of the poorest countries.

Limit negotiations to discriminatory barriers

Although regulation is often the binding market access constraint – e.g., in professional services – seeking to negotiate multilateral disciplines for regulatory policies greatly complicates matters. Greater progress may be feasible if attention is restricted to overt, discriminatory barriers to entry by helping to mobilize export interests while taking regulators out of the equation.

This is not to deny that domestic regulation that applies to all firms whatever their nationality may not be a more important source of inefficiency/costs than policies that discriminate against foreign suppliers. The “cost rectangles” associated with regulations that raise prices for all users, limit entry for all new service firms independent of nationality, or are redundant because similar but different rules already apply to foreign firms in their home market may be much larger than the “triangles” generated by the efficiency losses from (the tariff equivalent of) discriminatory policies. However, it is not

clear that much can be done through the GATS on domestic regulation. By removing one, important, reason for regulators to oppose their governments making commitments in “their” area, resistance from a powerful set of interest groups in all countries could be greatly reduced. Finally, a focus on policies that discriminate would not only diminish fears of the intrusiveness of the GATS, it would also reduce uncertainty regarding the implications of making commitments.

Improving services policies and performance in developing countries

Rather than seek to put in place specific disciplines for regulatory policies, the WTO might usefully devote more effort to make the effects of national regulatory disciplines more transparent. Greater transparency of policy – not just identification of the existence of policies, but assessments of their effects – may help build support in each WTO member for policy reform. This could also help inform efforts to assist developing countries to improve services regulation. Such countries may not be able to benefit from liberalization – and thus GATS commitments – if the preconditions for doing so have not been satisfied. Improved regulation – ranging from prudential regulation in financial services to pro-competitive regulation of network-based services – will often be critical to realizing the benefits of services liberalization. The same is true of actions to address adjustment costs or ensure universal access in liberalized markets.

At the 2005 Hong Kong Ministerial meeting of the WTO a task force on “aid for trade” was established. In its report (WTO 2006), the task force makes a number of recommendations for greater and more effective assistance to be given by high-income countries to developing countries.²¹ Whatever eventually is done to operationalize the task force recommendations, much of the aid for trade agenda at the country level arguably should target improving the quality and cost of services and regulatory strengthening and related institutions. This is not an agenda for the WTO to pursue as it has neither the expertise nor the country presence that is required to deliver effective assistance. However, explicitly supporting ‘soft law’ types of cooperation and encouraging the provision of development assistance for services could do much to put in place the preconditions for poor countries to benefit more from opening up services

²¹ See Prowse (2006) and Njinkeu and Cameron (2007) for extensive discussion of the rationale for aid for trade.

markets to international competition.²²

4. Concluding remarks

Most countries have made only limited use of the GATS to create a more secure trading environment by making legally binding market access commitments. It is clear that greater advantage could be taken of the opportunity offered by the GATS to lend credibility to past or ongoing reform programs by locking these in, and to further liberalize access for foreign providers. To some extent the limited progress made to date in the GATS may reflect a perception on the part of exporters and users of services that there is not much need for trade agreements to harness desirable domestic liberalization because such liberalization can be, has been and is being implemented on a unilateral basis. However, the available empirical evidence suggests that barriers to trade in services are often quite high, suggesting this cannot be more than a partial explanation at best.²³ Moreover, while the prospect of re-imposition of restrictive policies may be limited for the reasons discussed above, the resistance on the part of OECD countries to make more extensive liberalization commitments for mode 1, as well as recent moves by some countries to reduce foreign equity caps, suggests that the lock-in function of the GATS may be undervalued by services industries.

The willingness to offer more meaningful commitments may increase if some of the uncertainty regarding the payoffs to – and implications of – multilateral commitments can be reduced. While multilateral rule-making can help to promote and consolidate domestic regulatory reform, limiting the focus of negotiations to the large(r) WTO members and to clear-cut market access restrictions could attenuate concerns about regulatory autonomy while delivering significant gains in terms of greater competition on services markets. And by focusing more explicitly on policies that discriminate against foreign firms, both service export industries and users of services in importing countries may have greater incentives to support the process than they perceive to have at present.

If, in addition, more was done to actively help poorer countries achieve and implement beneficial domestic reforms through development assistance, interest groups

²² See Hoekman and Mattoo (2007) for an elaboration of this argument.

²³ The available evidence is surveyed and summarized in Hoekman (2006) and Dee (2005).

in these countries might over time come to see more advantages flowing from more active participation in the GATS. Economic cooperation and policy dialogue is a more appropriate and effective mechanism to promote a better regulatory environment in developing countries than the negotiation of binding disciplines.

To answer the questions posed in the title of this paper, GATS is not doomed to fail, but making progress will require a change in *modus operandi* and the use of additional instruments and mechanisms *outside* the WTO – it is necessary to go beyond negotiating legally binding policy commitments. Progress along the suggested lines is feasible and to some extent is already being pursued. Making the GATS work better does matter. While there are good reasons to expect unilateral reforms in services industries to be undertaken and maintained, there is substantial evidence that barriers to trade remain significant, and that there are large potential gains from further pro-competitive reform. Harnessing multilateral cooperation to help deliver such reforms is therefore important. As important is to more fully exploit the potential of the GATS as a lock-in mechanism. Indeed, the primary function of the GATS is arguably to ‘harvest’ unilateral reforms and to reduce the uncertainty confronting traders and investors as to the policy regime that they may confront in the future.

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