



Submission to the USITC investigation
‘Digital Trade in the U.S. and Global Economies’

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Digitalisation and services – a nation’s ability to trade

Very few would doubt the economic relevance of the digital economy and its bearing on innovation, economic growth and international development. However, this awareness has not translated into making the digital economy a priority in the current economic climate – and perhaps more importantly, the question of how the global trading system ought to deal with this evolution remains unresolved.

To begin, the invention of the internet and the resulting cross-border flow of data is the biggest advancement in trade facilitation since air travel. Its impact as a multiplier on economic growth is clearly evident – a business consultancy report states that in the past five years, the internet’s contribution to GDP growth amounted to 21% in mature economies (15% in the US) compared to only 3-5% in the BRICs despite their strong export orientation in ICT goods through supply-chain fragmentation.¹

Furthermore, UNCTAD estimates that half of the global services trade is enabled by the digital economy –² applied to the US, approximately 300 bn USD in services exports is enabled by (and ultimately depends on) openness of the digital economy. The number is five times larger than the current level of US export of the car industry in sheer turnover.³ The real parity in terms of value-added is probably closer to ten to one, as trade statistics suffer from double-counting of manufacturing components.⁴ It is also worth noting that in the EU, 95% of all newly created jobs are in the services sector.⁵

This points to the centrality of digitalisation and services in job creation and the trading system. Services account for typically 70-80% of the GDP in OECD countries while only

¹ McKinsey Global Institute, Internet matters: The Net’s sweeping impact on growth, jobs, and prosperity, 2011

² UNCTAD Information Economy Report 2009

³ UN Comtrade, 2012

⁴ Value-added in US transport equipment is approximately 27%, World Input-Output Database, 2013

⁵ European Commission, The Services Directive: Accomplishing the EU Single Market for services, 2012

43% in China – which is in line with least-developed countries like Cambodia and Ghana without sufficient infrastructure for commerce. Some emerging economies lack competitiveness in services and therefore fail to capitalise on the digital economy, which unleashes knowledge process outsourcing (KPO) or services and IP supply chains. Simply put – digitalisation made services tradable, and allowed the services economy to become tradable. By contrast, this is also why the US failed to sufficiently capitalise on the market openings it was granted in the Uruguay round – the networks of today were not available in the mid-90s, and services exporters had to expand through foreign-direct investments (FDIs) that required large amounts of capital, or was still restricted amongst many WTO members at the time.

The digital economy also spurred ‘servification’, or the integration and co-dependency between manufacturing and services. Market access of consumer goods or industrial machinery depends on services – such as financing, design, consulting, installations, maintenance –⁶ that typically are dependent on cross-border data flows. About 20-30% of the inputs in manufacturing comes from services, making them the most important ‘raw material’ of the US manufacturing process.⁷ Some goods have also transformed into services outright – the majority of software and entertainment products, previously distributed on discs, are now distributed online. Obviously, servification is not limited to inputs, support services and content – transaction environments, retailing and wholesale processing of goods have also gone online.

Therefore, it is barely an exaggeration to state that designing a relevant policy response to the digital economy is not a sector issue for the US technology industry: information technology and free cross-border data flows are pre-requisites for both manufacturing and services trade. Today, openness of the digital economy is about a nation’s ability to trade, nothing less.

Failures of modern trade policy

The multilateral system

To begin, the WTO with its expanding membership is deeply mired in the stalemate of the Doha round. It has provided little advancement on enhancing digital trade. The multilateral system is notoriously frozen in time over obsolete classification issues, like whether a software delivered on floppy disc is a good or a service. Even the plurilateral WTO IT Agreement (ITA) has failed to keep up with the pace of innovation cycles – some technologies (for example the DVD) have become obsolete before they were even considered for inclusion. Another mismatch between WTO and market realities is the e-commerce moratorium of 1998, which bans tariffs on ‘data transmissions’ between WTO members whereas tariffs are typically applied on physical goods. The practical use of the moratorium has been questionable as most governments are technically unable to impose levies on ‘imported’ data flows. Given the nature of the internet, such flows have been indistinguishable from ‘domestic’ ones.⁸

⁶ For a practical case study, see Rentzhog, ‘At Your Service: The Importance of Services for Manufacturing Companies and Possible Trade Policy Implications, National Board of Trade of Sweden, 2010

⁷ See note 4

⁸ See Lee-Makiyama, Samarajiva, Whither global rules for the internet? The implications of the World Conference on International Telecommunication (WCIT) for international trade, ECIPE Policy Brief No. 12/2012.

There are some deeper, structural issues with the WTO system – its architecture and pillars are clearly designed to negotiate tariffs for well-defined, and poorly fit to achieve results on cross-sectoral issues, which has resulted in weak commitments on horizontal issues like technical barriers to trade (TBT), investments (TRIMS) or the internet. The mode-based and positive list negotiations on services are not simply not suited for discussing cross-sectoral digital economy issues.

Despite these shortcomings, the multilateral system has also achieved some important results related to digital trade, notably from disputes. Given the impasse on rule making, it is perhaps not surprising that the dynamism comes from the judiciary system – all WTO disputes to date on services have concerned the internet in one form or another.⁹ The important principle of technological neutrality that grants online services same market access as their offline equivalents was implicitly derived from case law, and is now a part of WTO jurisprudence. Similarly, the WTO has established important principles on necessity and proportionality that could address excessive online protectionism disguised as political censorship or cyber security.¹⁰

Bilateral and regional agreements, and the route ahead

Unfortunately the bilateral and regional FTAs have not fared any better with regard to safeguarding the digital economy. The advancement achieved by the European Union in its next-generation trade agreements (e.g. the EU-Korea FTA) are relatively minor openings – such as removing foreign equity caps (FECs) in the telecommunication sector and relatively vague provisions on open data flows, which are limited to financial services.

As we have now moved on to the era of preferential trade agreements and ‘big’ FTAs, we need to bear in mind that EU and US FTAs are political economy tools that are primarily designed to deal with smaller counterparts with inconsistent and discriminatory legal systems. These FTAs induce regulatory reform and harmonisation amongst our counterparts in return for dismantling our own legacy protectionism. To take an example, the European Union has also introduced new language against excessive use of intermediary liability (starting with EU-Andean Community FTA) by directly transposing the language of EU’s own e-commerce directive into the FTA.

This practice of ‘exporting’ rules would become more difficult for the major trade agreements that are about to be negotiated in 2013, whether they are regional or plurilateral. In particular, the International Services Agreement (ISA) or the ‘big’ FTAs amongst world’s top five economies (EU-US FTA, EU-Japan FTA) are struck between consistent and high-quality regulatory regimes. These agreements are more likely to be driven by negative liberalisation (through national treatment, or in best case, mutual recognition) rather than positive rule making and setting common ICT standards between the signatories.

⁹ World Trade Organization, China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products, DS363; United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services, DS285

¹⁰ Hindley, Lee-Makiyama, ‘Protectionism Online: Internet Censorship and International Trade Law’, ECIPE Working Paper No. 12/2009

The overall lack of consistency and successes in digital trade liberalisation even in preferential agreements is partly due to the heritage of GATS, especially the mode-based negotiations – services are not delivered according to the theoretical modes of delivery of GATS and FTA schedules. They are exported to foreign markets in the form of either *competences* (consultants and experts flown in to perform a task), *intellectual property* (by transferring franchise licences, copyright or patents), plain *investments*, or as data. Unlike business mobility, IP and investments that are now established chapters of all modern trade agreements and the WTO, free movement of data is yet uncovered.

Finally, trade negotiators often fail to distinguish sector specific issues of the *ICT industry* (e.g. free trade for search engines, business software or smartphones) or ‘e-commerce’ (processing purchases in a digital environment irrespectively whether the delivery is fulfilled online or offline) with the economy-wide issue concerning ‘cross border data flows’ (i.e. the ability for services and manufacturers to freely move data across borders). These three concepts are not interchangeable. By failing to provide sufficient functional coverage on all three, most modern FTAs have delivered little or no improvements for the digital economy.

Online protectionism

Many business representatives have noted the rise of protectionism in digital trade. New legislative initiatives on cloud computing, network security and data privacy have also introduced restrictions on investments, government procurement or data localisation that discriminate against foreign firms. Governments may act on the pretext of national security or domestic stability, but clearly fail to design legislation without mercantilist side-effects – whereas there are no competent trade rules to curb such protectionism. Even antiquated quantitative restrictions, such as local content requirements are being reintroduced, with the most noted example being India’s Preferential Market Access (PMA) regulation. Policymakers are now undoing the learning that led to their unilateral dismantling in the 80s and 90s as local content requirements proved to be counterproductive in the ICT sector. Local content requirements destroys local competitiveness by prohibiting efficient sourcing, raising input prices for domestic producers, and ultimately leads to jobs being lost to open supply-chain hubs without such requirements like China.

Online and digital trade barriers are also more versatile and efficient in blocking digital supply chains than traditional trade barriers. For example, a smartphone can be rendered useless by locking it out from local telecom networks, blocking its operating system or any of its standard features such as mapping services, or by simple prohibitive tariffs against the device itself. Thus, trade disruptions can occur anywhere across the value-chain – starting from data access at the bottom, over-the-top (OTT) services, to the devices that run the services. Many trade barriers are designed as disproportionate and excessive liabilities against foreign providers compared to domestic ones. The debate so far has focused on intermediaries such as web portals and search engines, as they are often blamed for copyright violations or subject to disproportionate restrictions based on public morals and safety. However, the underlying problem – excessive liability for non-local online commercial activities – is the same across the entire value chain, from filmmakers to device manufacturers.

Each of the aforementioned discriminatory practices may have different pretexts and rationales, but are always implemented on the principle of ‘license to operate’. This is the presumption that no market actor may offer their products and services without prior

government approval, whether that approval is pending on its number of domestically produced components or the nationality of its programmers or shareholders. Another example of licence to operate is internet censorship – in 2009, my late colleague and I published our report on how internet censorship often has economic protectionist objectives in breach of WTO rules.¹¹ Since then, China has transformed its economic censorship into a system based on a priori licensing requirement for all internet content providers (ICP), which also applies extraterritorially. As a result, every website in the world needs to become a licensee in order to remain accessible in China.

Furthermore, regulatory divergences between open markets with legally consistent and non-discriminatory rules (but with conflicting standards and principles) is another concern. An example is the proposed General Data Privacy Directive (GDPR) in the EU. In pursuit of privacy, a European human right, GDPR may overreach its objective by assuming that only firms accountable in safe harbours 'equivalent' to the EU model could handle personal data on its citizens. A forthcoming study show that GDPR will reduce EU GDP by -0.35% (which is equivalent to doubling current rate of decline in the EU) even in the most conservative scenario by hampering European competitiveness.¹²

A case for a digital trade policy

The rising importance of services and data calls for a comprehensive digital trade policy – and a policy failure will have repercussions that goes beyond the ICT industry. Some argue that we must find usable metrics on cross-border data flows adopted to our antiquated paradigm of imports, exports and trade balances. Such suggestions are nothing but follies. Just to make a comparison, few would ever question that intellectual property, investments or business mobility are essential for US exports, or question how they relate to import and export statistics. Instead, we take their roles and benefits for the trading system as given.

First, as explained above, trade negotiations needs to distinguish cross-border data flows from ICT sector opening, and must be recognised as a separate discipline on equal footing with investments and intellectual property in the WTO (similar to TRIMS and TRIPS) and given their own chapters in FTAs. There are already several 'principles' – most notably the US-EU Trade Principles for ICT services, or the internet principles drafted by the OECD. However, general principles need to be codified into trade law within a trade agreement that can be enforceable.

This leads to a second point: If we distinguish the horizontal and sector specific issues, there is some logic to negotiate all market access issues of the ICT sector jointly in a cluster plurilateral, whether they are tariffs to foreign equity caps, and whether they concern goods or (eventually) services. There is already an existing negotiation platform for that purpose, namely the ITA.¹³ Media has reported that there was a 'considerable interest among both industrialised and developing nations to proceed' on negotiating tariffs and services market access jointly.¹⁴ Given that we have embarked on ISA negotiations,

¹¹ *ibid.*

¹² Forthcoming study by ECIPE on behalf of the US Chamber of Commerce

¹³ See Lee-Makiyama, Future-proofing world trade in technology: Turning the WTO IT Agreement (ITA) into the International Digital Economy Agreement (IDEA), 2011

¹⁴ Washington Trade Daily, Now an ICT plurilateral, March 21, 2012

the pressure from these talks will very soon incentivise the emerging economies to open up their services markets, starting with the ICT sector.

Third, we need to think outside the current framework for services. As mentioned, GATS and the mode-based system do not make sense for the digital economy, or for how the service industry is actually trading across borders. Admittedly, GATS has served us well – and without its annexes or the reference paper on basic telecoms, there would be no internet as we know it today. However, we would not be negotiating services with the mode-based system if we had started drafting GATS in the internet era. We need to seek convergence between preferential and multilateral systems of trade, but there is absolutely no merit in passing on the flaws of GATS to the ISA, TPP or the EU-US FTA.

Finally, addressing digital protectionism through trade policy may seem like a Sisyphean travail. A particular problem arises when the protectionism is reciprocated by the EU and the US for geopolitical reasons. Our own ICT industries reject such protectionism and jointly stated that ‘security is a function of how a product is made, used, and maintained, not by whom or where it is made’.¹⁵ When the EU or the US close their own markets for foreign investments, we are contributing to the balkanisation of the digital economy – which is exactly what protectionists in emerging markets want to do, as it justifies their own policies that keep US firms out of their high-growth markets.

There are more effective instruments than reciprocity to address disproportionate and excessive measures against US exports. The articles on proportionality and necessity under WTO law can and should be enforced against digital trade barriers – either through disputes in sufficiently clear cases, or in bilateral negotiations. Failing to enforce existing trade rules in the digital environment creates a double standard and a consensus that existing trade commitments do not apply online. As trade becomes increasingly dependent on services and data, this will inevitably lead to a deterioration of US market access and terms of trade.

¹⁵ Digital Europe, US Information Technology Industry Council (ITI), Japan Electronics and Information Technology Industries Association (JEITA), Global Information and Communications Technology (ICT) Industry Statement Recommended Government Approaches to Cybersecurity, June 2012