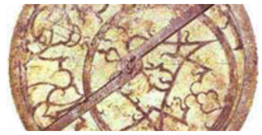
SciencesPo. | GEM Groupe d'Économie Mondiale

Policy Brief
September 2009



Leveraging Trade in Services to Consolidate Global Economic Recovery: An Agenda for the G-20

Ben Shepherd and Sébastien Miroudot[1]

Executive Summary

The time is ripe for G-20 policymakers to take strong and decisive action to reduce the costs of providing services abroad, because:

1. The costs of trading services internationally are at least twice as high as for goods, so the benefits from reform—increased production, trade, and employment at a time when they are critically needed to consolidate recovery—are potentially much larger.
2. Trade costs facing service providers have fallen more slowly than those facing manufacturers over the 2000-2005 period, despite the spread of advanced information and communication technologies. Policy action is clearly needed to reduce trade costs more rapidly.
3. Ambitious policy reforms, backed up by external commitments, have proven highly effective in reducing the costs of trading services internationally.

The Asia-Pacific Economic Cooperation (APEC) has moved forward on trade costs by adopting a result-based approach—a 5% reduction in trade costs over 5 years—that leaves member economies relatively free to choose the policies they adopt to reach their common goal. G-20 leaders should take a leaf out of APEC's book. The G-20 can demonstrate commitment to consolidating and sustaining global recovery by agreeing to reduce the costs of trading services internationally by at least 1% before end-2010. Policy reforms should be fully consistent with the WTO's non-discrimination obligations, and listed publicly on the G-20's website.

1. Introduction: Why Focus on Trade in Services?

Nearly two-thirds of all economic activity in the G-20—and over three-quarters in France, the USA, and the UK—is made up of services. So it is striking that while goods exports account for nearly 20% of the G-20's combined GDP, the corresponding figure for services is less than 5% (see Figure 1). Although services trade was growing rapidly prior to the current crisis—by 11% in 2007-2008, according to the WTO—it still represents a surprisingly modest share of the international economy.[2]

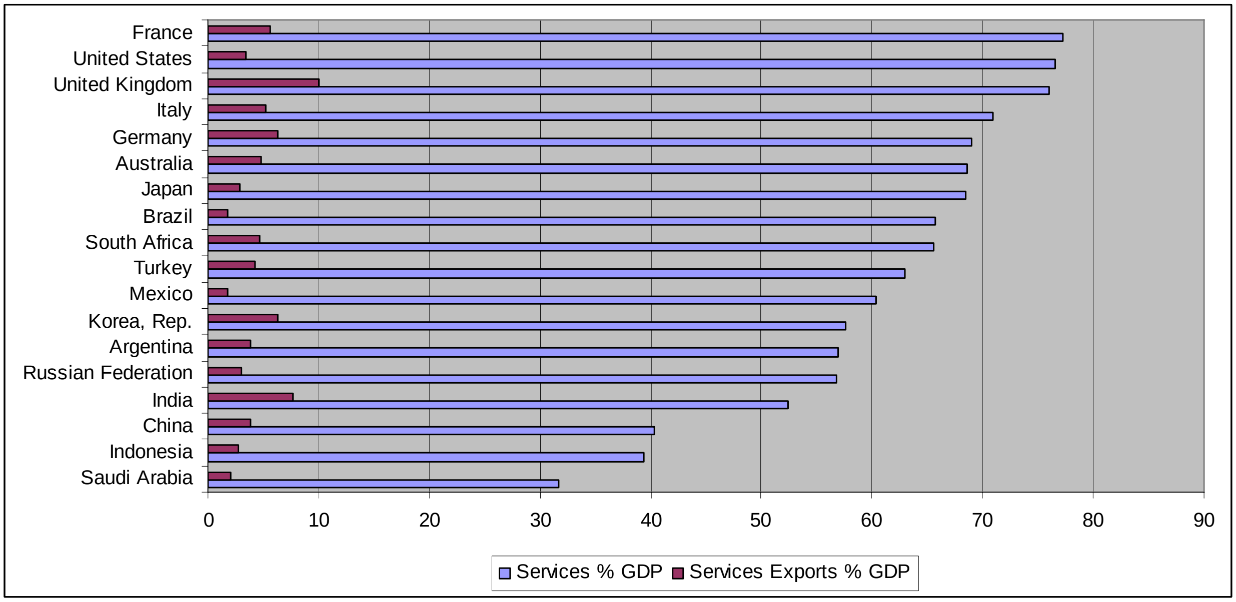
The question, of course, is: why?

---

[1] Independent trade economist and international development consultant, and research associate at GEM, SciencesPo (Ben@Developing-Trade.com); trade policy analyst, OECD, and research associate at GEM, SciencesPo (sebastien.miroudot@sciences-po.fr). Both authors are acting in a strictly personal capacity. The findings, interpretations, and conclusions expressed here are exclusively those of the authors. They should not be attributed to any organization with which the authors are, or have been, associated.

[2] See WTO (2009).

Figure 1: Services value added and exports, 2007 (% GDP).



A large part of the answer lies in trade costs, i.e. the full range of costs a firm confronts when it decides to sell its goods or services overseas. Many trade costs in both goods and services stem from regulatory measures, and so can be reduced through strong, decisive action by policymakers. We argue that in order to have maximum impact on recovery and growth, G-20 policymakers should focus on reform in the services sector, for three main reasons:

1. The costs of trading services internationally are at least twice as high as for goods, so the benefits from reform—increased production, trade, and employment at a time when they are critically needed to consolidate recovery—are potentially much larger.
2. Trade costs facing service providers have fallen more slowly than those facing manufacturers over the 2000-2005 period, despite the spread of advanced information and communication technologies. Policy action is clearly needed to reduce trade costs more rapidly.
3. Ambitious policy reforms, backed up by external commitments, have proven highly effective in reducing the costs of trading services internationally.

2. Barriers to International Trade in Services are High—And the Gains from Reform Large

It is notoriously difficult to catalogue and quantify the barriers to trade in services.[3] Unlike trade in goods, where ad valorem tariffs are the rule, trade in services is subject to a wide range of regulatory measures that can increase—often unintentionally—the costs of doing business abroad.

[3] See OECD (2009), and Mattoo & Gootiiz (2009) for important recent contributions.

As part of an ongoing GEM research project, we have used a new methodology to measure trade costs in goods and cross-border services markets in selected G-20 economies.[4] This methodology allows us to measure the average level of bilateral trade costs between countries: for example, the average of trade costs for exports from Canada to the USA and for exports from the USA to Canada. In services, data restrictions mean that we can only calculate trade costs for pure cross-border trade (GATS Modes 1 and 2), not for sales by foreign affiliates (Mode 3) or movement of service providers (Mode 4).

For comparative purposes, we express trade costs as ad valorem tariff equivalents. These numbers represent the total economic resources (as a percentage of price) required to move goods or services from one country to another. They encompass a wide range of factors other than traditional trade measures, including trade-related regulatory policies, and "natural" trade barriers such as geography, and cultural or linguistic differences. Thus, a country can have a high level of trade costs in part due to geographical isolation, and in part due to a restrictive policy stance. Previous work suggests that in most cases, policy is a significant determinant of trade costs—which means that policymakers can play an important role in reducing them.[5]

Figures 2 and 3 show the ad valorem equivalent trade costs facing G-20 goods and services producers in 2000 and 2005.[6] For goods, the 2005 average of trade costs was 47%, ranging from 38% to 63% of the final price of the goods.[7] For services, the numbers are much higher: the average was 104%, and the range ran from 96% to 131%.

[4] Technical details are set out in full in Shepherd and Miroudot (Forthcoming). Our approach is based on Novy (2009). We calculate ad valorem equivalent trade costs *t* between countries *i* and *j* in sector *k* at time *t* using the following formula: $t_{ijt}^{k} = \left(\frac{x_{iit}^{k} x_{jjt}^{k}}{x_{ijt}^{k} x_{jit}^{k}}\right)^{1/2(\sigma^{k}-1)} - 1$, where x_{ij} is production in country *i* consumed in country *j*, and σ is the intra-sectoral elasticity of substitution. We assume $\sigma = 8$ for goods and services, so our estimates of services tariff equivalents are most likely on the low side. Qualitatively, our results are robust to this assumption.

[5] See Nordås *et al.* (2008) and Novy and Chen (2008).

[6] Production and trade data are taken from the following sources: OECD input/output tables, the OECD Stan database, and EU-KLEMS. Data for Brazil, Russia, and South Africa are available for 2000 only. Data for India, Turkey, and Mexico are available for 1999, 2002, and 2003 respectively. Indonesia is excluded from the sample due to concerns about data reliability.

[7] All averages are GDP-weighted. Our result is remarkably close to that of Anderson and Van Wincoop (2004). Those authors estimate the level of international trade costs in goods—i.e., excluding domestic distribution—as approximately 55%.

Figure 2: Trade costs in goods and services, 2000 (ad valorem equivalent).

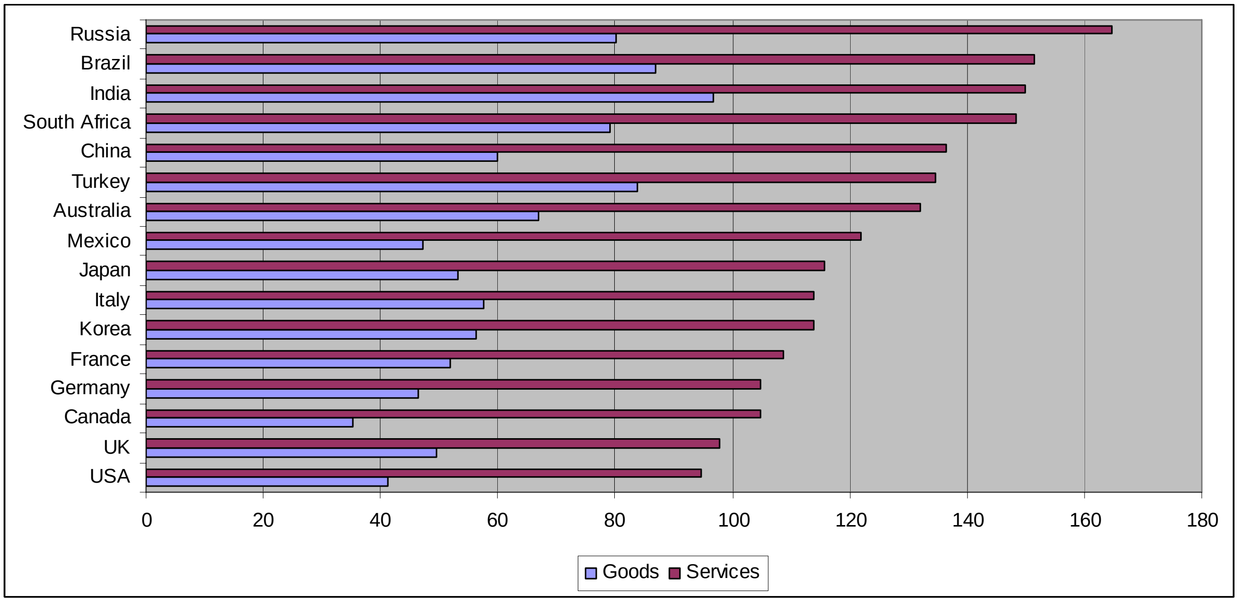
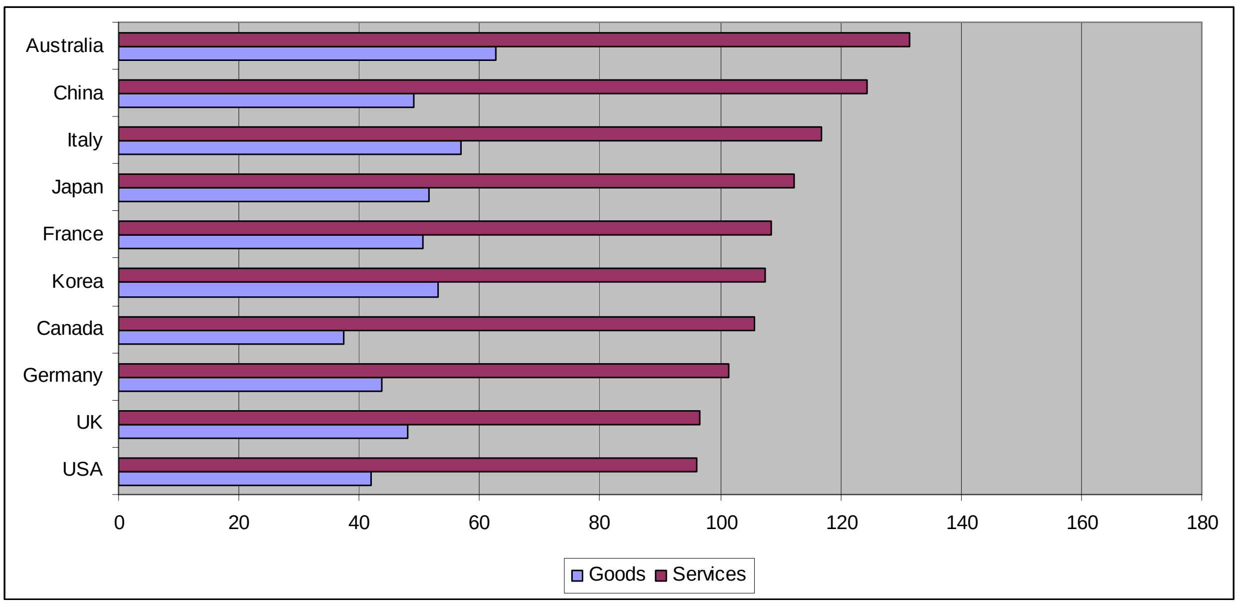


Figure 3: Trade costs in goods and services, 2005 (ad valorem equivalent).



As a first approximation, the gains from reducing trade costs rise with the square of the ad valorem equivalent. So a very rough "back of the envelope" calculation suggests that major trade cost reductions in services could increase global GDP by around four times as much as similar reductions in goods markets. Moreover, there can be strong knock-on effects from lowering trade costs in services: every firm in the economy needs access to competitively priced services in areas such as business/consulting, transport, and distribution. Indeed, the level of trade costs in goods is surely related to the level of trade costs in services, due to the importance of sectors such as transport, finance, and distribution in moving goods across borders. When these effects are considered, the medium- to long-run gains from services reform are potentially enormous.

Reform requires a significant investment of political capital, however. So it makes sense to start in the sector where the "bang-per-buck" of policy action is highest. There is no doubt that services fit the bill.

3. Trade Costs in Services Have Fallen Slowly in Recent Years

Given the rapid spread of advanced ICTs in recent years, we might expect that trade costs in services have been falling more quickly than trade costs in goods. But our research suggests that that is not the case. For the G-20 as a whole, the average decline in trade costs facing service providers over the period 2000-2005 was 1.2 percentage points, compared with 1.4 in goods. This is, of course, a small difference in absolute terms. But the proportionate fall in trade costs is much lower in services than in goods, due to the higher level of initial costs: 1.2% versus 2.9%. The importance of this difference is reflected in the fact that between 2000 and 2005, reductions in bilateral trade costs accounted for, on average, 8% of G-20 trade growth in goods but only 4% in services.[8] Income growth was therefore the major force behind increased services trade within the G-20. So even though services have proved relatively resilient to the current crisis,[9] policymakers should be concerned about the medium-term implications of falling incomes on trade, production, and employment in services sectors.

Moreover, these aggregate numbers mask important variation across countries. Figure 4 shows that most countries reduced trade costs in both sectors over the 2000-2005 period, although a few appear to have slipped backwards as well. What is most remarkable about this figure, however, is the standout role played by one G-20 member: China. In both sectors, China's trade costs have fallen by around twice as much in ad valorem terms as the country with the next largest fall: in services, costs were reduced by 12 percentage points; the corresponding figure for goods is 10 percentage points.

It is important to highlight two features of these results.

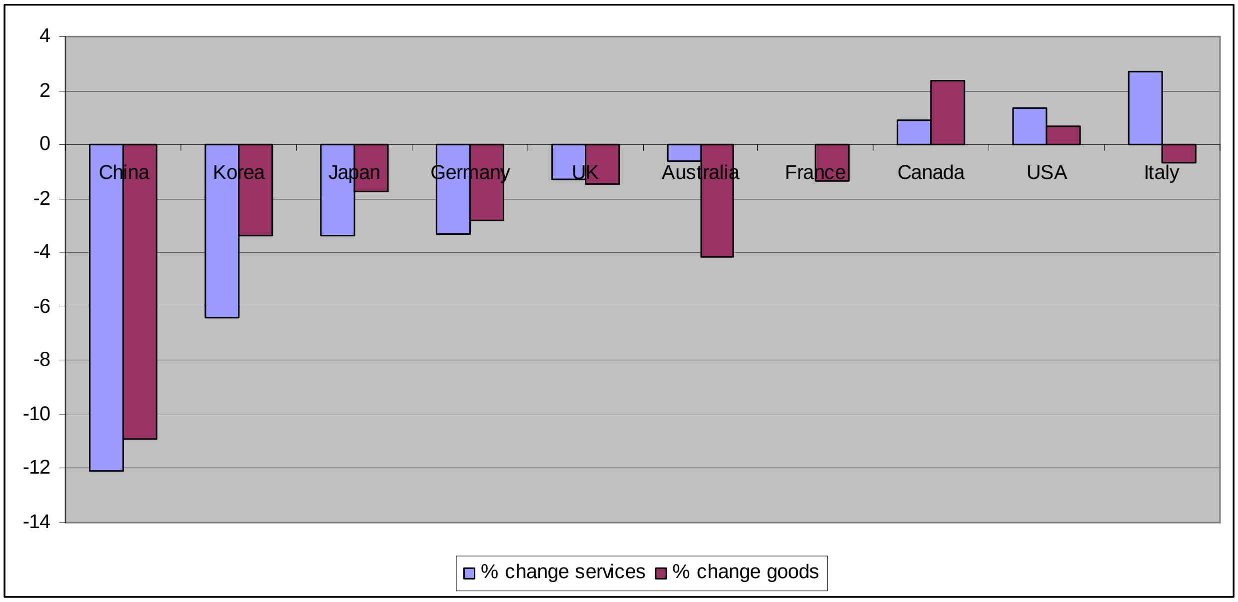
First, Figure 2 shows that in the base year (2000) China had high levels of trade costs relative to other G-20 members: the highest in services, and the second-highest in goods. So part of the reason for China's apparent success in absolute terms is that it started from a very high baseline. Nonetheless, even the proportional cost reductions involved are impressive: 18% in goods, and 9% in services.

---

[8] This calculation is based on the decomposition in Novy (2009). Specifically, the percentage of trade growth accounted for by reductions in bilateral trade costs is: $\frac{\Delta \ln\left(x_{ijt}^{k} x_{jit}^{k}\right) - \Delta \ln\left(x_{iit}^{k} x_{jjt}^{k}\right)}{\Delta \ln\left(x_{ijt}^{k} x_{jit}^{k}\right)}$.

[9] See Borchert & Mattoo (2009).

Figure 4: Changes in trade costs facing goods producers and service providers, 2000-2005 (ad valorem equivalent).



Second, the trade costs that we are measuring represent an average of trade costs facing foreign producers exporting to China, and trade costs facing Chinese firms exporting to other countries. Thus, we cannot conclude that the very large trade cost reductions observed for China are solely due to policy reforms undertaken at home. They are also linked to trade cost reductions by China's trading partners.

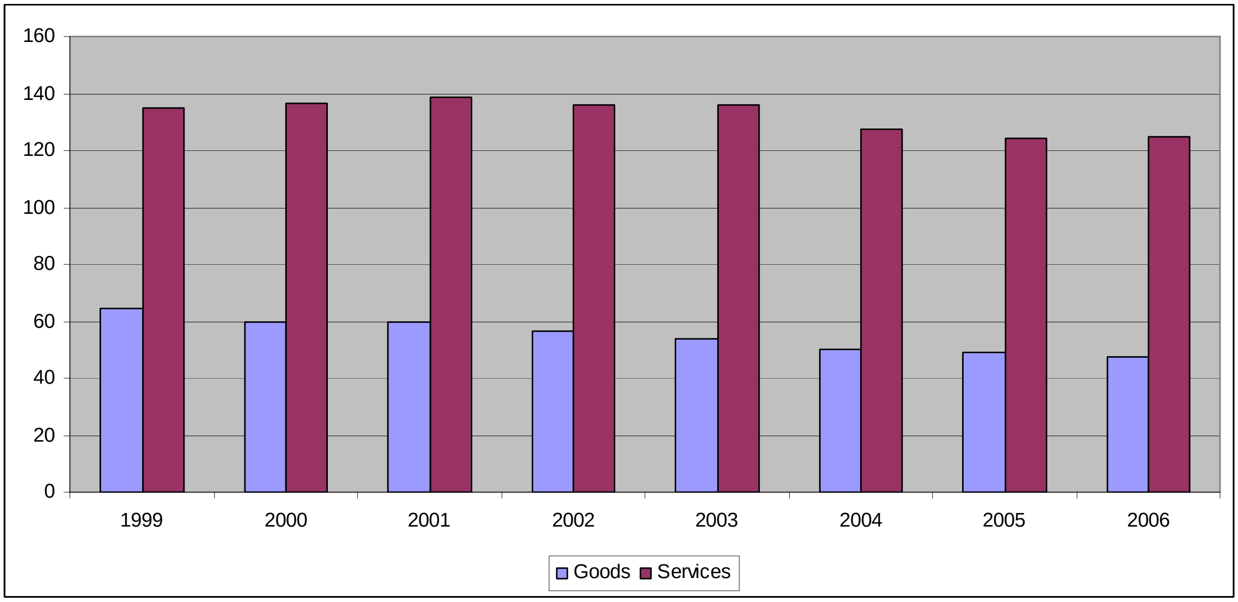
4. Domestic Reform and External Commitments can Reduce Trade Costs

There are two main lessons to be learned from China's recent experience with trade costs.

First, domestic policy reforms in services sectors can make a major difference to trade costs. In China's case, there is no doubt that such reforms have taken place since 2001. As is well known, the terms of China's WTO Accession Agreement had real "bite" in services, in the sense that they required significant liberalization of applied policies.[10] This is in stark contrast to most countries' GATS schedules submitted at the end of the Uruguay Round: they established binding policy ceilings, but contained little in the way of genuine liberalization. Whatever liberalization has occurred since the Uruguay Round has been undertaken unilaterally or preferentially, and it is therefore not surprising that changes in trade costs on a multilateral basis have been limited.

[10] See Mattoo (2004).

Figure 5: Trade costs in goods and services, China, 2000-2005 (ad valorem tariff equivalent).



Second, external commitment mechanisms such as the WTO can be extremely valuable as a means of pursuing and locking-in lower trade costs in services. In China's case, two mechanisms are at work. On the one hand, as discussed above, China's accession to the WTO involved genuine liberalization in services sectors. In addition, China's accession required that other WTO members extend the GATS non-discrimination obligations to its exporters. Since our trade cost measures take account of the barriers faced by foreign firms exporting to China, as well as the barriers faced by Chinese firms exporting to the rest of the world, the considerable reduction observed between 2000 and 2005 reflects these twin benefits of WTO-induced liberalization.

5. Conclusion: How the G-20 can Leverage Services to Consolidate Recovery

Results from our ongoing research project show that:

1. The costs of trading services internationally are at least twice as high as for goods, so the benefits from reform—increased production, trade, and employment at a time when they are critically needed to consolidate recovery—are potentially much larger.
2. Trade costs facing service providers have fallen more slowly than those facing manufacturers over the 2000-2005 period, despite the spread of advanced information and communication technologies. Policy action is clearly needed to reduce trade costs more rapidly.
3. Ambitious policy reforms, backed up by external commitments, can be highly effective in reducing the costs of providing services abroad.

Reducing trade costs in services sectors should therefore be a priority for G-20 members as they strive to consolidate economic recovery. They should use the upcoming Pittsburgh Summit to signal their commitment to leveraging trade in services for recovery and growth.

One way in which the G-20 could show leadership in this area is by drawing on the experience of the Asia-Pacific Economic Cooperation (APEC), with which nine G-20 economies are also associated. APEC's approach to reducing trade costs has been result-based, rather than instrument-based: member economies commit to quantitative targets, but are relatively free to choose the policy instruments by which those targets will be met. The 2001 Shanghai Target committed each APEC member economy to a 5% reduction in trade transaction costs over five years. Leaders followed up at the Busan Meeting by setting the goal of an additional 5% reduction by 2010. Monitoring—though imperfect—takes place through a transparency mechanism requiring member economies to report regularly on policy changes they have implemented.

Taking a leaf out of APEC's book, the Pittsburgh Summit should commit the G-20 economies to at least a 1% reduction in the costs of trading services internationally by end-2010. Although this goal may sound modest, it is nearly as large as the average reduction in trade costs achieved over the entire 2000-2005 period. It can be expected to provide a significant boost to the services sector at a critical moment.

A key advantage of our proposal—in particular given the state of the WTO services negotiations—is that each G-20 member retains the freedom to reach the 1% goal in the way it deems most efficient and effective. The only constraints they are subject to are the standard GATS non-discrimination obligations. To ensure that trade costs are genuinely and transparently reduced, a public register of policy reforms undertaken between the Pittsburgh Summit and end-2010 should be established on the G-20 website. Monitoring will be undertaken through future G-20 summits, and the efforts of civil society in the interim.

The Pittsburgh Summit represents a unique opportunity for G-20 members to go beyond the standstill engagement of the London Summit ("no new trade barriers") to make a positive commitment to lowering trade costs. By showing leadership at this critical time, the G-20 can make a significant and lasting contribution to global economic recovery.

References

Anderson, James; and Eric Van Wincoop, 2004, "Trade Costs", *Journal of Economic Literature*, 42(3), 691-751.

Borchert, Ingo; and Aaditya Mattoo, 2009, "The Crisis-Resilience of Services Trade", Policy Research Working Paper No. 4917, World Bank, http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2009/04/28/000158349_20090428090316/Rendered/PDF/WPS4917.pdf.

Chen, Natalie; and Dennis Novy, 2008, "International Trade Integration: A Disaggregated Approach", Working Paper, University of Warwick, http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/novy/integration.pdf.

Mattoo, Aaditya, 2004, "The Services Dimension of China's Accession to the WTO" in Deepak Bhattasali, Shantong Li, and Will Martin (eds.) *China and the WTO: Accession, Policy Reform, and Poverty Reduction Strategies*, Washington, DC: World Bank. http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2004/09/07/000160016_20040907115309/Rendered/PDF/298970PAPER0China010the0WTO.pdf.

Mattoo, Aaditya; and Batshur Gootiiz, 2009, "Services in Doha: What's on the Table?", Policy Research Working Paper No. 4903, World Bank. http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2009/04/16/000158349_20090416133806/Rendered/PDF/WPS4903.pdf.

Nordås, Hildegunn; Sébastien Miroudot; and Rainer Lanz, 2008, "Entry Barriers and the Extensive Margin: Estimating Trade Restrictiveness from Trade Flows and Lack Thereof", OECD Technical Workshop on Trade Barrier Assessment Methodology, Paris, 12 December 2008.
http://www.oecd.org/dataoecd/47/52/41722036.pdf

Novy, Dennis, 2009, "Gravity Redux: Measuring International Trade Costs with Panel Data", Working Paper, University of Warwick.
http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/novy/redux.pdf.

OECD, 2009, "Methodology for Deriving the Services Trade Restrictiveness Index", Paper prepared for the OECD Experts Meeting on the STRI, Paris, 2-3 July 2009.
http://www.oecd.org/dataoecd/49/18/42935959.pdf

Shepherd, Ben; and Sébastien Miroudot, Forthcoming, "Measuring the Costs of International Trade in Services", Working Paper, GEM SciencesPo.

World Trade Organization, 2009, *World Trade Report 2009: Trade Policy Commitments and Contingency Measures*, Geneva: WTO.
http://www.wto.org/english/res_e/publications_e/wtr09_e.htm