The International Services Agreement (ISA) — from the European vantage point

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Introduction: Wither services liberalisation?

These days, there is no shortage of opinion pieces or political statements that declare in their opening lines that the multilateral system in trade is 'now at a critical juncture': While most observers now agree the Doha round unworkable in its current form, trade in services has been in stasis for much longer. Besides from political sensitivities and practical difficulties that surround all services negotiations in general, this lack of progress on services in the WTO is in part explained by systemic reasons that relates to the negotiation sequencing of the Doha round. During the Hong Kong Ministerial Conference in 2005, the EU and services proponents succumbed to agreeing that agriculture and NAMA chapters would have to be agreed upon before services are negotiated. As a consequence, other WTO members with defensive interests on services could withhold their offers without risking their interests in other negotiation pillars. Although a signalling conference on services was organised to receive at least some idea of what was on the table in services, Doha offers have been minuscule compared to already existing GATS commitments. In fact, they contain no new market openings.[1] Liberalisation on services is indeed a Sisyphean ordeal, or as an anonymous services negotiator once put it in Geneva – 'Services would have to make do with whatever happens to be on offer by the time our colleagues in agriculture reach an agreement' – which is to say nothing.

Another aspect to the lack of new market openings relates to the amount of 'water in the tariffs'. There is a considerable gap between the services commitments in the WTO and domestic regulations that are applied on the ground. Several analysts on services trade have noted that all existing commitments in the WTO merely 'locked in' the existing liberalisation into multilateral commitments.[2] In the past two decades, economic reforms and market deregulation have also taken place on unilateral basis in pursuit of growth, and this is particularly true for emerging markets like India and China. As a consequence, most WTO members could introduce trade barriers that would double their restrictiveness without violating their commitments.[4] Meanwhile, the appetite for new successive negotiations under the WTO has been virtually non-existent.[5]

This gap between the GATS commitments and actual domestic laws is to a certain extent also explained by the proliferation of regional and bilateral free trade agreements. To date, almost a hundred FTAs have been notified to the WTO that also included

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[1] Borchert, Gootiiz, Mattoo, 'Policy Barriers To International Trade in Services: New Empirical Evidence', World Bank, 2010

[2] Roy, 'Services Commitments in Preferential Trade Agreements: An Expanded Dataset', WTO, 2011; ibid.

[4] Hoekman, Mattoo, 'Services Trade Liberalization and Regulatory Reform: Re-invigorating International Cooperation', World Bank, 2011

[5] GATS article XIX requires the members to 'enter into successive rounds of negotiations, beginning not later than five years' which is yet to happen.

comprehensive coverage of services. Surprising many, about half, are based on a structure similar to negative listing.[6] This modality usually provide for a more ambitious and 'future-proof' approach, assuming all sectors are included unless they are specifically exempt, in contrast to the positive listing approach of GATS commitments and EU FTAs to date where all commitments need to be specifically listed.

Despite GATS failing to open up new markets for European business or to services trade barriers, there has been little political engagement to move services out of that infamous junction of impasse – at least until the idea of a plurilateral agreement on services was floated by the end of 2011. The proposed International Services Agreement (ISA) is still very much a concept in development that is yet to be fleshed out into a proposal. The key questions, such as its participation, architecture – or even its political rationale – are still being contemplated.

The economic case for a plurilateral agreement

The economic case for a plurilateral agreement on services is almost self-evident. Neither is such an idea a novelty – in fact, the GATS itself is a plurilateral agreement that was created by a group of countries that chipped in their commitments until the collective offer was good enough to be extended to all members of the WTO on the principle of most favoured nation (MFN), irrespective of the risk of free riding from non-contributing parties. All subsequent services liberalisation has taken place on the basis of plurilateral MFN, most notably using 'reference paper approach' where a group of countries unilaterally agreed to be bound by a commonly adopted principles on telecommunications and financial services.[7] Although the key emerging economies are missing, a number of economies have signed the additional commitments on basic telecommunication services (82 to date) and to a lesser extent on financial services, and form the baseline for EU requests in services negotiations.

But improving the conditions of services trade is very much a concern for a few. The top ten economies account for 70% of world trade, with the EU (excluding intra-EU trade) and the US alone representing 40%; 27 WTO members are required to reach 90% coverage – the threshold established for sectoral plurilateral agreements in the WTO. The top 90% include developed OECD countries and developing countries alike, such as China (3rd place), India (5th, much due to its ICT industry) and Russia (11th). While travel and transport services account for half of world trade, the other half consists of business services.

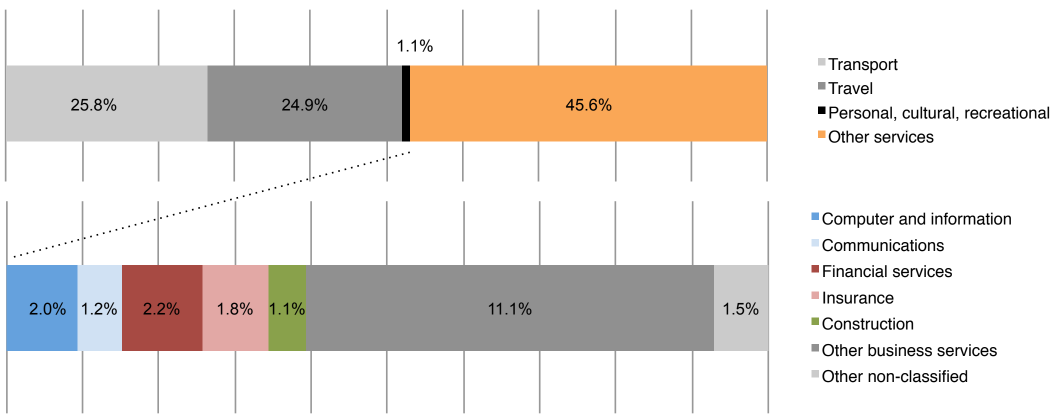
[6] WTO World Trade Report 2011, WTO, 2011

[7] Negotiating group on basic telecommunications, April 24, 1996; Understanding on Commitments in Financial Services

Top 90% (27 countries) of services trade 2010 (total trade and major categories)
Source: IMF EBOP

CATEGORY	Total trade ($)*	% of world trade in services*	Transport	Travel	Personal, cultural and recreational services	Other services
TOTAL	**5,064,304**	**100.0%**	**25.8%**	**24.9%**	1.0%	**45.6%**
EU27	1,192,603	23.5%	6.2%	4.3%	0.3%	12.7%
United States	763,681	15.1%	2.9%	4.2%	0.3%	7.7%
China	348,552	6.9%	1.9%	2.0%	0.0%	3.0%
Japan	249,226	4.9%	1.7%	0.8%	0.0%	2.4%
India	236,851	4.7%	1.2%	0.5%	0.0%	3.0%
Singapore	190,592	3.8%	1.2%	0.6%	0.0%	1.9%
Korea, Republic of	162,381	3.2%	1.3%	0.5%	0.0%	1.3%
China, Hong Kong SAR	158,869	3.1%	1.0%	0.8%	n/a	1.4%
Canada	144,916	2.9%	0.6%	0.9%	0.1%	1.3%
Switzerland	121,085	2.4%	0.3%	0.5%	0.0%	1.6%
Russian Federation	109,624	2.2%	0.5%	0.7%	0.0%	0.9%
Australia	99,960	2.0%	0.4%	1.0%	n/a	0.6%
Brazil	86,791	1.7%	0.3%	0.4%	0.0%	1.0%
Norway	80,764	1.6%	0.5%	0.4%	0.0%	0.7%
Thailand	76,168	1.5%	0.6%	0.5%	n/a	0.5%
Chinese Taipei	72,026	1.4%	0.4%	0.4%	0.0%	0.7%
Malaysia	67,668	1.3%	0.3%	0.5%	n/a	0.5%
Saudi Arabia	61,342	1.2%	0.3%	0.5%	n/a	0.4%
United Arab Emirates	53,399	1.1%	n/a	n/a	n/a	n/a
Turkey	52,180	1.0%	0.3%	0.5%	0.0%	0.2%
Israel	40,763	0.8%	0.2%	0.2%	n/a	0.4%
Indonesia	40,131	0.8%	0.2%	0.3%	0.0%	0.3%
Mexico	37,709	0.7%	0.1%	0.4%	0.0%	0.3%
Egypt	37,337	0.7%	0.3%	0.3%	n/a	0.2%
China, Macao SAR	36,226	0.7%	0.0%	0.6%	n/a	0.1%
South Africa	29,639	0.6%	0.2%	0.3%	0.0%	0.1%

Sector distribution
Source: IMF EBOP



Despite the high level of concentration to a few trading partners, services liberalisation is increasingly a universal economic interest. The value of the world trade in services has more than doubled during the past decade, growing faster than trade in manufactured goods, agriculture and raw materials. It is almost one quarter of world trade in terms of value, which may seem rather modest, but the value of manufacturing trade is considerably inflated by 'double counting' that takes place – with the emergence of global production networks, much of manufacturing trade consists of intermediate goods (components and raw materials) that are included several times as they move through the production chain in various countries before they are finally assembled and exported. Discounting this double counting, services trade would be close to being of equal size with goods trade, which is not surprising given that a significant level of world GDP comes from services. On the average 50% in the developing economies and 75% in the OECD economies that provide an important narrative for employment, crisis recovery and urban development – as we shall see, this is particularly true in the case of China.

Furthermore, services may not travel as well as gadgets, but the internet and multinational service providers have drastically improved marketability of both goods and services overseas. Lowering of the freight costs, cross-border data flows, intra-corporate transfer of competence, and global financial services provides the necessary infrastructure for exports and ability to tap into new growth outside the increasingly stagnant Single Market.

The dilemma of configuration

Although the overall economic rationale for an ISA may be evident, the political economy equation looks quite different. To begin, the modus operandi of plurilateral agreements, the so-called critical mass approach is out of the question if all services sectors are to be included. The WTO members are allowed to negotiate separate, stand-alone agreements if they represent 90% of world trade, but unlike the two zero-tariff agreements – the WTO IT Agreement (ITA) with interests crossing the north-south divide, or WTO Pharmaceutical Agreement with a heavily concentration amongst only seven countries – services trade is impeded by members who have clearly expressed defensive agendas during the DDA talks: China and India alone represent more than 12% of world trade alone, and who would have a blocking vote; Russia would argue that it has already undertaken its obligations to liberalise its services trade through its accession, a justification that China has used for many years after joining the WTO to avoid further concessions in the DDA.

However, one of the beauties of the WTO system is its dual nature. On one hand, it represents a system that is governed by rules. On the other hand, the system also provides a freedom for members to bargain themselves out of them. A possible scenario could be a new WTO agreement exclusively amongst a smaller group, such as the suggested Really Good Friends (RGF) of Services that that represent at least two-thirds of world trade short of the critical mass threshold.[8] RGF countries would then negotiate a waiver from the other WTO members to negotiate a new WTO agreement on services its own, in return for concessions on other Doha negotiation areas, most likely on both agriculture and non-agricultural market access (NAMA).

Such a waiver would allow the RGF (or any configuration of likeminded) to negotiate a comprehensive package of market-deep liberalisation amongst them inside the WTO system, building on existing structures of dispute settlement and agreements, including its exceptions and rules. Most likely, such an agreement would be on non-MFN basis, where the benefits are only offered to its members. Although aforementioned zero-for-zero agreements are on MFN-basis, exclusive circles of non-MFN agreements are not unprecedented in the history of the WTO. This configuration is not all too dissimilar to the Government Procurement Agreement (GPA), created during the Uruguay Round as a by-product of the negotiations that led up to the creation of WTO. The 28 members of this non-MFN agreement still cover substantially less than 90% of all public procurement in the world.

But the overall likelihood of such a scenario depends on two questions: First, why would the ransom cost of 'setting services free' from the bonds of Doha be any less expensive than concluding the round itself, or likely to succeed as attempts to save whatever that can be saved from the round (the so-called 'early harvest' or 'organ harvesting' exercises) have so far failed?[10] One single player, whose interest is to maintain status quo, or to keep services hostage until a future grand bargaining can be reached, is sufficient to shatter the prospects of a GPA-like agreement inside the WTO. Furthermore, a decision to incorporate the ISA in the WTO puts the services proponents in a familiar dilemma: ISA participants would have to negotiate the ransom sum with the non-participants first, before there are any clear ideas of the benefits of a services plurilateral – a dilemma similar to the one of Hong Kong sequencing described in the introduction.

If the all-sector agreement cannot be concluded inside the WTO, there are few other options that still remain. One would be to consider separate stand-alone sector agreements, especially in sectors with high degree of concentration, such as financial services and computer and information services; construction is another area, but most likely impeded by sensitivities. Few sectors have already some building blocks already in place: On telecommunications and financial services, there are the reference papers – who are now relatively outdated and unable to attract signatories due to national security issues or the economic crisis. Another obvious place to start is expanding the ITA from the pre-internet era into a full-scale cluster agreement for both goods and services encompassing all of the digital economy.[11]

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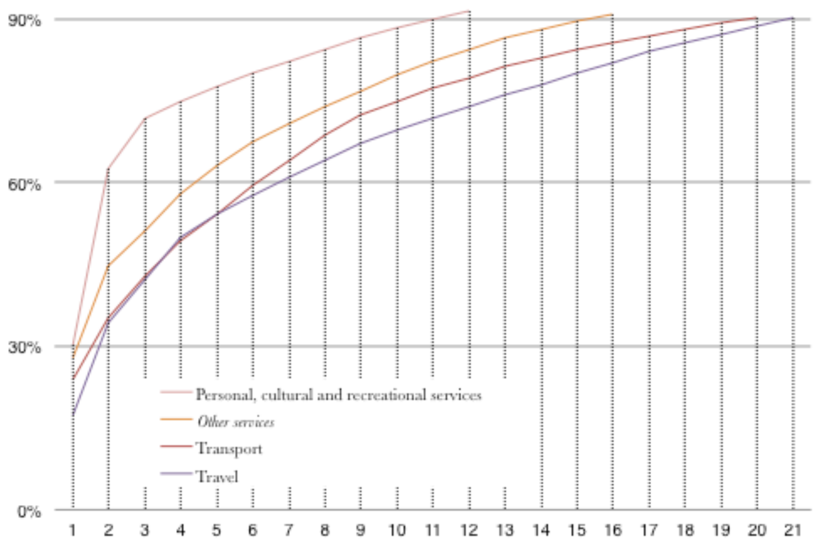
[8] Really Good Friends (RGF) of Services are Australia, Canada, Chile, Chinese Taipei, Colombia, the EU, Hong Kong China, Japan, Korea, Mexico, New Zealand, Norway, Pakistan, Singapore, Switzerland and the US

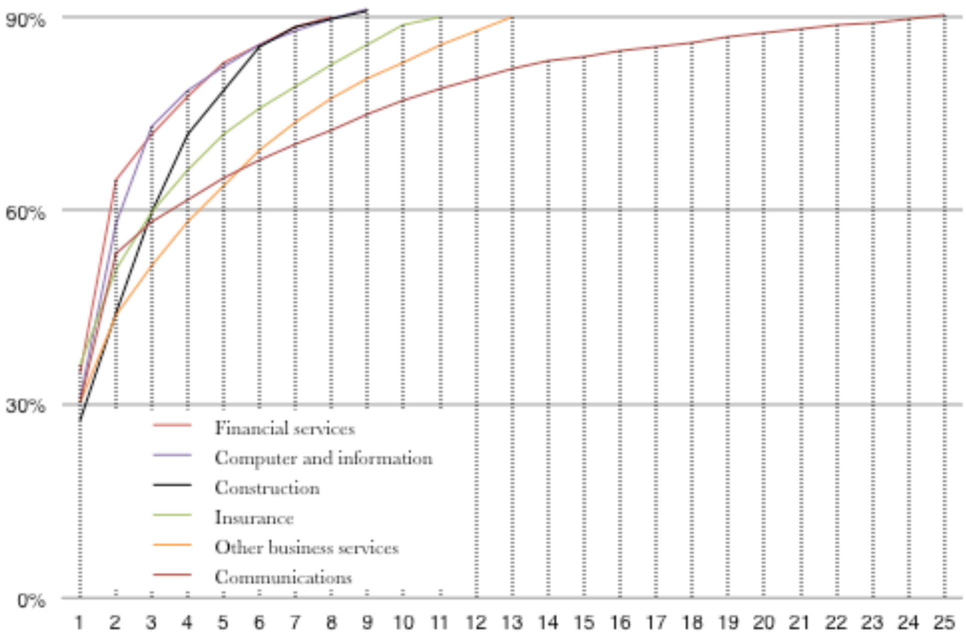
[10] Schwab, 'After Doha: Why the Negotiations Are Doomed and What We Should Do About It', Foreign Policy, May/June 2011

[11] Lee-Makiyama, 'Future-proofing world trade in technology', ECIPE, 2011

Minimum number of countries required to reach critical mass in major services categories (by number of WTO members needed)
Source: IMF EBOP



Minimum number of countries required to reach critical mass in Other services subcategories *(by number of WTO members needed)*
Source: IMF EBOP



The red herring of the MFN issue

Some commentators have doubted the value of sector agreements as they take place on MFN basis, as they doubt the value of any plurilateral agreement without any incentives to outsiders to reform and join. But such analysis is based on misunderstandings about how both domestic regulations on services and trade agreements are drafted. Almost all commitments undertaken in trade agreements on either cross-border supply (mode 1 and 2) or commercial presence (mode 3) are implemented in national law in such manner that they are opened to all parties, even when they are offered bilaterally to one specific country in a bilateral preferential deal. At least for a European legislator, there are significant issues with drafting laws that state that one specific named country shall receive preferential treatment while others do not.

Meanwhile, regulatory co-operation in services is almost without exception offered to the specific contracting party. In particular domestic regulations (qualification requirements, licensing) and mode 4 (presence of natural persons through contractors or intra-corporate transfer) can only be done on non-MFN basis. For example, in the EU-Korea FTA, Korea recognises the lawyer titles within the EU although they do not automatically extend these privileges to every country that EU signs FTAs with on a MFN basis. Thus, the question of MFN or non-MFN is merely academic in most cases. For the countries outside the plurilateral talks, it is a question of whether their offensive and defensive interests are in mode 3 (likely to be on MFN basis in either case) or domestic regulation and mode 4 (that are non-MFN).

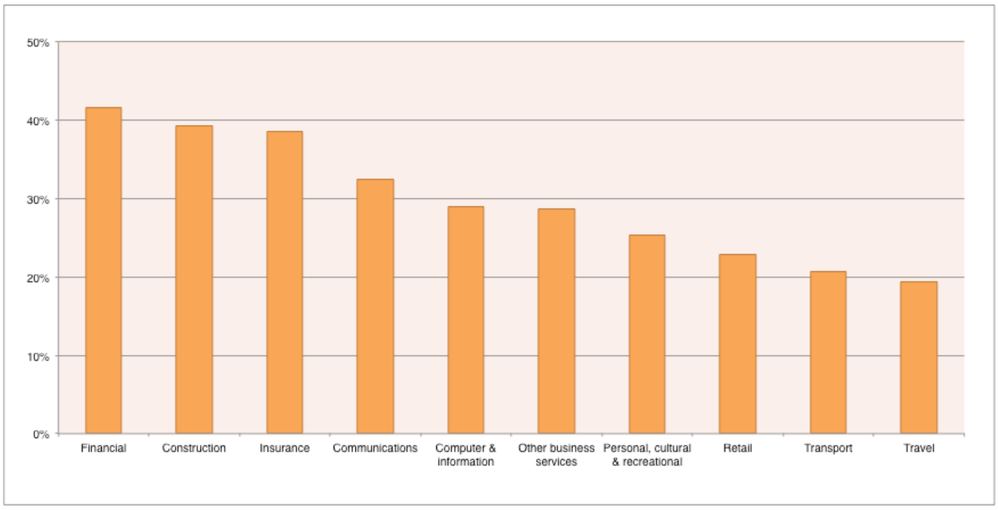
A FTA outside the WTO?

The other option would be an agreement outside the WTO, permissible under the much-discussed Article V of GATS. ISA would be a *de jure* a multi-party FTA outside the WTO, like the Trans-Pacific Partnership (TPP) amongst countries that do not share a body of water between them. Such an agreement would need to have substantial sector coverage, in terms of both number of sectors, volumes and modes of supply, without any possibility to have a blanket exclusion of the political sensitive opening of mode 4.

For most free trade proponents (where the majority of the competitive European services industry should find their political domicile), it is an attractive second-best alternative. As the services trade between the EU and the US alone has a turnover of $330 bn annually, a services-only FTA would exceed the value of most bilateral FTA talks they are both embarked on. But the value of trade agreements (inside or outside the WTO) cannot be based on existing trade volumes alone. There is a vast difference on level of trade restrictiveness amongst the trading partners of the EU. While there are several analysis on restrictiveness of services trade, few of them have the relevant sectoral or geographic coverage to be useful in the context of ISA; some of the analysis are highly subjective, based on assessments by 'wise men' rather than econometrics that can be used in determining the relative importance of modest barriers on existing large volumes of trade, against high barriers on low volumes today.

Following figures represent the closest approximation based on tariff equivalents, i.e. the effects of services barriers translated to tariffs,[13] based on twenty economies that represents more than 80% of services trade.[14]

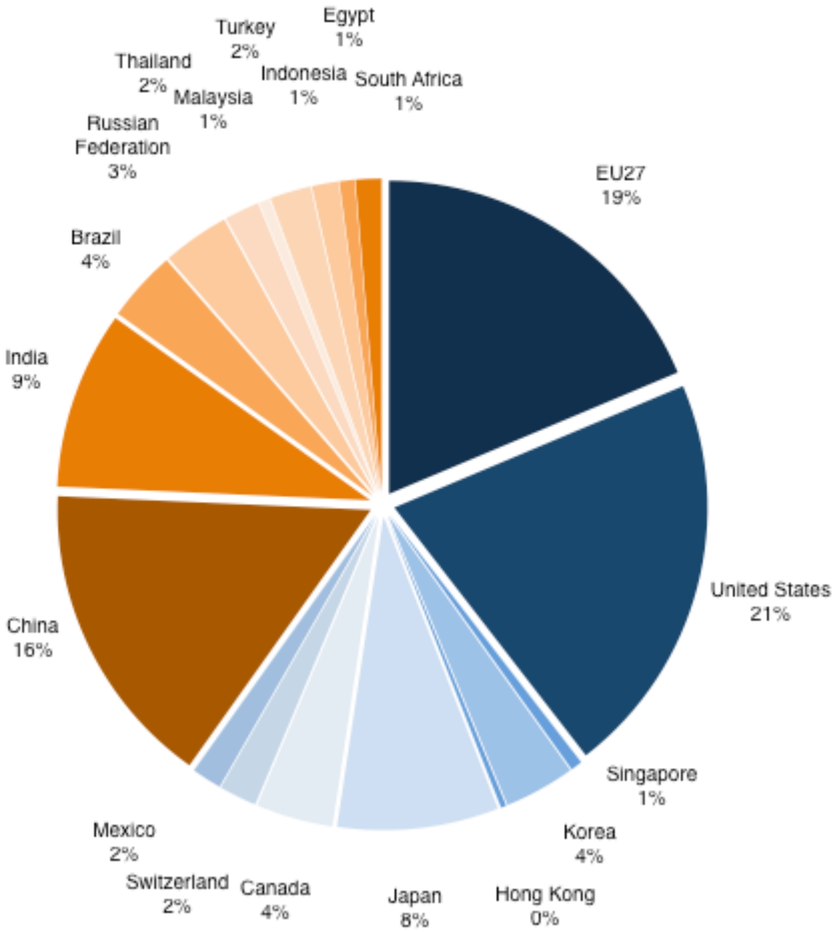
Trade restrictiveness in services trade (tariff ad valorem equivalents) by sector weighted by trade volumes
Source: Own calculations based on Fontagné, Guillin, Mitaritonna, GTAP, IMF EBOP



The service barriers are most severe in financial and business services that are heavily regulated, or where protection of domestic firms is common, such as the construction sector. Overall, they confirm the view that services barriers are higher and often twice the level applied on goods, whereas world trade in goods trade have benefited from extensive tariff cuts while the aggregate levels of services barriers have stood still.[15]

[13] Fontagné, Guillin, Mitaritonna, Estimations of Tariff Equivalents for the Services Sectors, 2010 (based on GTAP modelling)
[14] The EU, the US, Singapore, Korea, Hong Kong, Japan, Canada, Switzerland, Mexico, China, India, Brazil, Russia, Thailand, Malaysia (2009), Turkey, Indonesia, Egypt, South Africa
[15] See Miroudot, Sauvage, Shepherd, 'Trade Costs and Regulation in Services Sectors', WTO, 2012

Trade costs amongst leading services traders
(Approx. 80% of world trade where blue indicates RGF members and orange are non-members)
Source: Own calculations based on Fontagné, Guillin, Mitaritonna, GTAP, IMF EBOP



The geographic distribution shows that 50~60% of the trade costs ought to be generated by trade barriers imposed by RGF members. Almost an identical figure is derived from trade barriers in the OECD countries. The conclusion is therefore that the EU could address half of its trading costs in the ISA while the other half will remain outside it, mostly in the high growth emerging economies where trade barriers and potentials of liberalisation are inarguably higher. These figures are neither decisively convincing nor discouraging for a plurilateral agreement. Furthermore, less than 25% of the trade costs are derived from countries that the EU does not engage in bilateral talks with. Given existing FTAs, the on-going FTA talks (with India, Singapore, Canada) and the prospective bilateral accords the US and Japan, there is only one single country amongst the list of top ten largest services traders that is outside of any prospective bilateral or variable geometry for the EU – and that exception is China.

China's trajectory towards a services economy

A strong emphasis on manufacturing sector and investment has left Chinese services sector lagging behind in international comparison. The GDP share of services is only 43%, and services account for 34% of employment. This places China in ranks of least-developed countries such as Cambodia or Ghana. Given that estimated 20 million people enter the labour market on an annual basis, investment and manufacturing can only generate half of these jobs even at the current rate of growth. As returns from fixed assets and manufacturing exports are either unsustainable or exposes China to volatility of external demand, services are increasingly seen as a key driver for growth; a lack of competitive financial services market in China has also been considered as major impediment for a growth model based on domestic consumer demand; services are also an important compliment to China's manufacturing base and crucial component in moving it towards higher value-added, which explains why professional services, supply chain management, logistics, ICT and financial services are growing rapidly in China.

The services sector in China receives the same amount of investments as manufacturing, and the bulk of the investment goes into real estate services. China still imposes restrictions on most services sectors with heavy administrative burden, geographic restrictions to urban areas, opaque regulations, licensing requirements and foreign equity caps (FECs) in media, telecommunication, transports, electricity distribution, finance & insurance and healthcare where foreign ownership is restricted often below 50%. Still, as domestic capital formation in China is under-performing, its services sector growth depend on FDIs, with foreign capital providing up to the very limit (and often the above) the equity caps; there are now services equivalents to Special Economic Zones for manufacturing, in order to promote China as outsourcing destination.

Relevance of the services sector in China
Source: China Statistical Yearbook; Mofcom minimum targets

	Employment share	GDP Share (%)	Contribution to GDP growth (%)
1980	13.1	21.6	
1985	16.8	28.7	
1990	18.5	31.6	17.3
1995	24.8	32.9	26.6
2000	27.5	39	34.8
2005	31.4	40.5	43.3
2010	34.6	43.1	38.5
2015	41	48	50
2020	45	52	60

The current five year plan sets far more ambitious targets by increasing the services' share of GDP to 50% and 41% of employment by 2015;[16] China's Ministry of Commerce (Mofcom) also plan to expand China's trade in services to 20% of its external trade by 2020, which translates into a trillion USD for services. By 2015, Chinese services markets must exceed manufacturing in contribution to GDP growth. Most industrial policy planners regardless of nationality have the unpleasant habit of communicating unrealistic goals for competitiveness and reform that they are rarely held accountable for, and Chinese planners may share these indulgences. However, these quantitative goals of rapid expansion of services sector are hinged on three factors:

First, and most importantly, the plan is dependent on substantive and rapid opening of markets to foreign service providers, especially between 2015 and 2020. This entails substantive new market access outside its current trading partners that mostly consists of neighbouring economies – its business model must go global in order to achieve the levels envisaged.

Second, China cannot substitute the incoming FDI under current and coming planning cycle. But looking at today's artificially suppressed levels of foreign investments, China has potential to attract more investments that provide necessary knowledge transfer, especially in business and professional services markets that are necessary to build tertiary sectors.

This leads to the third and final point, namely that services markets must be deregulated with respect to restrictions put on mode 3. As a late entrant to the WTO system, China's commitments in the WTO have relatively little water in the tariffs, unlike other members. This is also true for China's GATS commitments , which limits China's policy space to introduce new services barriers while create immediate link between whatever concessions it makes through its trade policy and effects on domestic regulations with no 'water in the tariffs' that buffer.

As China's rebalancing of its economy is to continue, the question is not if China would opens up – but a question of when (or how gradually), in what forum, and to whom.

[16] The Twelvth Five-Year Guideline for 2011-2015 at the Fifth Plenary Session of fifth plenary session of the 17th Central Committee of the Communist Party of China

Concluding remarks

The EU is inevitably the cornerstone of any international agreement on services. As the leading services exporter and world's largest services economy, it accounts for almost a quarter of world trade in services and more than one-third of the trade within RGF. The decision whether there will be an earnest attempt to pursue a plurilateral agreement is very much in the hands of the EU. But the question is how the EU will respond.

This short policy brief has so far outlined some of the potential gains and opportunity costs of ISA: As other trade agreements that build on existing other trade agreements, the ISA would be a post-modern trade agreement in its construct by aggregating various variable geometries – of GATS, reference papers, BITs, regional agreements and FTAs, including a prospective transatlantic accord – into one single comprehensive package. The ISA, like all trade agreements, looks like statistical anomalies that are unlikely to succeed at onset. Still, trade deals are concluded thanks to horse-trading, political (mis)calculations and timing. A post-Doha package that would pave way for the ISA under the auspices of the WTO would have few drawbacks in both the short and the long term. After all, few people in Brussels regret that the GPA was conceived, only the financial crisis and macroeconomic dynamics that have led to a striking lack of negotiation leverage against some prospective members.

Whether a deal is concluded inside or outside the WTO, the ISA provides benefits in market access by scaling down relatively moderate trade barriers on existing trade between relatively open economies. But the central questions in assessing the relevance of the ISA is not about market opening in short term, but a systemic one: First, it will become the determinant of the level of future services liberalisation if it is successfully concluded. Second, it will determine the forum of where future liberalisation will take place – inside the WTO or outside it. The ISA is merely a step towards multilateralising the provisions in our next-generation FTAs/RTAs. The objective to open up emerging markets is simply out of reach without an intermediate stop – it is how well or how poorly the ISA is likely to perform that role that needs to be assessed, especially given the steep cost of failure involved: if the ISA is pursued but an agreement yet fails to materialise, it would significantly undercut the EU positions in its negotiation with every non-participating country, including India and Mercosur: the EU and the likeminded countries may even face outright retaliation by being excluded from the emerging economies. On the question of feasibility, one must take into account whether the crisis-struck EU and U.S. are able to muster necessary support for concessions even in sensitive sectors or State/Member State levels. Attempts of mercantilist cherry picking could lead to a collapse of the negotiations, and perhaps deservedly so.

The services proponents led by the EU would be committing several cardinal sins if it fails to shape the debate on the future of services liberalisation after Doha – first, as the largest demandeur on services it need to provide a roadmap in sequential steps that goes beyond short term business interest for market access and profits. Second, it needs to prove that the plurilateral is not another attempt of preferential barrier for its own sake in a geopolitical zero-sum game. The only way of doing so is most likely by attempting sectoral, critical mass plurilaterals under MFN in parallel in sectors where they can be pursued – most likely in the ICT sector and the digital economy, building on various existing elements.

The final question relates to China's role in the WTO. Although the WTO may not be able to conceive new trade liberalisation, preservation of the multilateral rule based system is an end in itself, at least for the EU. The existing GATT and GATS commitments are de facto the EU's FTA with China, while China is also more dependent on the MFN benefits than any other trading power. As an economic policy making apparatus whose strategies are deeply rooted in realist perspectives, China has successfully opened up its economy whenever it has been faced with challenges or opportunities that are too expensive to stand outside of. While this logic led China on its path towards its meticulously planned accession to the WTO, it also explain its reluctance to enter the GPA: The Chinese may have considered once to open up their domestic public procurement in return for attractive opportunities overseas, but they are questioning whether the EU and the US market would in fact be open to them, and China's introduction of world's largest stimulus package of 4 trillion RMB must lead it to rethink its strategies.

Despite the immediate need to achieve domestic reforms in the services sector, China is unlikely to agree to any accord that means full scale opening of its markets to anyone and anywhere. Reforms in China are continuing, but as a patchwork economy where a fragile equilibrium is constantly on the verge of a financial crisis, 'a cautious piecemeal incrementalism has replaced bold structural upheaval as the order of the day'.[18] There is less appetite for liberalisation on wholesale basis, while there may be bigger interest in sector agreements where China is performing reasonably well, which once again points at ICT services, or construction services where it has an export competitiveness that is five times higher than the US. The options between ISA and sector agreements under MFN are not mutually exclusive – one may even look at the latter as an early harvest of the ultimate goal to go multilateral.

[18] De Jonquières, China's Challenge, ECIPE, 2012