Service Trade Liberalization as a Development Opportunity

K.C. Fung
University of California and University of Hong Kong

Alan Siu
University of Hong Kong

October 25, 2006

Paper written for presentation at the WTO/UNESCAP ARTNet workshop on Post-Doha Research Agenda for Developing Countries, October 30-31, 2006, Macao.
As is well known, the three major areas of negotiations for the Doha Round trade talks are:

- cuts in agricultural subsidies and protections
- service trade liberalization
- reductions of industrial tariffs

From a negotiation standpoint, giving up more service sector openings is a “negative” for developing countries.

But service sector openings can promote economic growth.

Many services (finance, distribution) serve as intermediates and lubricants for other sectors.

Services can be viewed as an additional channel for economic development.

One can argue that it is also a relatively “clean” way to promote development.

Some services are also labor-intensive.

Two aspects: Service liberalization as engine of growth and political economy of service liberalization.
2. Services and Growth

- Many service sectors act as intermediates and lubricants (such as finance and distribution) for other industries

- There has been a lively debate among researchers on the sources of economic growth in East and Southeast Asia (e.g. Krugman, Young and Lau)

- Economic growth can be attributed to growth of inputs and technical progress

- There seems to be a consensus that before 1985 economic growth in the NIEs, ASEAN4 and China were all due to growth of inputs, with no technical progress

- According to Lau, after 1985, there was some technical progress. But if we add human capital and research and development to the traditional inputs (physical input and labor), then there was no technical progress again

- Japan is the consistent exception in Asia

- East and Southeast Asia need to continue to invest in education and in research and development
2. Services and Growth

Table 1. Sources of Economic Growth in East and Southeast Asia (pre-1985)

<table>
<thead>
<tr>
<th>Country</th>
<th>Physical Capital</th>
<th>Labor</th>
<th>Technical Progress</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>74.61</td>
<td>25.39</td>
<td>0.00</td>
</tr>
<tr>
<td>South Korea</td>
<td>82.95</td>
<td>17.05</td>
<td>0.00</td>
</tr>
<tr>
<td>Singapore</td>
<td>63.41</td>
<td>36.59</td>
<td>0.00</td>
</tr>
<tr>
<td>Taiwan</td>
<td>86.60</td>
<td>13.40</td>
<td>0.00</td>
</tr>
<tr>
<td>Indonesia</td>
<td>88.79</td>
<td>11.21</td>
<td>0.00</td>
</tr>
<tr>
<td>Malaysia</td>
<td>66.68</td>
<td>33.32</td>
<td>0.00</td>
</tr>
<tr>
<td>Philippines</td>
<td>66.10</td>
<td>33.90</td>
<td>0.00</td>
</tr>
<tr>
<td>Thailand</td>
<td>83.73</td>
<td>16.27</td>
<td>0.00</td>
</tr>
<tr>
<td>China</td>
<td>94.84</td>
<td>5.16</td>
<td>0.00</td>
</tr>
<tr>
<td>Japan</td>
<td>55.01</td>
<td>3.70</td>
<td>41.29</td>
</tr>
</tbody>
</table>

Source: Kim and Lau (1996)
In the growth accounting framework, services can be treated as an additional input.

Alternatively, services can be used to augment physical capital (serviced-enhanced capital), much like education-enhanced labor (human capital).

However we treat this, we can see that service trade liberalization will lead to a higher growth rates for developing countries, including Asian developing economies.

To do this quantitatively, we need to conduct empirical research in this area, using services in our growth accounting.

This will allow us to examine how much economic development can be attributed to service trade liberalization.

If indeed service trade liberalization can foster development in developing countries, why is such liberalization not happening more and to a great extent?

The answer is political economy. There are losers from liberalizations of services, who will lobby the governments in developing countries.

We next want to examine the political economy aspects in a simple model. The actual institutional details obviously will differ from one economy to the next.
3. Lobbying

- Stylized economic characteristics of service trade:
  - trade barriers are more like regulatory and entry barriers
  - due to barriers to entry, service industries often exercise various degrees of market power, i.e. they tend to be imperfectly competitive
  - services tend to be “lubricants” or “catalysts” for other industries

- According to GATS, there are four modes of trade in services:
  - cross-border trade
  - trade in which consumption occurs abroad
  - services are provided via FDI
  - movement of natural persons

  In our model, we will focus mainly on the third type, with firms entering a foreign market.

- Formal sector consists of:
  - service industry
  - manufacturing industry
  - agriculture
There are entry barriers against foreign affiliates.

The service and manufacturing industries are import-competing, but the country exports agricultural products.

The informal sector produces the numeraire good N

α^s are owners of capital in the service industry

α^m are owners of capital in the manufacturing industry

α^a are owners of capital in the agricultural business

α^w are the mobile, homogeneous labor

Owners of capital lobby, owners of the mobile factor do not.

In the service industry, there are n identical firms with the price being \( P^s(S) \), \( S=ns \)

The profit function \( \pi^s \) is:

\[
\pi^s = sP^s(S) - C^s(s, w, r)
\]

Profit maximizations of these imperfectly competitive firms lead to:

\[
\pi^s_s = P + sP' - C^s_s = 0
\]
\[
\pi^s_{ss} = 2P' + sP'' - C^s_{ss} < 0
\]
We can show that:

\[ S_n > 0 \]
\[ \pi_n^s < 0 \]

- Entry leads to an expansion of the service supplies.
- Entry leads to a reduction of profits.

The profit functions of the manufacturing firm and the agribusiness are:

\[ \pi^m = mP^m(M) - C^m(m, w, r, P^s) \]
\[ \pi^a = aP^a(S) - C^a(a, w, r) \]

The service good is used as an input or lubricant to the manufacturing sector.
3.1 Liberalization

- $V^i$: gross utility of a member of each group $s$, $m$, $a$ and $w$
- With no lobbying, policymakers choose an appropriate level of $n$ to maximize social welfare.

$$\text{Max}_n W = \alpha^s V^s + \alpha^m V^m + \alpha^a V^a + \alpha^w V^w$$

- We adopt a version of Grossman - Helpman “Protection for Sale” model here.
- Various interest groups offer contribution schedules corresponding to different degrees of entry barriers to the government. The government takes these schedules into account and maximizes:

$$\text{Max}_n V^G = (\beta^s - 1)\lambda^s(n) + W$$

- A weighted sum of the contributions and the general welfare, with $\beta^s > 1$ and assuming for now that only the service sector capital owners will lobby.
- First order condition leads to:

$$V^G_n = (\beta^s - 1)\lambda^s_n(n) + W_n = 0$$

But interest groups make contributions up to the point where the marginal benefit of lobbying equals the marginal cost:

$$\alpha^i V^i_n = \lambda^i_n(n)$$
So \( V_n^G = (\beta^s - 1)(\alpha^s V_n^s) + \alpha^s V_n^s + \alpha^m V_n^m + \alpha^a V_n^a + \alpha^w V_n^w = 0 \)

\[ \beta^s \alpha^s V_n^s + \alpha^m V_n^m + \alpha^a V_n^a + \alpha^w V_n^w = 0 \]

- Compared to the welfare maximizing case, more weight \( \beta^s > 1 \) is added onto the interests of the lobby group \( s \).
- We can easily show that \( dh / d\beta^s < 0 \)
- Lobbying by the service providers leads to trade restrictions in services.
Cross-cutting lobbying

- What if we allow the manufacturing industry to lobby for policies in the service sector?
- \( \text{Max}_n V^G = (\beta^s - 1)[\lambda^s(n)] + (\beta^m - 1)[\lambda^m(n)] + W \)
- \( dn/d\beta^m > 0 \)
- Allowing cross-cutting lobbying will enhance trade liberalization in the service sector.
- Manufacturers may not have an advantage in lobbying entry policies in the service sector compared to service providers.
- More transparent policymaking and more transparent regulations in the service sector will facilitate such cross-cutting lobbying.
In many service industries of developing economies, the provision of services is done by state-owned enterprises.

Government bureaucrats and ministries derive explicit and implicit income from the state-ownership of these service providers.

Maximization of the government objective function leads to:

\[ V_n^G = \beta^s \alpha^s V_n^s + \beta^m \alpha^m V_n^m + \alpha^a V_n^a + \alpha^w V_n^w + \alpha^b V_n^b = 0 \]

where \( V_n^b \) is the impact of a relaxation of the trade restriction in the service industry on the utility of the government bureaucrats in control of the state-owned service providers.

\[ dn/d\alpha^b < 0 \]

Reducing the number of state-owned service providers will enhance trade liberalization in the service industry.
3.3 Cross-Sectoral Negotiations

- In the literature, there has always been a notion that cross-sectoral negotiations will enhance liberalization across the board.

- For the proposed cuts in subsidies and tariffs in the EU farm sector, it is clear that these cuts are contingent on “satisfactory” openings in the service industries in the developing countries.

\[ V_n^G = \beta^s \alpha^s V_n^s + \beta^a \alpha^a V_n^a(t) + \beta^m \alpha^m V_n^m + \alpha^w V_n^w + \alpha^b V_n^b = 0 \]

- \[ \frac{dn}{dt} < 0 \]
  
  \( t \) is the farm tariff rate imposed by the EU.

- Cross-Sectoral negotiations will enhance trade liberalization in the service sector.
Service trade liberalization is an important channel for fostering economic development.

Using the growth accounting framework, Asian developing economies need to continue to invest in education and R&D.

Service sector liberalizations will augment these two channels.

Why are service sector liberalizations slow? We focus on a simple model of lobbying.

We use this model to highlight how it can be used to discuss several interesting issues in the context of global trade negotiations:

- Cross-industry lobbying
- State-owned service providers
- Linked or cross-sectoral negotiations

WTO can contribute to service sector liberalizations.

More economic research needs to be done.