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## **Preferential Trade Agreements in Services: Friends or Foes of the Multilateral Trading System?**

Carsten Fink\*

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Abstract: A fashionable feature of new generation preferential trade agreements (PTAs) has been the inclusion of a trade in services component. Does this trend imply a fundamental shift in the governance of world services trade towards fragmented and discriminatory trade arrangements? This paper will use the experience of PTAs negotiated so far and the literature on the political economy of regional integration to analyze the nature of preferential services liberalization and its consequences for the multilateral trading system. It will argue that these agreements unleash political economy forces that both help and hinder further progress at the WTO.

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\* The author is a Visiting Senior Fellow, Groupe d'Économie Mondiale at Sciences Po (GEM). He is grateful to Rudolf Adlung, Simon Evenett, Marion Jansen, Juan Marchetti, Martín Molinuevo, Deunden Nikomborirak, Martin Roy, Raúl Sáez, Andrea Schmid, and Constantinos Stephanou for helpful comments and suggestions. The views expressed in the paper are the author's own.

## 1. Introduction

Preferential trade agreements (PTAs) are proliferating around the globe. At the end of 2006, the World Trade Organization (WTO) counted 366 PTAs that had entered into force (see Figure 1). Only 142 of these agreements were concluded between 1948 and 1994—the period from the establishment of the GATT to the end of the Uruguay Round. The remaining 224 agreements entered into force thereafter. To put it provocatively, just after WTO members pledged their commitment to a non-discriminatory trading system by concluding the most far-reaching of all multilateral trading rounds, they went off to sign a plethora of discriminatory trading pacts.<sup>1</sup>

A fashionable feature of the ‘new generation’ PTAs has been the inclusion of a trade in services component. At the end of 2006, 54 such services PTAs were in force (they are counted separately by the WTO), of which only 5 predate the conclusion of the Uruguay Round (see Figure 1). The rising interest in services trade agreements reflects underlying technological and policy developments. Not too long ago, economic textbooks equated services with nontradeables. However, rapid advances in information and communication technologies has enabled cross-border trade in many service activities—from auditing accounts to educating people. In addition, many governments have transferred the provision of infrastructure services to the private sector, expanding the scope for foreign investment in services.

The proliferation of PTAs marks an important shift in the governance of world trade. Some economists view these agreements as inherently undermining the multilateral trading system and being ultimately harmful to the cause of free trade. Jagdish Bhagwati famously compared the emerging PTA landscape to a ‘Spaghetti bowl’ with preferences like noodles criss-crossing all over the place. He submits that the multiplication of preferential agreements weakens the willingness of countries to invest more lobbying effort into pushing the multilateral envelope.<sup>2</sup> Others view them as stepping stones towards eventual multilateral integration. Bergsten (1998), for example, argues that partial liberalization through PTAs promotes broader liberalization by demonstrating its payoff and familiarizing domestic politics with trade reform. In addition, the adverse impact of new preferential arrangements on outsiders induces the latter to seek new multilateral agreements.

So far, this debate has been mainly confined to the effects of goods PTAs. However, preferential liberalization of services trade differs from preferential tariff liberalization in a number of important ways, warranting separate analysis. This paper performs such an analysis. It considers the experience of services PTAs negotiated so far and the literature on the political economy of regional integration to analyze the nature of preferential liberalization in services and its consequences for the multilateral trading system. Whereas some of the traditional arguments advanced in support of either a stepping stone or stumbling stone view still apply, others are of comparatively less relevance in the services context. In

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<sup>1</sup> At the same time, Messerlin (2007) and Pomfret (2007) point out that the number of notified agreements exaggerates the true importance of preferential trading arrangements. Most PTAs notified after 1995 are bilateral agreements, in contrast to an equal mix of bilateral and regional agreements pre-1995. In addition, more than 30 percent of current PTAs notified to the WTO consist of intra-European trade deals, many of which have already been or are likely to be abrogated. That said, the number of WTO notification also underestimates the actual number of PTAs, as several agreements have not (or not yet) been notified.

<sup>2</sup> See, for example, Professor Bhagwati’s 2003 testimony to the US House of Representatives, available at <http://www.columbia.edu/~jb38/testimony.pdf>.

particular, the nature of rules of origin in services raises hopes that PTAs will not generate vested interests opposing further multilateral liberalization for fear of preference erosion. Nonetheless, there are still reasons to worry about the emergence of political economy forces that may hinder further progress at the WTO.

To arrive at these conclusions, we first need to review the salient features of services PTAs negotiated so far, drawing on recent research reviewing the ‘new generation’ agreements. This review will focus on the discriminatory nature of PTA commitments and, in this context, discuss the nature of rules of origin in services (Section 2). We will then try to explain some of these features by pointing to the inherent characteristics of services trade and the political economy implications of these characteristics (Section 3). Based on this analysis, we will explore what the special nature of services PTAs means for reciprocal bargaining (Section 4) and for the prospects for further multilateral integration (Section 5). The final section will offer concluding remarks.

## 2. Salient features of services PTAs

The recent popularity of services PTAs has prompted a number of studies that have assessed what these agreements have actually accomplished.<sup>3</sup> Notably, Sauvé (2005) and Fink and Molinuevo (2007) discuss the different architectural approaches adopted by services PTAs. Stephenson (2005), Roy, Marchetti and Lim (2006), and Fink and Molinuevo (2007) evaluate the liberalization content of selected agreements. Sáez (2005), Marconini (2006), and Pereira Goncalves and Stephanou (2007) review the negotiating experiences of countries in the Western Hemisphere.

In what follows, we summarize the landscape of services PTAs as described in these studies. To begin with, PTAs follow the WTO’s General Agreements on Trade in Services (GATS) in adopting a wide definition of trade in services. Liberalization measures cover four different modes of supply: cross-border trade (mode 1), consumption abroad (mode 2), commercial presence (mode 3), and presence of natural persons (mode 4). The inclusion of the latter two modes broadens the concept of ‘trade’ to include the movement of capital and labor.<sup>4</sup> In fact, since many service activities require the close physical proximity between consumers and suppliers, mode 3 is commercially the most important vehicle of trading services—accounting for an estimated 50 percent of global commerce in services (WTO, 2005).

No services PTA has established immediate free trade in all service sectors. Like the GATS, PTAs come with schedules of commitments that detail the remaining trade restrictive measures—either on a positive or negative list basis. Trade restrictive measures usually fall into two categories: (i) a list of explicit market access barriers, including non-discriminatory and discriminatory quantitative restrictions; and (ii) and national treatment limitations, covering all remaining discriminatory measures.<sup>5</sup>

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<sup>3</sup> In this paper, we refer to the term ‘preferential trade agreements’ loosely to include any bilateral or regional agreement that seek the liberalization of trade in services outside the WTO—such as free trade agreements (FTAs), economic partnership agreements (EPAs), and bilateral trade agreements (BTAs).

<sup>4</sup> In contrast to the WTO, many PTAs feature horizontal disciplines on investment and the presence of natural persons. In other words, these agreements broaden the concept of ‘trade’ across both goods and services.

<sup>5</sup> Negative list agreements typically establish additional classes of measures. However, most of these additional classes are either due to commitments in negative list schedules not distinguishing between modes of supply or they relate to measures that would otherwise be captured by a PTA’s national treatment obligation. An

A comparison of a country's multilateral and PTA commitment schedules reveals the trade preferences one PTA party grants to another. Table 1 broadly distinguishes between five categories of trade preferences created by PTA commitments. These categories are not mutually exclusive in the sense that a country's PTA schedule may contain undertakings associated with two or more of the five categories shown.

**Table 1: Trade preferences created by services PTAs**

|   | Type of commitment   | Nature of preference  | Example   | Degree of discrimination |
|---|--|---|---|--------------------------|
| 1 | PTA commitment reproduces GATS commitment  | Parties can invoke dispute settlement mechanisms of PTA to enforce trade commitment                             | Cambodia's and Vietnam's commitment under the ASEAN-China Agreement on Trade in Services  | None                     |
| 2 | PTA commitment goes beyond GATS commitment, but does not imply actual liberalization           | Reduced risk of policy reversal for service suppliers from parties  | Indonesia's commitments under the ASEAN Framework Agreement on Services   | None                     |
| 3 | PTA commitment implies actual liberalization, which is implemented in a non-discriminatory way | Reduced risk of policy reversal for service suppliers from parties  | Chile's commitment to permit insurance branching under the Chile-US FTA   | None                     |
| 4 | PTA commitment implies actual liberalization, rules of origin are liberal                      | Service suppliers from parties benefit from improved market access, set of eligible service suppliers is wide   | Singapore's financial services commitment under the Singapore-US FTA  | Weak, though it depends  |
| 5 | PTA commitment implies actual liberalization, rules of origin are restrictive                  | Service suppliers from parties benefit from improved market access, set of eligible service suppliers is narrow | Thailand's elimination of a foreign equity limitation for construction and distribution services under the Australia-Thailand FTA | Strong                   |

The first category covers cases where a country's PTA undertaking reproduces in part or in full its GATS commitment. For example, all of Cambodia's and Vietnam's commitments under the ASEAN-China Agreement on Trade in Services fall into this category. The only 'preference' created by such a commitment is the enforceability of treaty obligations through the PTA's dispute settlement mechanisms. In the case of state-to-state disputes, this type of preference is arguably weak. The WTO's Dispute Settlement Understanding (DSU) already offers parties a credible forum for adjudicating state-to-state disputes. The advantages of

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exception may be prohibitions of (non-discriminatory) performance requirements, though many positive list agreements also feature such prohibitions in separate investment chapters.

resorting to a state-to-state dispute settlement mechanism under a PTA are likely minor—if they exist at all.<sup>6</sup>

More importantly, many PTAs provide for an investor-to-state dispute settlement mechanism that extends to obligations affecting investments in services (mode 3).<sup>7</sup> This type of dispute settlement is not available under the WTO. It allows private service suppliers to directly invoke the disciplines established by a PTA against a government before an international arbitration court. A government's acceptance of such scrutiny can strengthen the credibility of its investment regime. For certain infrastructure services, for example, foreign investors incur substantial sunk costs at the time of entry and may generate profits only after several years. The ability to challenge adverse government measures in the future may increase the confidence of foreign investors at the time of making the investment. That said, a PTA commitment is only one among many variables—and unlikely the most important one—that service suppliers consider in their investment decisions.<sup>8</sup> In addition, economists disagree about the extent to which the credibility afforded by investor-to-state arbitration is associated with greater foreign investment flows, with some studies suggesting only a small, if any, effect.<sup>9</sup>

The second category of trade preferences consists of PTA commitments that go beyond a country's GATS commitment, but do not imply any new market opening. For example, most commitments scheduled under the ASEAN Framework Agreement on Services fall into this category.<sup>10</sup> The benefit of this type of PTA commitment consists of an enforceable guarantee that another party's policy will not become more restrictive—or at least not more restrictive than what is committed. Such a guarantee is not only relevant for investment in services (as just discussed), but also for other modes of supply. Mattoo and Wunsch (2004), for example, argue that trade commitments on mode 1 can pre-empt protectionist pressure for services that have only recently become tradable, notably those linked to business process outsourcing.<sup>11</sup> Notwithstanding its guarantee value, the preferential character of a category 2 commitment is arguably still weak, as there is no discrimination in the actual application of trade policies.

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<sup>6</sup> In fact, several of the state-to-state dispute settlement mechanisms embedded in PTAs fall short of the WTO DSU in that they do not feature a procedure to overcome a possible deadlock in the appointment of arbitral panelists. Such a deadlock has occurred, for example, in the case of a complaint brought by Mexico against the United States under the North American Free Trade Agreement (NAFTA), as discussed in the Panel Report on *Mexico—Soft Drinks* (WTO Document WT/DS308/R, Annex C, pages C-5 and C-87). See also Fink and Molinuevo (2007) for further discussion.

<sup>7</sup> There is variation in the scope of obligations covered by investor-to-dispute settlement. Some agreements confine this type of dispute settlement to disciplines on expropriation, whereas others extend it to violations of national treatment, most-favored nation treatment and other obligations. See Roy (2003) and Fink and Molinuevo (2007).

<sup>8</sup> Studies have shown that the most important variables explaining foreign direct investment decisions include the size of a country's economy, its growth potential, exchange rate movements, and the quality of institutions. See Blonigen (2005) for a recent survey of the literature.

<sup>9</sup> Hallward-Driemeier (2003) and Rose-Ackerman and Tobin (2005) find no or only a weak empirical relationship between the existence of a bilateral investment treaty and inflows of foreign investment. However, using a different estimation sample, Neumayer and Spess (2005) find a strong positive relationship.

<sup>10</sup> See Fink (2007).

<sup>11</sup> At the same time, Mattoo and Wunsch (2004) acknowledge that it is uncertain whether restrictions on cross-border trade can be meaningfully enforced in an online environment given the current state of technologies. Thus, the precise guarantee value of mode 1 commitments is uncertain.

Commitments in the third category consist of undertakings that imply new market opening. However, the associated changes in laws and regulations are implemented in a non-discriminatory way, such that service suppliers from non-parties equally benefit from the more liberal policy environment. Chile's commitment to permit branches of foreign established insurance companies under the Chile-US FTA is an example of this type of market opening measure. For service suppliers from parties, commitments falling into the third category create only a weak trade preference. It is the same as the one associated with PTA commitments of the second category: a reduced risk of policy reversals.

The fourth and fifth categories of commitments cover cases where PTA commitments imply new market opening, which is implemented in a discriminatory way. In other words, only services trade between PTA parties benefits from the more liberal policy environment. Yet what exactly constitutes 'services trade between PTA parties'? To answer this question, it is necessary to understand the rules of origin established in services PTAs. Rules of origin in services are different from their counterparts in the goods case. In services, they mainly seek to resolve the question of whether service suppliers from non-parties established in one of the parties benefit from a PTA commitment. Suppose, for example, that a bank from country A has established a subsidiary in country B, can that subsidiary benefit from the trade preferences under a PTA between B and C?

Notwithstanding important nuances in the rules of origin adopted by PTAs, one can distinguish between two basic approaches.<sup>12</sup> The more liberal approach extends PTA benefits to all companies that are incorporated in one of the parties and are engaged in substantive business operations there. The more restrictive approach limits PTA benefits to companies that are ultimately owned or controlled by domestic persons.

As an example, Singapore's commitments in financial services under the Singapore-US FTA imply new market opening, but the agreement extends trade preferences to all service suppliers incorporated in the US that can prove substantive business operations. Preferential market opening of this type does not discriminate against companies with non-party "nationality". Still, discrimination occurs with respect to those non-party service suppliers that are not commercially active in a PTA party.

From an economic perspective, the level of discrimination depends on three factors: (i) the openness of PTA parties to foreign investment by non-parties; (ii) whether non-party service suppliers would in any case do business in a PTA party; and (iii) the tax and business transaction costs associated with departures from a service supplier's preferred international corporate structure. In the specific case of the Singapore-US FTA, discrimination may well be muted: the US government does not impose restrictions on foreign investment in services, large multinational service suppliers are likely to have a voluntary presence in the US territory, and many choose to have their global or regional headquarters there. In other cases, however, discrimination may be more pronounced.

The Australia-Thailand FTA exemplifies the more restrictive approach. Under this agreement, Thailand permits full foreign ownership in construction and distribution services, but restricts this benefit to companies that are owned and controlled by Australian persons.<sup>13</sup>

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<sup>12</sup> For a detailed discussion of the rules of origin adopted by East Asian PTAs, see Fink and Molinuevo (2007).

<sup>13</sup> See Articles 804 and 905 of the Australia-Thailand FTA. The ownership and control rule does not apply to the agreement's chapter on the Promotion and Protection of Investments.

Service suppliers from non-parties—even if they are established and engaged in substantive business operations in Australia—continue to face a 49 foreign equity limitation when investing in these sectors in Thailand. Studies have shown that an ownership and control requirement can substantially reduce the set of service suppliers eligible for preferential treatment, implying the strongest form of discrimination.<sup>14</sup>

Similarly, trade commitments that lead to the actual liberalization of ‘mode 4 trade’ also bring about strong discrimination. Rules of origin for natural persons are relatively straightforward, because individuals, unlike companies, cannot be simultaneously present in many countries. All PTAs extend trade benefits in this area to nationals of parties. Some agreements also include non-nationals that are permanent residents of parties. In either case, the set of eligible service suppliers is well-circumscribed.

Having established the five categories of trade preferences, an obvious question is how many PTA commitments fall into which categories. We cannot answer this question precisely. Studies that have evaluated the liberalization achievements of PTAs have shown that the overwhelming majority of agreements offer at least some value added commitments relative to countries’ GATS undertakings. Thus, we can easily characterize category 1 as an exception to the rule. However, it is difficult to assess comprehensively to what extent PTA commitments imply new market opening and, if so, how such market opening is implemented. No database exists on countries’ laws and regulations in services that would allow for a comparison of PTA commitments to domestic policies.

Still, some inferences are possible. Roy, Marchetti, and Lim (2007) analyze 32 services PTAs and provide 32 examples of so-called liberalization pre-commitments—promises to open up a particular service activity at a future point in time. It is reasonable to assume that these pre-commitments imply new liberalization (though new liberalization is not necessarily limited to cases of pre-commitments). In addition, the rules of origin for companies adopted by the overwhelming majority of PTAs are of the more liberal type. This author is aware of only three agreements—the Australia-Thailand FTA mentioned above, the Thailand-Japan FTA and the India-Singapore Comprehensive Economic Cooperation Agreement (CECA)—that have opted for a domestic ownership and control rule.<sup>15</sup> In other words, for the most part, commitments in PTAs concluded thus far fall into categories 2, 3, and 4.

There is one exception to this conclusion. As pointed out above, actual liberalization commitments for ‘mode 4’ trade can create strong discrimination. Indeed, there are several PTAs that have offered new market opening for this form of services trade.<sup>16</sup> Most prominently, under the Japan-Philippines Economic Partnership Agreement (EPA), Japan

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<sup>14</sup> See Fink and Nikomborirak (2007) for a review of simulation studies on the implications of different rules of origin undertaken for ASEAN countries.

<sup>15</sup> See Article 87 of the Thailand-Japan FTA. In the case of the India-Singapore CECA, the ownership and control rule only applies to service supplied through commercial presence. See Article 7.23(c) of that agreement. Fink and Molinuevo (2007) offer a detailed review of the rules of origin adopted by 25 East Asian PTAs.

<sup>16</sup> In addition to PTAs, there are numerous bilateral agreements managing temporary labor flows between countries. See Hoekman and Winters (2007).

permitted the entry of Filipino nurses and caregivers—provided that they meet certain qualification requirements.<sup>17</sup>

A final important feature of many PTAs is the inclusion of a non-party most-favored-nation (MFN) clause. For example, Article 76 of the Japan-Philippines EPA reads:

*“Each Country shall accord to services and service suppliers of the other Country treatment no less favorable than that it accords, in like circumstances, to services and service suppliers of any non-Party.”*

In other words, Japan and the Philippines will extend to each other any preference granted to any third country. In fact, parties to a PTA with such an obligation might as well—and for transparency purposes would be well-advised to—include in their commitment schedules any benefit previously granted to a non-party. While similar in their effect, non-party MFN clauses should not be confused with the multilateral MFN obligation under the GATS, which requires WTO members not to discriminate between fellow members in the application of services policies.

The inclusion of a non-party MFN clause in a PTA serves to soften discrimination inherent in existing services agreements. It also reduces discrimination in future PTAs, as countries need to extend any negotiated trade preference to existing PTA partners. In addition to PTAs, many bilateral investment treaties (BITs) have also incorporated MFN clauses. In principle, a government bound by such a BIT clause has to extend all investment preferences to its BIT partner, including those emanating from PTA commitments under mode 3 in services.

How relevant are non-party MFN obligations in muting the discriminatory impact of PTAs? It is difficult to precisely answer this question. Many PTAs and BITs with non-party MFN obligations expressly carve out other PTAs from their scope.<sup>18</sup> In addition, agreements typically allow for the scheduling of exceptions to the MFN discipline. Houde, Kolse-Patil, and Miroudot (2007) argue that those exceptions are often broad, undermining the discipline’s reach. That said, there are cases where non-party MFN treatment bites. For example, Colombia will need to extend its market opening commitment in financial services under the Colombia-US FTA to fellow members of the Andean Community, due to the MFN obligation established in the Cartagena Accord of that Community. More research is needed to better understand the precise reach of non-party MFN clauses in trade and investment agreements.

### **3. Explaining key features of services PTAs**

The design of services PTAs differs in several ways from more traditional goods PTAs. These differences ultimately stem from the inherent characteristics of services, notably the regulatory nature of government measures affecting services and the need for close physical

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<sup>17</sup> It is not entirely clear whether Japan’s commitment on nurses falls within the scope of mode 4, at least as defined by the GATS. If nurses are employed directly by public hospitals or private hospitals owned and controlled by Japanese persons, they would likely fall outside the scope of mode 4. See Chaudhuri, Mattoo, and Self (2004) for further discussion.

<sup>18</sup> Such exemptions are found, for example, in the EFTA-Korea and EFTA-Singapore FTAs. UNCTAD (2004) offers an overview of PTA exception clauses established in BITs.



proximity between suppliers and consumers of services. In this section, we will attempt to explain two important features of services PTAs established in the previous section: non-discriminatory implementation of market opening commitments and the adoption of liberal rules of origin.<sup>19</sup>

*Why may governments opt for non-discriminatory implementation of their PTA commitments?*

As pointed out in the previous section, governments may choose to implement at least some of their PTA commitments in a non-discriminatory way. Given available evidence, it is not possible to assert that non-discriminatory implementation is the general trend in PTAs, but it is sufficiently important to demand explanation. From an economic perspective, such a course appears sensible, as it promotes neutrality in competition from abroad. Yet it seems puzzling that countries would enter into a preferential arrangement just to abandon negotiated preferences when implementing their trade obligations.

One reason for non-discriminatory implementation may be the practicability of policy discrimination. Trade protection in services does not take the simple form of a tax on trade flows, but consists of a myriad of laws and regulations affecting services and service suppliers. Discrimination in the application of these measures may not always be feasible. Even if it were feasible, it would require governments to verify the origin of services or service suppliers, increasing the bureaucratic burden on implementing agencies.

There is no documented evidence to support this explanation, though this author's conversations with selected government officials involved in the administration of PTAs have confirmed its relevance. At the same time, the practicability argument does not seem fully convincing. Just because trade protection is not exercised through tariffs does not mean that governments cannot discriminate. Indeed, the history of trade policy in international air transport—which is largely excluded from the GATS and from PTAs—has shown that discrimination in services can be put into effect. In addition, the Mainland-Hong Kong Closer Economic Partnership Agreement (CEPA) illustrates how governments can verify the origin of service providers. A special certification mechanism under that agreement requires interested service suppliers to prove compliance with the agreement's rules of origin. By June 2007, 1123 service suppliers had submitted applications for certificates to be eligible under CEPA, of which 1087 had been approved.<sup>20</sup>

Three additional explanations are possible. First, governments may expressly seek to avoid the economic distortions associated with actual discrimination. Our understanding of trade diversion effects and their consequences in services is still at its infancy. One notable concern is the creation of a first-mover advantage for globally second-best firms (see Mattoo and Fink, 2004). Second, the nature of liberalization measures may be such that the first liberalization step—for example, the break-up of a monopoly or the admission of foreign

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<sup>19</sup> The inclusion of non-party MFN clauses is best explained by bargaining considerations, to which we turn in the next section.

<sup>20</sup> The Mainland-Macao CEPA has established a similar certification mechanism (see Fink, 2005). In contrast to most other services PTAs, the origin rule in these two agreements sets out a number of specific criteria for meeting the substantive business operations test. However, these criteria do not appear to significantly reduce the set of eligible service suppliers. They primarily seek to exclude non-party service suppliers which are not credibly linked to Hong Kong's economy. Emch (2006) discusses the compliance of this origin rule with GATS Article V.6.

branches—faces the most political opposition. Once a government has taken that step, there may be little remaining opposition for extending the measure to third countries, especially if the PTA partner is a large economy with a large pool of competitive service providers.

Third, a country may be bound by non-party MFN clauses in other PTAs (or in BITs)—see the discussion above. If such MFN clauses cover a country's most important trading partners, discrimination against the remaining countries may be of little relevance. That said, even though PTAs have been proliferating rapidly, the reach of non-party MFN clauses is far from universal, as pointed out in the previous section.

#### *Why do most PTAs opt for liberal rules or origin?*

There is a seemingly straightforward answer to this question: 'because they have to'. Like its goods *alter ego*—GATT Article XXIV—GATS Article V prescribes a series of conditions that treaties on economic integration in services must fulfill in order to constitute a lawful exception from the multilateral MFN principle. One of these conditions, GATS Article V.6, reads:

*“A service supplier of any other Member that is a juridical person constituted under the laws of a party [...] shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement.”*

In other words, this provision prescribes precisely the liberal rule of origin found in most PTAs, as described in the previous section.<sup>21</sup> GATT rules on regional integration have frequently been characterized as doing little to disciplines goods PTAs.<sup>22</sup> Yet in the case of the GATS, one might argue that Article V.6 has meaningfully limited the extent to which WTO members can discriminate through preferential arrangements.<sup>23</sup>

The explanation offered by this GATS requirement is not sufficient, however. It assumes that WTO members show divine respect for WTO rules on regional integration, which one may question.<sup>24</sup> Even if GATS Article V.6 was the decisive factor in crafting PTA origin rules, why did WTO members agree on this article in the first place? In addition, a special and differential treatment provision in Article V offers PTAs “*involving only developing countries*” the option to limit trade preferences to service suppliers owned or controlled by

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<sup>21</sup> Notwithstanding the liberal character of most PTAs' rules of origin, certain elements of these rules raise questions of compliance with GATS Article V. See Emch (2006) and Fink and Molinuevo (2007). Interestingly, GATS Article V does not establish any discipline on rules of origin for natural persons—for example, by requiring the extension of trade preference to individual service suppliers from non-parties whose centre of economic interest is in a PTA party. Adlung (2006) argues that this omission biases Article V rules against natural persons.

<sup>22</sup> See, for example, World Bank (2005).

<sup>23</sup> Emch (2006) has characterized GATS Article V.6 as the restoration of the multilateral MFN principle for service suppliers from non-PTA parties.

<sup>24</sup> Fink and Molinuevo (2007) confront East Asian FTAs with GATS Article V requirements. While an authoritative judgment of compliance can only emerge from WTO dispute settlement, there are serious questions about whether these FTAs comply with the 'substantial sectoral coverage' and 'elimination of substantially all discrimination' requirements of GATS Article V.

persons of the parties.<sup>25</sup> Yet most PTAs among developing countries have not taken advantage of this option.<sup>26</sup> Why do countries appear to voluntarily adopt rules of origin that extend trade preferences to established non-party service suppliers that show substantive business operations?

One explanation may be that governments consider domestically established non-party service suppliers as part of the domestic economy. In fact, governments in some jurisdictions face constitutional limits in discriminating against companies on the basis of their origin once they are established in the domestic territory. Surely, established non-party service suppliers employ domestic residents and pay taxes to the government. Improved access to PTA markets by such suppliers may be associated with employment gains and greater fiscal revenues—like in the case of goods trade. A government may even purposely seek liberal rules of origin in its PTAs to attract foreign direct investment (FDI) from non-parties, turning the economy into a trading hub for services.

While these considerations go a long way in explaining the adoption of liberal rules of origin, they leave some open questions. The benefits of enhanced access to PTA markets depend critically on the mode through which services are supplied. In the case of modes 1 and 2, for which the supply of the service occurs from or in the domestic territory, the expectation of employment gains and greater tax revenue seems reasonable. However, for the commercially more important third mode—the establishment of a commercial presence in the territory of the PTA partner—employment gains may be small. The domestic economy may still benefit from greater tax revenue, though much depends on how companies transfer profits between countries and how these profits are taxed.

From a political economy perspective, it is not clear whether politicians and trade negotiators consider domestically established non-party service suppliers as part of their constituencies. For example, it is interesting to note that membership of the US Coalition of Service Industries—the main US interest group lobbying for market opening abroad—seems to be made up almost entirely of US household names. It does not appear to extend to major non-US service suppliers established in the US.<sup>27</sup> Similarly, the European Services Forum, which promotes the same interests in the EU, mostly represents European service suppliers—though selected non-European companies participate in the Forum as well.<sup>28</sup>

In addition, governments frequently pursue industrial policy goals in setting services policy, seeking to promote national champions or the emergence of an ‘indigenous’ service industry. Whatever their economic merit, such goals do not seem to have played a major role in crafting origin rules in services PTAs.

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<sup>25</sup> See GATS Article V.3(b). It is also worth noting that PTAs not posing any conflict with the GATS MFN discipline—such as the US bilateral trade agreements with non-members of the WTO—are not bound by GATS Article V.

<sup>26</sup> For example, the ASEAN Framework Agreement on Services, the ASEAN-China Trade in Services Agreement, and the MERCOSUR Protocol of Montevideo on Trade in Services extend trade preferences to all established service suppliers that engage in substantive business operations in a party.

<sup>27</sup> See <http://www.uscsi.org/members/current.htm>.

<sup>28</sup> See <http://www.esf.be/pdfs/Members%20Biographies.pdf>. Examples of non-European companies that are members of the Forum include Electronic Data Systems, Oracle, and Universal Music.

Even if we assume that the exporting country has an economic or political interest in a liberal rule of origin, the adoption of such a rule is subject to bargaining between PTA parties. It is not clear whether a country that primarily imports services necessarily goes along with a liberal proposition. A wider set of service suppliers eligible for trade preferences implies greater import competition, which may or may not conform to the objectives of the importing country's government.

A final explanation may relate to the network characteristics of many service activities. Service providers in a variety of sectors—whether financial intermediation, transportation, telecommunications, distribution, or professional services—can reap economies of scale and scope by simultaneously supplying services in several countries. They therefore seek the greatest possible flexibility in designing their global corporate structures, with the freedom to choose from which location and through which mode to service any given market. Even though restrictive rules of origin may offer selected companies a competitive edge, a PTA landscape with restrictive rules of origin will make multinational service providers collectively worse off. In other words, this explanation offers a rationale for GATS Article V.6—a global requirement for PTAs to adopt a liberal rule of origin.<sup>29</sup> It may also offer a rationale for liberal rules of origin in individual PTAs, if one takes into account the 'repeated game' character of PTA negotiations. Excluding non-party service suppliers in one PTA may lead those non-parties to retaliate by equally opting for more restrictive origin rules in their PTAs.

In sum, there are plausible political economy reasons why PTAs opt for liberal rules of origin. Still, we are left with some open questions about the precise motivations and political economy influences underlying government choices—not least because selected agreements *have* opted for a more restrictive approach.

#### **4. Reciprocal bargaining**

The negotiation of trade agreements invariably involves reciprocal bargaining, whereby a government views its own market opening as a concession given and foreign market opening as a concession received. The logic of reciprocity is not rooted in the economics of trade opening. As Krugman (1997) famously pointed out, the economist's case for open markets is essentially a unilateral case. If trade liberalization brings about economic benefits and governments are convinced of these benefits, market opening should be pursued regardless of what other countries may do.

Nonetheless, economists go along with reciprocity because it serves a useful political economy purpose. Suppose that a government is convinced about the merits of trade liberalization, but faces opposition from vested interests that stand to lose from foreign competition. Negotiated as part of a package of trade commitments, a government may be in a better position to proceed with market opening, because it can muster support from those constituents that stand to gain from improved access to foreign markets. In addition,

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<sup>29</sup> A possible third explanation may be the difficulty of determining the nationality of a company. Multi-level equity holdings, the presence of nominees, and public trading of equity can obfuscate a company's ultimate ownership and control. However, this problem can be solved by putting the burden of proof of domestic ownership and control on the preference-seeking service suppliers, as is practiced in agreements that operate a domestic ownership and control requirement. See Fink and Nikomborirak (2007) for further discussion.

Bhagwati (2002) points out that the mutuality of concessions suggests fairness and makes adjustment to trade reforms politically more acceptable.

In this section, we explore how the design of services PTAs affects incentives for striking reciprocal bargains. In particular, we first point out that the ‘leaky’ nature of services PTAs poses a seeming bargaining puzzle, for which we offer several explanations. We then consider the potential for strategic bargaining behavior and, in this context, discuss the incentives posed by non-party MFN clauses.

### *The puzzle of ‘leaky’ PTAs*

Viewed against a background of reciprocal bargaining, the pattern of services PTAs described in Section 2 poses, at first blush, a puzzle. Suppose that service providers from country C benefit from country A’s market opening under a PTA between A and B. Two types of benefits are possible. First, if country A implements its market opening commitment in a non-discriminatory way, country C service providers face the same competitive conditions as country B service providers. Second, if A implements the agreement in a discriminatory way but the PTA adopts a liberal rule of origin, then at least those country C service providers established in country B and having substantial business operations there benefit from the trade preference. Several questions emerge: why would country B be willing to pay country A the full price for this market opening measure? In addition, why would country A make such a commitment, if it can sell the same market opening measure to country C in future preferential or multilateral trade negotiations involving A and C? In other words, a ‘leaky’ PTA reduces a country’s negotiating coinage for future trade agreements—be they preferential or multilateral. Why would a government voluntarily undermine its future bargaining position?

It is useful to illustrate this puzzle with two specific examples. Section 2 already described Chile’s commitment under the Chile-US FTA to permit branches of foreign established insurance companies, which the country implemented in a non-discriminatory way. It is too early to tell who will be the main beneficiaries of this liberalization measure, as the implementing legislation only came into force in June 2007. If history is any guide, however, it is not at all clear whether the beneficiaries will be US companies. Closer cultural ties and greater market familiarity have led most foreign participants in Chile’s financial sector to come from Europe (mainly from Spain).<sup>30</sup> Interestingly, the Chile-EU FTA, which was signed before the Chile-US FTA, did not feature the same liberalization measure. Why was the United States willing to pay for Chile’s commitment with concessions in other negotiating areas, if there is a good possibility that the resulting commercial opportunities will be seized by European financial institutions? Equally, why was Chile willing to extend insurance branching rights to non-US companies without demanding a payment for this move from other trading partners—especially from the EU?<sup>31</sup>

The second example comes from the North American Free Trade Agreement (NAFTA). As part of that agreement, Mexico committed to eliminate foreign ownership restrictions on financial institutions established in Canada and the US. After NAFTA’s entry into force in

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<sup>30</sup> In banking, roughly two-thirds of the foreign bank presence in Chile has been attributable to Spanish banks. See Crystal, Dages, and Goldberg (2001). Unfortunately, no equivalent estimate could be found for the insurance sector.

<sup>31</sup> Saéz (2006) discusses Chile’s negotiating experience in financial services with the EU and the US.

1994, there was indeed substantial new investment in Mexico's banking sector from US-based banks. However, it turned out that most US investors were actually subsidiaries of Spanish and Dutch financial institutions, taking advantage of NAFTA's liberal rules of origin.<sup>32</sup> Again, why were Mexico and the US willing to strike a bargain, when the main beneficiaries of that bargain did not sit at the negotiating table?

The bargaining puzzle associated with "leaky" PTAs can be viewed in another way. If the ground rules of PTA negotiations foresee liberal rules of origin or the possibility of non-discriminatory implementation of PTA commitments, the logic of reciprocity would predict bargaining to only lead to a shallow exchange of market opening concessions. Countries will refrain from tabling ambitious offers to not undermine their negotiating coinage for future agreements with other trading partners.

### *Some explanations*

Several arguments can be put forward to explain why countries might still be willing to strike reciprocal trade deals, even if PTAs are 'leaky'. First, trade agreements do not always follow the logic of mercantilism. Strategic and foreign policy considerations sometimes motivate governments to open up their markets. For example, China's commitments under its CEPAs with Hong Kong and Macao are arguably less the outcome of reciprocal bargaining, but rather reflect the context of the 'one country, two systems' formula.

Second, as explained in Section 2, at least part of the value of a PTA commitment is an assurance against policy becoming more restrictive. Even though non-party service suppliers may directly or indirectly benefit from a PTA-induced market opening measure, non-party governments would not be able to challenge a party's non-compliance with its PTA obligations through the state-to-state dispute settlement mechanism of the PTA in question.<sup>33</sup> To the extent that governments value the legal security offered by a trade commitment, they may still be willing to strike a reciprocal bargain even if that bargain does not offer any new market opening.

Third, again as pointed out in Section 2, the adoption of liberal rules of origin may still imply significant discrimination. For example, the requirement of establishment and substantive business operations may easily exclude small and medium-sized service suppliers from non-parties that do not have a large international presence to begin with. Even for large service suppliers, departures from their preferred international corporate structures may entail significant tax and transaction costs. Thus, a government implementing a PTA commitment in a discriminatory way but with liberal rules of origin will still retain some negotiating coinage in 'selling' the same market opening measure to third countries in future trade negotiations.

Fourth, countries do not negotiate services PTAs in isolation. In fact, the decisive factors to launch PTA negotiations are often found outside the service sector. If the expected gains from an overall package of PTA commitments are sufficiently large to overshadow associated bargaining disadvantages with other trading partners, it may still be possible to strike a reciprocal bargain—even if the resulting agreement is 'leaky'. Such a scenario may apply to

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<sup>32</sup> This example is described more fully in World Bank (2004).

<sup>33</sup> Whether or not non-party investors can avail themselves of the PTA's investor-to-state arbitration mechanism depends on whether they fall under the rule of origin adopted by the agreement.

the situation of a small developing country negotiating a PTA with a large developed country, whereby the latter is demanding services market opening in exchange for preferential access to its goods market. For example, such an asymmetric bargain situation led Costa Rica to agree to the dismantling of public monopolies in insurance and telecommunications under the US-Central America-Dominican Republic FTA.<sup>34</sup>

However, this argument still leaves open the question of why the developed country would agree to a ‘leaky’ PTA. One factor may be that at the time of signing the PTA, it does not know whether the PTA partner will implement its commitment in a discriminatory or non-discriminatory way. Even if it expects non-discriminatory implementation, it may feel confident that its own service suppliers are sufficiently competitive to capture a significant share of the PTA partner’s market, regardless of third-country competition.

A second reason may relate to the country’s longer term trade policy strategy and applies specifically to the US. In documenting the US strategy of ‘competitive liberalization’, Evenett and Meier (2007) argue that the US explicitly seeks to ‘export’ a US-style trading framework. It sees this framework as spurring countries’ integration into the global economy, promoting peace and prosperity, and inducing other countries to follow a similar path. In other words, the US views the promotion of market-based and open economies in its systemic interest, even if not all trade commitments by trading partners directly advance US export interests. In addition, the US seeks to promote a particular template of trade agreement—encompassing a wide range of trade-related topics, the adoption of particular architectural approaches, and certain minimum standards of openness.<sup>35</sup> Even if not all aspects of this template are a commercial priority in relation to every US trading partner, the adoption of the full template is still important as a precedent for future trade negotiations.

Assessing the success of the US strategy of competitive liberalization goes beyond the scope of this paper. However, it is worth noting that US FTAs negotiated so far only cover a small share of US trading partners. In particular, coverage does not yet extend to the large and fast-growing emerging markets which arguably have stronger bargaining power—such as Brazil, China, India, or South Africa.<sup>36</sup> In addition, one may argue that a strategy of competitive liberalization actually calls for strong discrimination, in order to create incentives for non-parties to enter into trade agreements as well (more on that in the next section).

A fifth and final explanation for ‘leaky’ PTAs may simply be timing. For example, progress in multilateral trade negotiations is measured in years or even decades—a time span which typically exceeds the term of elected politicians. For countries ready to commit to market opening, a PTA forum may—but does not always—deliver quicker results. In other words, the overall gain from a PTA today may exceed the discounted loss of having fewer negotiating chips in future trade negotiations.<sup>37</sup>

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<sup>34</sup> See Echanti (2006). It should be noted that Costa Rica has not yet ratified this FTA.

<sup>35</sup> The United States Representative Ms. Susan Schwab has characterized US FTAs as ‘gold-standard’ trade agreements. See footnote 17 in Evenett and Meier (2007).

<sup>36</sup> The US recently signed an FTA with Korea, though this agreement still awaits ratification in both countries.

<sup>37</sup> A related consideration is that a PTA may allow parties to harvest unilateral liberalization by trading partners between multilateral trading rounds. Such harvesting may occur through follow-on negotiations in PTAs or through automatic upward ratcheting clauses, as incorporated in a number of existing agreements.

### *Strategic behavior and non-party MFN clauses*

The existence of joint gains from an exchange of market opening concessions is a necessary but not sufficient condition for countries to strike a reciprocal bargain. Countries may behave strategically, especially if they know that trade policies are negotiated in different forums. In this context, Schwartz and Sykes (1996) have pointed out that bargaining may be more effective in PTAs than at the multilateral level. Since trade commitments at the WTO are made on a (multilateral) MFN basis among 151 members, there are incentives to free ride—countries not engaging in the negotiating process with the hope that others bargaining for market opening from which they would benefit. The smaller number of players involved in PTA negotiations may help to overcome possible free rider problems.

In addition, under preferential liberalization, domestic service providers exporting or investing in the PTA partner country would face no or only weak competition from service suppliers outside the PTA area. In other words, the value of a PTA partner's market opening may be higher if it is done on a preferential rather than non-discriminatory basis. In the end, governments may be willing to pay more for preferential market access abroad, leading to deeper exchanges of market opening commitments.

That said, the bargaining advantages offered by PTAs are less clear cut than they may first appear. There are ways of reducing the free-rider problem in multilateral trade negotiations. Notably, services negotiations under the Doha Development Agenda (DDA) have adopted a plurilateral negotiating approach, whereby groups of members put forward collective liberalization requests to other groups.<sup>38</sup> As for a country's willingness to pay more for preferential market access, that willingness depends critically on the security of trade concessions. If a PTA partner subsequently grants equal access to non-parties, the gain from preferential market access will be transitory. In a world of rapidly proliferating PTAs and simultaneous PTA and WTO negotiations, the scope for deeper bargaining may be limited. In addition, the more 'leaky' are PTAs the less are the gains from preferential market access to begin with. In the end, it remains an empirical question whether a PTA forum allows for more effective bargaining.<sup>39</sup>

Strategic considerations are also relevant in explaining the implications of including a non-party MFN clause in a services PTA. To begin with, for any given PTA, each party has an incentive to ask its trading partner for MFN treatment, as it ensures that domestic service providers benefit from current and future trade preferences extended to non-parties. However, a country bound by many non-party MFN obligations faces a less favorable

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<sup>38</sup> See Annex C of the Hong Kong Ministerial Declaration. Admittedly, it is not fully clear how far a plurilateral negotiation approach would reduce free-rider problems. Since final commitments will still be made on MFN basis, participation in groups requesting market opening may itself be subject to strategic behavior. See Schwartz and Sykes (1996).

<sup>39</sup> In an econometric investigation of East Asian services FTAs, Fink and Molinuevo (2007) find that the number of FTA parties has a statistically significant negative effect on the depth and breadth of countries' liberalization undertakings relative to the GATS. This finding is consistent with the hypothesis of more effective bargaining among a smaller number of players. That being said, it should be considered as tentative, as Fink and Molinuevo's measures of the breadth and depth of liberalization undertakings are based on simple counts of commitments, which can only imperfectly capture the true value of trade commitments.



bargaining situation in future PTAs. A new PTA partner knows that any negotiated preference will be extended automatically to others. Thus, service exporters and investors from that partner will not have exclusive access to the domestic market, reducing the value of a future PTA commitment. Consequently, the willingness of a new PTA partner to pay for additional market opening may be reduced. Moreover, to the extent that a country expects its PTA partner to negotiate additional agreements, the free-rider problem described above for WTO negotiations re-emerges. If country C knows that any PTA preference granted by country A to country B will be automatically extended to C through a non-party MFN clause, C may hold back from paying for the same negotiated commitment in its own PTA negotiations with A.

Admittedly, these considerations appear theoretical—not least because the precise reach of non-party MFN clauses in existing agreements is not clear (see Section 2). From a more pragmatic perspective, one may argue that a country with liberal trade policies in services has a stronger interest in a non-party MFN clause than a country that maintains substantial trade restrictions under a PTA. The former has few preferences left to grant and can only benefit from the extension of future market opening measures by PTA partners. The latter may be more cautious about widening the scope of any future liberalization undertaking and may not want to weaken its bargaining position for negotiations with other trading partners. It is thus not surprising that PTAs involving developed countries feature a non-party MFN obligation more often than agreements between developing countries—though there are many exceptions to this rule.<sup>40</sup>

## 5. Friends or foes of the WTO?

With the considerations of the previous three sections in mind, we can return to the question raised in the introduction: are services PTAs more likely to be friends or foes of the WTO?

The economic literature offers several political economy models that analyze countries' incentives to engage in multilateral liberalization after signing a PTA, focusing on the case of goods trade. Krishna (1998) shows how a trade diverting PTA will generate vested interests against further multilateral liberalization. Inefficient firms that can only export because of preferential market access to a PTA partner will oppose any further market opening towards third countries with more efficient firms. Similarly, Levy (1997) demonstrates that a bilateral PTA that offers the median voter greater overall gains than a multilateral trade agreement will undermine support for the latter.

However, there are also forces backing the stepping stones view. Businesses in countries left out by PTAs may feel that they are harmed by not having preferential access to foreign markets. PTAs may thus strengthen the incentives of governments excluded from such agreements to also engage in reciprocal liberalization. Such a change in incentives may directly enhance the support for multilateral liberalization or prompt the negotiation of new PTAs. In the latter case, a 'domino' dynamic may be triggered that leads governments to enter into PTAs with all their major trading partners (Baldwin, 1995). Such a situation is still not equivalent to free multilateral trade, as producers still face origin rules when exporting to different destinations. However, Baldwin (2006) argues that increased production

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<sup>40</sup> See Table 6 in Fink and Molinuevo (2007).

unbundling will then generate systemic political economy forces favoring the multilateralization of preferential agreements.

In principle, similar political economy forces could be unleashed from preferential liberalization of services trade. However, the ‘leaky’ nature of services PTAs arguably attenuates some of these forces. If PTA commitments are implemented in a non-discriminatory way, no vested interests will emerge opposing further multilateral market opening. Even if they are implemented in a discriminatory way but come with liberal rules of origin, the emergence of such vested interests may still be limited. Political influence is typically exerted by owners of capital (Grossman and Helpman, 1994) and on precisely this aspect rules of origin of the liberal type do not discriminate: domestic capital and foreign capital are treated equally, as long as companies are established in a PTA territory and have substantive business operations there. By the same token, services PTAs themselves are less likely to trigger a domino dynamic laying the grounds for eventual multilateralization, as the exclusionary effects of such agreements are less severe.

Notwithstanding this conclusion, there are several other considerations that lead to a more refined assessment of the systemic consequences of services PTAs. We start with three considerations favoring the stepping stones view. For one, PTAs do offer inroads towards more open markets. As such, they may reduce resistance to committing at the WTO. This scenario seems especially likely, when PTAs achieve difficult trade reforms—such as the breakup of a monopoly. In these cases, widening the market opening measure to all WTO members may face little remaining political resistance, as already pointed out in Section 3. In addition, one may argue that a positive reform experience at the PTA level may strengthen the support for binding services trade policy at the multilateral level.

Second, there may be positive spillovers from PTA to WTO negotiations. Reciprocal bargaining in services trade is more information-intensive than in the goods case, requiring a resource-intensive stock-take of domestic laws and regulations across a large number of sectors that might be considered measures subject to trade disciplines. Information gaps have arguably been one of the factors contributing to the slow progress of multilateral services negotiations. Governments that have carried out a comprehensive stock-take in the course of PTA negotiations are likely to be better prepared for services talks at the WTO.

Third, the inclusion of a non-party MFN clause in services PTAs and BITs may strengthen incentives to negotiate at the multilateral level. A country that has concluded agreements with such clauses covering all its major trading partners will find itself in a situation where it cannot extend any new market opening measure on a preferential basis. From a bargaining perspective, this country should have an interest in ‘selling’ its market opening to the whole WTO membership and, in any case, may find it difficult to find a trading partner willing to ‘pay’ for the commitment at the PTA level.

At the same time, there are also a number of considerations suggesting that PTAs may turn out to be harmful to the multilateral cause. First, it is again important to consider that services commitments are the outcome of a broader set of negotiations, also encompassing trade in goods and a large number of rule-making issues. It is conceivable that a country may refrain from tabling a WTO commitment in order to preserve negotiating coinage for a PTA deal. As pointed out above, in certain circumstances a country’s economic welfare from a PTA may be higher than from a multilateral trading round. An example would be a small country obtaining preferential access to a large and highly protected agricultural market. If

the quid pro quo for agricultural market access were service market opening, the small country would want to first sell its services market opening measure to its PTA partner before going multilateral.<sup>41</sup>

Second, preferential deals in services may remove important bargaining chips from the multilateral negotiating table. In particular, the proliferation of PTAs may undermine a multilateral grand bargain whereby developed countries would commit to trade reforms in agriculture in return for emerging economies committing to trade liberalization in non-agricultural market access (NAMA) and services. Such a multilateral bargain appears essential for negotiating the reduction of domestic subsidies in agriculture, which by nature cannot be reduced on a preferential basis.

A negotiating linkage between agriculture, NAMA and services is clearly manifested in the position of WTO members on both sides of the table. For example, in presenting its agriculture offer in the run-up to the Hong Kong WTO Ministerial Conference in 2005, the European Union stated:

*“In order to demonstrate our increasingly skeptical Member States and civil society that this is not going to become an agriculture-only Round, we need to agree to move speedily and substantively forward on other issues. [...] We have to see agreement amongst us [...] on the principles and objectives that will see substantial improvement in overall market access [...] in services [...].”<sup>42</sup>*

Similarly, at a meeting of the Special Session of the Council for Trade in Services in March 2007, the Brazilian representative explained that *“what Brazil needed to know [...] was what progress was going to be forthcoming in other areas of the negotiations so that it could calibrate accordingly what it was going to put on the table on services.”<sup>43</sup>*

At the same time, it is uncertain how a link between agriculture, NAMA and services will be effectuated, should the current multilateral trading round ever come to a successful conclusion. Trade concessions in services are not straightforwardly negotiated through a formula approach, complicating any quantitative linkage between the different negotiating areas.<sup>44</sup> Possibly for that reason, the Hong Kong Ministerial Declaration only calls for *“a comparably high level of ambition in market access for Agriculture and NAMA”*—without mentioning services.<sup>45</sup> Indeed, agreeing on modalities in agriculture and NAMA is widely

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<sup>41</sup> Consistent with this argument, Roy, Marchetti, and Lim (2007) document that countries' PTA commitments often show more ambition than their offers tabled in the DDA services negotiations. However, the lack of ambition in WTO offers may also reflect the fact that the multilateral services talks have been “held hostage” by the lack of progress in negotiations on agriculture and non-agricultural market access. The final services commitments emerging out of the DDA's single undertaking may well be more ambitious.

<sup>42</sup> See “Making Hong Kong a Success: Europe's Contribution,” Brussels, October 28, 2005. Available at [http://trade.ec.europa.eu/doclib/docs/2005/october/tradoc\\_125641.pdf](http://trade.ec.europa.eu/doclib/docs/2005/october/tradoc_125641.pdf).

<sup>43</sup> See WTO Document TN/S/M/23, April 5, 2007.

<sup>44</sup> In the run-up to the Hong Kong WTO Ministerial Conference in 2005, the European Union advanced the idea of establishing quantitative negotiating benchmarks for services. However, this approach was rejected by developing country WTO members and finds no mentioning in the final Hong Kong Ministerial Declaration.

<sup>45</sup> See paragraph 24 of the Hong Kong Ministerial Declaration, available at [http://www.wto.org/English/thewto\\_e/minist\\_e/min05\\_e/final\\_text\\_e.htm](http://www.wto.org/English/thewto_e/minist_e/min05_e/final_text_e.htm).

perceived as the key to unlocking the overall negotiating round. At the same time, services are part of the DDA's single undertaking and the demandeurs in services will likely make agricultural and NAMA modalities conditional on a satisfactory outcome in services.

In any case, the current PTA landscape does not seem to pose a significant obstacle to striking multilateral bargains, at least in the near future. The countries targeted most frequently in the 2006 'plurilateral' services requests are middle income countries which, for the most part, have not entered into PTAs with developed countries.<sup>46</sup>

Third, the potential for PTAs undermining progress at the WTO may be more severe in the area of mode 4 trade. As described in Section 2, rules of origin for individual service suppliers are by nature more restrictive, bringing about strong discrimination. As explained above, discriminatory preferences do not automatically alter incentives in such a way that governments will oppose further multilateral liberalization. However, such scenario is a distinct possibility. For example, would the Philippines easily accept the erosion of its preferential access to the Japanese market for nursing services by Japan making a similar commitment at the WTO?<sup>47</sup>

Notwithstanding this possibility, a bigger question is whether non-discriminatory liberalization of mode 4 trade will ever become a reality—at least, as far as greater mobility of low and semi skilled workers is concerned. One may argue that it is precisely the multilateral MFN obligation that may lead countries to shy away from committing under the GATS. Mattoo (2005) and Hoekman and Winters (2007) advance that the entry of foreign service providers raises certain deeply rooted fears—including loss of national identity, competition for jobs, and illegal immigration—which are better addressed in a bilateral or regional forum. Preferential arrangements allow host governments to manage labor inflows more carefully, taking into account cultural and other ties between countries. In addition, they can make improved access conditional on enhanced cooperation on matters such as pre-movement screening and selection, accepting and facilitating return, and combating illegal migration. In sum, even though discriminatory treatment of mode 4 may complicate progress at the WTO, it may equip countries with the necessary flexibility to achieve at least *some* liberalization in this area.<sup>48</sup>

Fourth, one may argue that PTAs divert scarce negotiating resources. The negotiation of each trade agreement requires its own share of preparation, consultation, coordination, and travel. For countries negotiating many PTAs, there is the risk that the devotion of negotiating resources to these agreements comes at the expense of reduced engagement at the WTO.<sup>49</sup>

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<sup>46</sup> The 12 most frequently targeted countries are Argentina, Brazil, China, Egypt, India, Indonesia, Malaysia, Pakistan, Philippines, South Africa, Thailand, and Turkey.

<sup>47</sup> It is interesting to note, however, that Japan made an almost identical commitment on the entry of nurses and caregivers in its EPA with Thailand.

<sup>48</sup> That said, Mattoo (2005) still believes that the GATS has a useful role to play. Host countries could commit to allow access to any source country that fulfills certain pre-specified conditions. Initially, these conditions could be specified unilaterally, but eventually it would be desirable to negotiate them multilaterally.

<sup>49</sup> As pointed out in footnote 43, Roy, Marchetti, and Lim (2007) find that countries' PTA commitments often show more ambition than their offers tabled in the DDA services negotiations, which would be consistent with the hypothesis of diverted negotiating resources. However, as already pointed out, the limited ambition of Doha Round offers may simply reflect the "lagging" state of the services negotiations under the DDA's single undertaking.

Similarly, PTAs may draw away the attention of top policymakers from multilateral negotiations. It may also lead to a dilution of political capital, especially in countries where support for trade liberalization is thin.<sup>50</sup>

As a final point, it is worth noting that services PTAs are less likely to give rise to the ‘spaghetti bowl’ syndrome intrinsic to the proliferation of goods PTAs. In the latter case, rules of origin restrict exporters’ use of imported intermediate inputs. Taking advantage of PTA preferences requires ongoing proof that exported products meet origin rules. Different origin rules for different PTA partners may prevent countries from reaping economies of scale, as products with one set of imported intermediate inputs may qualify under the rules of one agreement but not others. In services, rules of origin primarily deal with the origin of service *providers* rather than the origin of the traded services. Service exporters remain free to rely on the import of intermediate inputs of goods and services from anywhere in the world.<sup>51</sup> At most, exporters face a one-time certification process which is unlikely to noticeably affect a supplier’s production cost. That being said, different levels of openness in services for different trading partners may reduce the transparency of the trading regime, especially in light of the regulatory nature of services trade barriers.<sup>52</sup> Service suppliers may need the advice of professional lawyers to understand how they can do business in a PTA partner’s market. Such informational barriers may prove especially challenging for small and medium-sized service suppliers unfamiliar with business conditions in foreign markets.

## 6. Concluding remarks

This paper sought to assess the systemic consequences of the current proliferation of services PTAs. There is little doubt that these agreements will leave their mark on the WTO, although it is too early to tell whether they will turn out to be helpful or harmful to the multilateral cause. The arguments put forward in this paper suggest that there is at least one important reason to hope that services PTAs are more likely to be WTO-friendly compared to goods PTAs: the ‘leaky’ nature of services agreements may limit the emergence of political economy forces resisting further MFN-based market opening. That being said, the paper also discussed a number of other considerations that point to a more pessimistic outlook of the systemic consequences of these agreements—not least because services agreements are typically part of a broader set of trade negotiations.

Looking at the evolving landscape of PTAs, one of the most interesting questions is whether future preferential deals will cover trading relations between large economies. Leaving aside the older regional arrangements (EC, NAFTA, MERCOSUR, ASEAN), there is currently no bilateral PTA between the world’s top-10 economies and there are only five bilateral

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<sup>50</sup> Jagdish Bhagwati makes this point in his editorial “America’s bipartisan battle against free trade”, *The Financial Times*, April 9, 2007.

<sup>51</sup> One might argue that PTAs establish a rule of origin for services supplied through modes 1 and 2. For example, cross-border trade in services is typically defined as the supply of a service ‘from the territory of one party into the territory of another party’. At what point is a service supplied from outside the territory of a party if a service supplier relies on the import of intermediate service inputs from a non-party? While legal questions of this type may well arise at some point, they still seem academic. See Fink and Molinuevo (2007) for further discussion.

<sup>52</sup> The interaction of PTA commitments with GATS liberalization undertakings and obligations in BITs as well as the presence of non-party MFN clauses may further undermine the transparency of the trading regime.

agreements between a top-10 and a top-20 economy.<sup>53</sup> This landscape is consistent with the bargaining scenario outlined in Section 3: small economies negotiating with larger economies, with the former being primarily interested in preferential access to the goods markets of the latter. Larger economies may still prefer to negotiate at the WTO—especially those countries which stand to benefit from a reduction of domestic subsidies in agriculture. By the same token, however, if future PTAs were to extend to trading relations between large economies, it would become increasingly difficult to strike multilateral bargains. Indeed, a number of PTA negotiations are under way—for example, Australia-China, Australia-Japan, EC-ASEAN, EC-India, EC-Korea—that could pave the way in this direction.

A second concern is for future PTAs to discriminate more strongly against non-parties by introducing an ownership and control requirement in origin rules. Such a move could be motivated by industrial policy objectives, the desire to limit import competition, or to prevent free-riding on reciprocal bargains. The cases of the Australia-Thailand, Japan-Thailand and the India-Singapore agreements show that this scenario is not just hypothetical. Fortunately, GATS Article V.6 has curtailed the ability of PTAs to go down that route, insofar WTO members respect this article. However, agreements involving only developing countries are not bound by it and are free to adopt an ownership and control requirement.<sup>54</sup> Even though such agreements are unlikely to ever cover a large share of global services trade, they could potentially have systemic consequences for the multilateral trading system, which operates on the basis of one country, one vote.<sup>55</sup>

Finally, it is important to keep in mind that the negotiation of services PTAs is still a relatively new phenomenon—for governments negotiating them and for economists studying their causes and consequences. The paper's discussion pointed to a number of open questions in our understanding of these agreements. Four questions appear paramount. First, it would be important to have a better empirical understanding of the extent to which PTA commitments lead to *de novo* liberalization. Are the pre-commitments identified by Roy, Marchetti, and Lim (2007) just the 'tip of the iceberg' or are they isolated incidences of actual market opening?

Second, where *de novo* liberalization occurs, there is still relatively little we know about the implementation of market opening commitments. It is easy to point to examples where implementation has happened in a non-discriminatory way. However, we do not have a good empirical understanding how often governments take this implementation route. It is interesting to note that except China's CEPAs with Hong Kong and Macao, no other PTA known to this author has established a registration mechanism that formally verifies service

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<sup>53</sup> This point was originally made by Messerlin (2007). The five agreements in the second category are Australia-US, Japan-Indonesia, Japan-Mexico, Japan-Thailand, and Korea-US. Economies are ranked by their 2004 GDP measured in PPP-exchange rates, taking into account individual EC member states. The top-20 economies account for approximately 80 percent of the world's GDP.

<sup>54</sup> Since Australia and Japan are not considered developing countries in the WTO, it is not immediately clear how the ownership and control requirement in the Australia-Thailand and Japan-Thailand agreements comply with GATS Article V.6. Indeed, the European Union has raised this issue in the WTO Committee on Regional Trade Agreements. See WTO Document WT/REG185/M/1.

<sup>55</sup> Then again, some developing countries are already bound by non-party MFN clauses in existing PTAs and BITs with developed countries, potentially limiting the scope for discrimination—regardless of the rules of origin adopted in PTAs.

suppliers' compliance with the agreements' rules of origin.<sup>56</sup> However, discriminatory application of market opening measures can also occur at the level of national laws and regulations or, even less transparently, through discretionary regulatory decision-making—such as the allocation of licenses.

Third, when implementation does proceed in a discriminatory way but rules of origin are liberal, we have few insights into the precise extent of discrimination, its economic effects, and its political economy consequences. As argued in Section 2, much will depend on circumstances—a country's openness to foreign investment by non-parties, whether non-party service suppliers invest in any case in one of the PTA parties, and the costs associated with departures from a service supplier's preferred international corporate structure. It is interesting to observe, for example, that those European banks that invested in Mexico through their US subsidiaries after the entry into force of NAFTA, opted to transfer ownership of their Mexican operations to their European headquarters, once Mexico extended its trade preference to the European Union in the late 1990s.<sup>57</sup> In other words, even when foreign investment is allowed and non-party service suppliers establish voluntarily, PTAs with liberal rules of origin may still generate substantial trade and investment diversion.

Fourth, there is need to better understand the exact reach of non-party MFN clauses in PTAs and BITs. As discussed in Section 2, numerous agreements have adopted such clauses, but their impact is often limited due to special carve-outs for PTAs and exceptions lists. The latter particularly complicate an assessment of the reach of these clauses, as countries may lodge reservation for the precise measures for which they introduce discriminatory treatment.

Roy, Marchetti, and Lim (2007) make a sensible call for the WTO to step up its surveillance of services PTAs, including the implementation of market opening commitments. A precedent for deeper surveillance already exists at the WTO in the form of China's transitional review mechanism, under which China is obliged to provide information on changes in laws and regulations as well as the issuance of service licenses.<sup>58</sup> Greater transparency on the part of governments would help shed light on the questions raised above. However, there is also need for analytical studies, which scrutinize the economic effects and political economy consequences of preferential market opening in services. Even though research on services trade reforms is invariably constrained by limited data availability and the regulatory nature of market opening measures, there is scope to study recent liberalization episodes that can be directly attributed to the conclusion of PTAs. The results of such studies would offer governments more guidance in designing their trade negotiating strategies and would help refine the conclusions drawn in this paper.

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<sup>56</sup> Most other agreements simply give parties the right to deny the benefit of a PTA to service suppliers that do not meet the agreement's origin rules.

<sup>57</sup> See World Bank (2004).

<sup>58</sup> The transitional review mechanism will expire in 2010, eight years after China's accession to the WTO. See Annex 1A in WTO Document WT/L/432.

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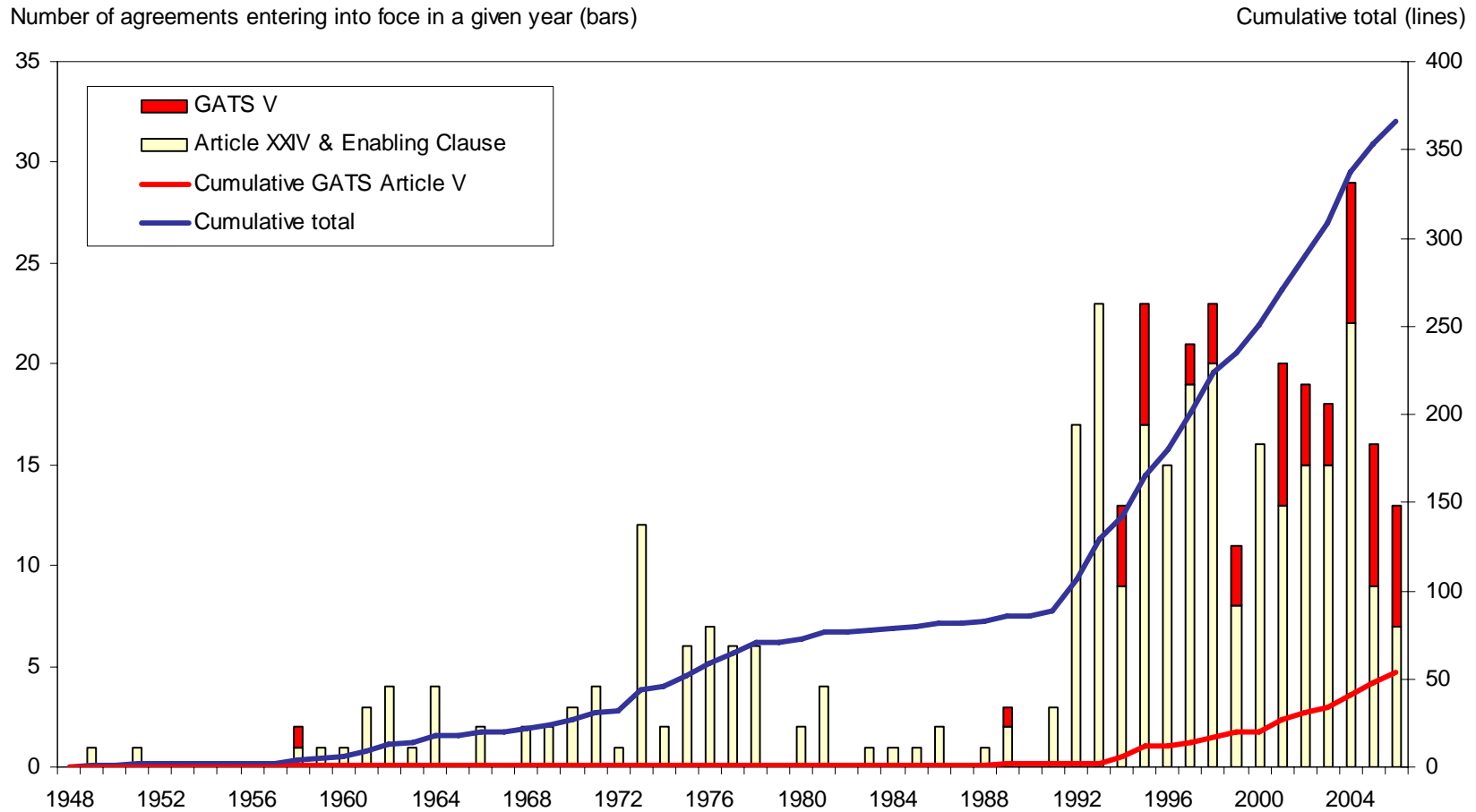
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**Figure 1: PTAs notified to the WTO, by year of entry into force**



**Note:** Services PTAs are notified under GATS Article V. Goods PTAs are notified under GATT Article XXIV or the Enabling Clause. The numbers depicted here include PTAs that have become inactive since their notification to the WTO.

**Source:** World Trade Organization ([http://www.wto.org/english/tratop\\_e/region\\_e/regfac\\_e.htm](http://www.wto.org/english/tratop_e/region_e/regfac_e.htm))