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978-1-107-06235-1 - WTO Domestic Regulation and Services Trade: Putting Principles into Practice

Edited by Aik Hoe Lim and Bart De Meester

Excerpt

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An introduction to domestic regulation and GATS

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1 Introduction

International trade in services is governed principally by regulatory measures. Unlike trade in goods, border measures in the form of tariffs and quotas are not the main barriers to trade. This peculiarity of services trade is due to the manner by which services are produced and consumed. Due to the intangible and non-storable nature of services, suppliers and consumers often have to be in physical proximity to each other for the transaction to be completed. For this reason, economists have traditionally considered services to be non-tradable across borders and have paid little attention to it in trade theory.

Yet, in today's global economy, trade in services is very much a tangible phenomenon – representing over one-fifth of international trade. With technological improvements, there are now greater possibilities for services to be supplied over a distance. Moreover, services trade as defined by the first multilateral agreement on this subject, the General Agreement on Trade in Services (GATS), encompasses not only cross-border trade (Mode 1), but also the consumption of services abroad (Mode 2), commercial establishment of service suppliers in another territory (Mode 3) and the presence of foreign natural persons for the supply of services (Mode 4). Given that the GATS modal coverage goes beyond traditional product-based trade flows, a far wider range of measures fall under the scope of the agreement.

While disciplines under the General Agreement on Tariffs and Trade (GATT) are confined to the cross-border flow of goods, GATS marked an important extension to measures affecting both the service (i.e. the product) and the service supplier (i.e. the producer). The expanded coverage of GATS reflected the nature of services sectors where regulations are more often than not directed at the service supplier rather than at the service itself. For instance, unlike the situation with goods, quality standards are often not based on the characteristics of the

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service, but on the competence and performance of the service supplier. What this meant is that with GATS, trade negotiations would venture into areas of internal regulation never before recognized as trade policy. This raised one of the most difficult issues in international trade, namely, the relationship between trade liberalization and domestic regulatory autonomy. The pragmatic solution utilized by the drafters of the GATS was to distinguish between three types of services measures:

- quantitative restrictions on entry/establishment (including legal form requirements), whether discriminatory or not;
- discriminatory measures modifying the conditions of competition in favour of national services and service suppliers;
- domestic regulations that are neither discriminatory nor quantitative in nature.

The GATS framework by design defined measures falling under the first two categories as market access and national treatment limitations. These are subject to the disciplines of GATS Articles XVI and XVII, and negotiations to progressively eliminate them.

The third category of measures would not be considered as necessarily imposing trade restrictions. For want of a better term, they constitute 'domestic regulations' from the perspective of GATS and are therefore not subject to progressive liberalization. It is no accident that the GATS Preamble explicitly recognizes the right of members to regulate and introduce new regulations on the supply of services in order to meet national policy objectives. Nevertheless, the agreement also foresaw that domestic regulations may have trade-restrictive effects and mandated the establishment of relevant disciplines under GATS Article VI:4. Given the pervasiveness of domestic regulation in services sectors, a clear identification of trade-restrictive effects, intended or unintended, as well as the criteria to be used in evaluating the unnecessary burdensomeness of regulation has been fraught with difficulty. At the same time, there is increasing evidence that regulatory constraints have an important and significant effect on services trade, and may even negate the gains from external trade liberalization.

By way of an introduction, the following sections provide some background on the GATS negotiations on domestic regulation disciplines for readers who may not be familiar with this body of work. They also serve to outline the issues which are addressed in this book and to introduce the chapters.

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2 The services regulatory challenge of open markets

Services sectors in many countries have undergone a major transformation over the last three decades, moving away from a model where services were provided often as a function of government to one where services are provided on a competitive and commercial basis. The degree of change, however, varies across regions and sectors. Historically, several infrastructural and social services, such as telecommunications, transport and public utilities, as well as essential consumer services, such as education and health, have been directly provided by government entities, usually in monopoly situations.

In many of these sectors, governments have progressively transformed their role from that of a primary supplier to being a supervisor or regulator of competitive markets. In other sectors, where there has always been strong private sector involvement, technology and market globalization has made the task of regulation ever more complex with the emergence of either new services or the involvement of an expanded range of private actors. The shift towards private or joint public–private provision of services has often resulted in more and not less regulation and has been described as the rise of the so-called ‘regulatory state’ (Majone 1997; Glaeser and Shleifer 2003). Indeed, the experience of Organisation for Economic Co-operation and Development (OECD) countries has been that the regulation of services markets has increased just as sectors were privatized and opened up to competition (Blundell and Robinson 2000). In developing countries, the establishment of new regulations, laws, contracts, institutions, regimes and processes have also been an important feature of infrastructure reforms associated with telecommunications, transport and public utilities (Eberhard 2007).

Through the regulatory framework, governments may wish to increase welfare by correcting market distortions, minimizing the impact of externalities and preventing anti-competitive practices. Specific characteristics of services markets make the use of regulation particularly important. Services are generally considered to be intangible and non-storable, and their supply often requires an interaction between the supplier and consumer. This implies that users frequently cannot easily assess the quality of the service until they have consumed it. Through regulation, governments seek to avoid that service suppliers exploit such information asymmetries. For instance, regulation may impose information requirements to inform consumers in advance, or impose qualification requirements for professionals, or licensing requirements that

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seek to ensure the competence of the service supplier and, thus, the quality of the services provided. Unlike goods, it is difficult if not impossible to subject services to any form of *ex ante* physical testing. Thus, regulations will often be attached to the competence and conduct of the service supplier.¹ This explains why in services there is often greater emphasis on the qualification requirements of the service supplier as a way to indirectly control the quality of the services provided.

In the context of developing countries, a frequently cited concern is the need for some form of government intervention to ensure that markets contribute to poverty reduction and to help bring about inclusive and sustainable development.² This policy objective may sometimes be pursued through regulation which aims to ensure that services are available to all citizens at equitable conditions, no matter their location or income. In the case of infrastructure services, for instance, universal service obligations may sometimes require expansion of the network to remote areas or affordable pricing for poorer segments of the population. Furthermore, the provision of certain services may create negative externalities – the costs of which are insufficiently borne by the parties themselves. For instance, heavy road transport or intensive tourism could strongly affect the environment. Excessive risk-taking by financial institutions can undermine the financial stability of all countries and create macroeconomic tensions around the world. Box 1.1 provides a list of regulations typically used to achieve certain policy objectives.

Liberalization of services markets has thus required not just the removal of market access constraints but also the implementation of new regulation or re-regulation to ensure regulatory quality and efficiency, transparent processes, as well as appropriately mandated regulatory bodies. At the same time, it has been well noted in economic literature that regulation may be captured by special interest groups, and thus flourish for reasons totally unrelated to addressing market failure or development needs (see e.g. Stigler 1971; Peltzman 1976). Governments are thus subject to lobbying by those groups seeking to ensure that privileges and rents stemming from regulation are maintained. In such cases, even when regulatory intervention is warranted on public policy

¹ See *Technical Standards in Services: Note by the Secretariat*, WTO doc. S/WPDR/W/49, 3 September 2012.

² See Cook *et al.* 2004: 11; *Services, Development and Trade: The Regulatory and Institutional Dimension*, Note by the Secretariat, UN doc. TD/B/C.I/MEM.3/11, 15 December 2011, p. 7.

BOX 1.1 EXAMPLES OF SERVICES-SPECIFIC REGULATION TO PURSUE
PUBLIC POLICY OBJECTIVES

Equitable access

Sectors: In the transport or telecommunications sectors, governments often want remote regions to be served, regardless of profitability. Basic equity objectives may prompt governments to ensure that all citizens have access to education and essential health care at low or zero costs.

Measures: Cross-subsidization schemes to ensure that revenues in profitable areas are reinvested in favour of underdeveloped regions or persons in financial need; licensing conditions which include ‘universal service obligations’ (e.g. commercial hospitals are required to treat a certain percentage of patients free of charge, or postal and telecommunications services must be provided at equal conditions across the country, regardless of profitability considerations).

Consumer protection

Sectors: With regard to professional, financial or health services, the complexity of the service that is provided makes it very difficult for consumers to appreciate quality or safety prior to consumption. Service suppliers may exploit such information asymmetries.

Measures: Prudential and other technical standards to be complied with by service suppliers; transparency-related publication requirements on costs, risks, side-effects, among others, to enable the consumer to make informed decisions; education and training requirements to ensure competence; mandatory professional liability insurance.

Reduction of environmental impacts and other negative externalities

Sectors: Road and air transport cause pollution and noise; tourism could put the environment under stress and disturb natural habitats.

Measures: Traffic restrictions over weekends, during night hours or in sensitive areas; zoning laws and building codes; tax/subsidy-schemes to mobilize funds for preservation of cultural heritage.

Macroeconomic stability

Sectors: Financial institutions may engage in imprudent lending or design complex financial instruments that are insufficiently understood. As a consequence, depositors may lose confidence and withdraw their money, inter-bank lending may suffer, credit supply to the real economy be hampered, and so forth.

BOX 1.1 (*cont.*)

Measures: To ensure stability, financial institutions must comply with measures such as minimum capital requirements; higher capital reserves when new financial instruments are provided; diversify assets to limit exposure to individual clients; and regularly reporting on their activities.

Avoidance of market dominance and anti-competitive conduct

Sectors: Concerns about anti-competitive conduct arise in sectors prone to market concentration, including services with network effects and interconnection needs (e.g. transport and telecommunications) and liberalized former monopolies (e.g. postal and courier, education and energy).

Measures: Limitations on market shares; introduction of price surveillance or mandatory price caps; interconnection guarantees; government-mandated technical standards to replace company-specific requirements.

grounds, governments may be ‘bought’ into relying on those measures that benefit the interests of a few at the expense of the general good.

The complexity and diversity of services regulation also implies that regulators who are less experienced or have fewer resources might be more easily ‘captured’ by special interest groups even if they intend to act in pursuit of the ‘public interest’.³ Regulations may in such situations seek to reduce market contestability and thereby protect incumbent suppliers from competition. To what extent such regulatory actions can be disciplined under a trade agreement, how to distinguish protectionism from the pursuit of legitimate domestic objectives, and what should the due balance be between the goal of trade liberalization and domestic regulatory autonomy, have all been major sources of tension.

3 GATS context

GATT addresses this tension by focusing on non-discrimination which is its primary discipline. From this perspective, it follows that measures applied at the border, such as a quota or tariff, would be subject to trade disciplines. Since these measures can only be applied to foreign goods, they are the natural and legitimate concern of trade negotiations.

³ See the discussion of political economy considerations underlying regulatory intervention in WTO 2012: 75–6.

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Once the goods have entered the territory they might be subject to so-called 'behind the border' or 'non-tariff' measures in the form of internal regulations. Although such measures may have trade effects, GATT has traditionally been careful not to venture too far into subjecting internal regulations to trade disciplines and has mainly focused on ensuring non-discrimination through the observance of national treatment. That being said, due to the prominence of non-tariff measures, successive GATT rounds have expanded or strengthened disciplines on regulatory measures, including through improvements to the WTO Agreement on Technical Barriers to Trade (TBT Agreement) and the negotiation of a new Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement).

In the case of services trade, the starting point has always been the 'behind the border' measures. Most services restrictions are not applied at the border and are found in a country's internal regulation. Thus, unlike the case for goods trade, there was no convenient shortcut of focusing on border measures as explicit trade barriers. Rather, the challenge for services was to identify from the wide range of internal regulations those which can be considered to be trade restrictions and subject to liberalization commitments. Ultimately, GATS undertook an implicit ranking of measures as instruments of protection. First, quantitative restrictions affecting entry and establishment, whether discriminatory or not, may serve to protect the incumbent service supplier from protection. Such limitations have a general effect on market contestability and would thus be a form of trade restriction. Second, discriminatory measures on foreign services and service suppliers serve to modify conditions of competition in favour of domestic services and service suppliers. The trade-restrictive impact of such measures is evident.

The GATS confines liberalization to the absence of six types of market access measures (Article XVI) and national treatment discrimination (Article XVII). Market access restrictions are defined as six listed types of measures, mainly of a quantitative, quota-type nature (GATS Article XVI:2). National treatment violations are measures that, either *de jure* or *de facto*, modify the conditions of competition in favour of national services or service suppliers. Such market access or national treatment measures can be maintained only in those service sectors for which no specific commitments have been inscribed. In sectors where bindings have been undertaken, such measures violating the market access or national treatment obligation can only be used if they

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have been specifically listed as limitations to the commitment. Traditionally, trade negotiations focus on the removal of these limitations. Outside of these provisions, governments have by and large unfettered autonomy to decide the shape and content of the remaining regulatory framework.

4 Negotiating disciplines on domestic regulation

Yet, services trade may be affected by non-discriminatory economy-wide or sector-specific regulations relating to the environment, public safety, zoning, consumer protection and competition policy. While such regulations are necessary, they can determine the conditions for the entry and operation of service suppliers in several ways. First, the choice of the regulatory instrument is important in achieving the required policy objective, as some may be more trade-friendly than others. Admittedly, distinguishing between a legitimate policy objective and disguised protectionism in the instrument of choice is far from obvious. Second, even if the instrument is optimal, there is the question of whether more could be done to administer the regulation in a transparent and less trade-burdensome manner. Third, regulatory frameworks for services tend to involve many agencies with different objectives, authority and requirements. Such fragmentation may occur at both the national and international level, and regulatory cooperation between agencies and the recognition of experience, qualifications and standards can do much to help lessen the cost of compliance for the service supplier and enhance international trade.

Thus, while GATS has been careful not to suggest that domestic regulations are trade barriers, it acknowledges that they could potentially be trade restrictive. Two major concerns are involved: how to ensure that regulations serve legitimate policy objectives and are not used as an alternate form of protectionism; and how to mitigate the unintended trade-restrictive consequences of national differences in regulatory requirements, as well as the manner in which they are administered. GATS Article VI:4 contains a negotiating mandate to develop any necessary disciplines that seek to ensure that regulatory requirements and procedures (i.e. licensing, qualifications and technical standards) do not constitute unnecessary barriers to trade in services. Article VI:4 indicates that the disciplines are intended to ensure that domestic regulations are, among others:

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- (a) based on objective and transparent criteria, such as competence and the ability to supply the service;
- (b) not more burdensome than necessary to ensure the quality of the service;
- (c) in the case of licensing procedures, not in themselves a restriction on the supply of the service.

Pending the entry of new disciplines, GATS Article VI:5 imposes a standstill obligation. Members are to refrain from applying measures that would nullify or impair a specific commitment, which are incompatible with the criteria set out in Article VI:4, and could not have reasonably been expected at the time when the commitments were made. This discipline thus applies to new measures of domestic regulation. Apart from Article VI:5, GATS also contains a number of general obligations that promote good governance. These include obligations on transparency, as well as on the availability of judicial, arbitral or administrative tribunals or procedures for review of decisions at the request of an affected service supplier, and appropriate remedies where justified (GATS Articles III and VI:2). Where the procedures are not independent of the agency entrusted with the administrative decision concerned, members have to ensure that procedures in fact provide for an objective and impartial review (*ibid.*). For sectors where specific commitments are taken, there are additional obligations to ensure that all measures of general application are administered in a reasonable, objective and impartial manner; that the competent authority informs applicants of the decision concerning the application or its status; and that there are adequate procedures to verify the competence of professionals of any other member (GATS Article VI:1, 3 and 6).

GATS disciplines on domestic regulation could be said to share similar objectives to those espoused by good regulatory practices.⁴ The latter typically recommend the design of objective, criteria-based and transparent rules to promote efficiency and to lessen the scope for discretionary decision-making (Mamdouh 2010). The discourse on regulation has also sought to promote regulatory reform and audits, and the establishment of institutions empowered that are legally and functionally independent of any market actor. Key questions have been: the economic impact of regulation, including on trade and investment; the potential economic

⁴ For instance, see Lafont 2005; Eberhard 2007; 'APEC-OECD Integrated Checklist on Regulatory Reform', available at www.oecd.org/regreform/34989455.pdf.

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and trade costs of regulatory measures; and how such impacts might be alleviated through better design and administration of regulations (UNCTAD 2010). Although trade disciplines and good regulatory practices appear to share common principles of transparency, non-discrimination, impartiality and objectivity, and necessity, how to transform such principles into disciplines on domestic regulation has been far from obvious.

5 Principles and issues in the negotiations

Domestic regulation under GATS Article VI was one of those areas which members decided to set aside for finalization at a later stage. At the end of the Uruguay Round, members could not reach consensus on how to treat non-discriminatory non-quantitative measures, which would be outside the scope of Article XVI (market access) and Article XVII (national treatment), but could still have an important effect on trade in services. Failure to reach agreement on domestic regulation was not too surprising as, more than any other area in GATS, it would have to address the thorny issue of the acceptable balance between trade liberalization and regulatory flexibility.

Thus, the negotiating mandate under GATS Article VI.4 and the subsequent Decision on Domestic Regulation set forth a three-fold work programme. Members were tasked with developing generally applicable disciplines (i.e. horizontal disciplines); disciplines as appropriate for individual sectors or groups thereof; and the development of general disciplines for professional services. In 1995, a Working Party on Professional Services (WPPS) was created and it produced two results in the accountancy sector: the elaboration of voluntary Guidelines for Mutual Recognition Agreements or Arrangements in the Accountancy Sector; and the WTO 1998 Disciplines on Domestic Regulation in the Accountancy Sector (Accountancy Disciplines). These disciplines apply only to that sector and only where specific commitments have been made for accountancy. Although the Accountancy Disciplines were completed in 1998, they are not yet in force. At that time, members decided to integrate them into GATS at the end of the current round of negotiations, along with any other disciplines that may be developed. Those negotiations eventually became part of the Doha Development Agenda, which have not yet been concluded.

Despite having no legal effect as yet, the Accountancy Disciplines have been influential in shaping the further negotiations which were undertaken by the Working Party on Domestic Regulation (WPDR), the body which