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Commercial Services: Regulatory and Policy Issues**

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# **Extending ASEAN Preferential Trade to Commercial Services: Regulatory and Policy Issues**

## **Abstract**

The Association of Southeast Asian Nations (ASEAN) has broadened its membership to include nine nations in Southeast Asia, bringing formerly hostile states into the ASEAN fold. It has deepened the economic cooperation dimension of ASEAN with the ASEAN Free Trade Agreement (AFTA). Implementation of AFTA, which will lower tariffs on almost all tradable goods to zero to five percent by the year 2003, has been pushed forward ahead of its original schedule. ASEAN is now in the process of liberalization of commercial services under the ASEAN Framework Agreement on Services (AFAS). Though selected service industries have been previously included in economic cooperation arrangements, AFAS represents a more complete effort at extending preferential treatment to services within the region. This paper examines the theoretical and policy issues in the liberalization of tradable commercial services within a region. In particular, regulatory, technological and related investment policy issues must be considered within a regional trading arrangement that wishes to extend intra-group preferences to tradable commercial services. Issues of rules of origin, technical standards, and differential investment restrictions necessary to implement preferential trade in services are evaluated.

## **I. Introduction**

ASEAN Ministers signed the ASEAN Framework Agreement on Services (AFAS) in Bangkok on December 15, 1995. The objective of the framework agreement is to increase trade in services among the member states and thereby enhance the efficiency and

productivity of service industries. As the ASEAN Free Trade Agreement (AFTA) moves forward in goods on an accelerated timetable, AFAS negotiations will seek to put in place preferences in services trade among members.

It is noted in AFAS that Article V of the General Agreement on Trade in Services (GATS) permits preferential liberalization of trade in services among parties to an economic integration agreement. When one considers the complexity of the GATS agreement, involving as it does a large potential universe of commitments by each WTO member, there is some merit in attempting to advance liberalization on a preferential basis in a region. Interest in liberalization of international transactions in commercial services is a relatively new phenomenon for the ASEAN member states and holds promise because of the large and expanding role of services and trade in services in these economies. One may question the significance of opening preferential trade in services among the ASEAN members. However, if the preferences are made broadly available to all service suppliers with a commercial presence within ASEAN, the agreement has the potential to contribute substantively to efficiency of service industries and therefore of all other industries using service sector inputs.

AFAS consists of 14 Articles. The first article reiterates the objectives of AFAS but also states that the agreement will A . . . eliminate substantially restrictions to trade in services amongst Member States; and . . . liberalize trade in services by expanding the depth and scope of liberalization beyond those undertaken by Member States under the GATS with *the aim of realising a free trade area in services.*<sup>1</sup> Hence, one may speak of extending ASEAN free

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<sup>1</sup> ASEAN Secretariat. 1996. "ASEAN Free Trade Agreement on Services," in *Fifth ASEAN Summit*, Jakarta: p.111. The depth and scope of liberalization attained under the

trade (AFTA) to trade in services without the baggage that characterized the multilateral negotiations that resulted in GATS.<sup>2</sup> The ASEAN leaders statement establishes that the first round of negotiations on services committed to by six ASEAN member states (excluding Vietnam, Laos and Myanmar) will emphasize financial services, maritime transport, telecommunications, air transport, tourism, construction, and business services and will be completed no later than December 1998. Subsequent rounds will be held on a flexible basis in order to achieve a higher level of liberalization.<sup>3</sup>

In their statement the ASEAN leaders indicate that the AFAS commitments will cover *all services sectors and all modes of supply*.<sup>4</sup> However, they also allow member states flexibility in determining which sectors they offer for negotiation. Upon examination of the brief actual text of AFAS one finds no mention of modes of supply. The AFAS does not clearly establish that all service sectors will be liberalized. The framework agreement fails to state that only those specific service sectors listed by members are not to be liberalized, hence, AFAS adopts a positive list approach similar to GATS rather than a negative list

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GATS initially was very limited. The commitments of ASEAN members are listed in Robert R. Teh, Jr., 1996. "Preferential Liberalization of Services in ASEAN," in Chia Siow Yue and Joseph Tan, eds., *ASEAN in the WTO*, Singapore: Institute of Southeast Asian Studies.

<sup>2</sup> Bhagwati, Jagdish, 1987, *A Trade in Services and the Multilateral Trade Negotiations*, *World Bank Economic Review*, Vol. 1, No. 4. Bhagwati argued that GATS should be distinct from GATT (the General Agreement on Tariffs and Trade) so as to avoid unwanted linkages between market access in services and goods.

<sup>3</sup> ASEAN Secretariat. 1996. "Bangkok Summit Declaration of 1995" in *Fifth ASEAN Summit*, op. cit., p. 68.

<sup>4</sup> *Ibid.*, p. 68.

approach.<sup>5</sup> Hence, the success of the negotiations depends on the willingness of member states to provide extensive coverage in services negotiations. Broad and extensive inclusion of service sectors is important in achievement of the objectives of increasing services trade and improving efficiency of service industries. It is also a key to AFAS being consistent with GATS. Adoption of a negative list approach would be a major advance compared with GATS, but this is not the case with AFAS.

Liberalization of all modes of supply is important if services markets are to be open and competitive. For example, if service providers are forced to operate in a heavily regulated environment in a member country the tendency is for that member government to restrict trade in like services.<sup>6</sup> In order to compete, foreign service providers must in that case establish themselves through foreign direct investment (FDI) and thus become subject to the regulatory regime of the host country.<sup>7</sup> If all modes of supply are liberalized it is likely that such heavily regulated sectors will come under pressure from foreign service providers that are not subject to the national regulations of that member provided substitutes or like services can be provided through an alternative mode of supply.

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<sup>5</sup> See Sherry M. Stephenson, "Comparative Approaches to Services Liberalization in Southeast Asia and in the Western Hemisphere: Challenges to ASEAN," *1998 Contemporary Working Papers in International Trade and Finance*, Alfred E. Eckes, Ed., Laredo, TX: Texas A&M International University, January 1998. In contrast to the GATS limited positive list approach, some Western Hemisphere free trade agreements have adopted a more comprehensive negative list approach.

<sup>6</sup>Holmes, Sir Frank. 1988. *Issues in International Transactions in Services*, in Leslie Castle and Christopher Findlay, (eds.), *Pacific Trade in Services*. Sydney: Allen & Unwin, p. 77.

<sup>7</sup> This is a violation of the right of non-establishment and is inconsistent with the liberalization of all modes of supply. AFAS denies this right by not covering all modes of supply, see Stephenson 1998, op.cit.

Four possible modes of supply have been identified and have been enshrined in the GATS. Karsenty and Mattoo (1996) provide a summary.<sup>8</sup> Service providers may or may not be present in the territory of the member in order to deliver the service. Two modes do not require presence of the service provider in the territory of the member: 1) cross-border supply, and 2) consumption abroad. Two modes do require presence of the service provider in the territory of the member: 3) commercial presence, and 4) presence of natural persons. The above four modes are essentially defined on the basis of the origin of the service supplier and consumer, and the degree and type of territorial presence which they have at the moment the service is delivered.<sup>9</sup> Only the first mode unambiguously allows services transactions to occur without movement of the supplier or demander of the service. Bhagwati (1987) distinguishes between services that require physical proximity and those that can be delivered over long-distance<sup>10</sup> and also distinguishes cases based on the mobility or immobility of service providers and consumers. Often services are non-storable and require simultaneous provision and use involving different economic entities or agents.<sup>10</sup>

A Typology of service transactions may be developed accordingly as in Hoekman (1994) and Sampson and Snape (1985)<sup>11</sup>. Such a Typology will distinguish between

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<sup>8</sup>Karsenty, Guy and Aaditya Mattoo. 1996. *GATS, Trade in Services, and the Modes of Supply*. Geneva: WTO Secretariat. The four modes of supply are distinguished by criteria set forth in an Explanatory Note (see footnote 9 below).

<sup>9</sup>Quoted in Karsenty and Mattoo p. 3 from *Scheduling of Initial Commitments in Trade in Services: Explanatory Note*, September 3, 1993, GATT, Geneva. Legal interpretation of GATS may differ from the criteria set out in that document.

<sup>10</sup>See Bhagwati, 1987, op.cit. Cross border services require intermediation by postal or telecommunications facilities.

<sup>11</sup>Hoekman, Bernard. 1994. *Conceptual and Political Economy Issues in Liberalizing International Transactions in Services*, in Alan V. Deardorf and Robert M. Stern, (eds.), *Analytical and Negotiating Issues in the Global Trading System*, Ann Arbor: University of

separable and non-separable services, the modes of supply, and the movement of suppliers and demanders (or in the case of repair services of property owned by suppliers or demanders). It should be recognized that modes of supply are not necessarily mutually exclusive. For example, commercial presence and movement of natural persons may be complementary to supply of a service that can be supplied over a long distance through cross-border trade.<sup>12</sup> On the other hand, as was pointed out above, in the case of services that are heavily regulated, requiring establishment of commercial presence while restricting cross-border trade may be a strategy to force foreign suppliers to compete on a less favourable basis than they would otherwise choose. It is important to recognize that the criteria used by GATS may not be adequate to cover all actual modes of supply.<sup>13</sup> Obtaining estimates of the relative importance of various modes of supply in a particular service sector is often problematic because of gaps in statistical coverage of international services transactions as they are defined in GATS.<sup>14</sup>

Trade between parents and affiliates of multinational enterprises is often missed in balance of payments statistics in services because countries do not yet collect statistics on Foreign Affiliates Trade (FAT). In GATS international trade in services is defined to include local sales by foreign affiliates or agents that are considered to be residents and therefore excluded from standard balance of payments statistics services transactions. For

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Michigan Press, pp. 501-543. Sampson, Gary and Richard Snape. 1985. Identifying the Issues in Trade in Services, *The World Economy*, June, pp. 172-175. Stern, Robert M. and Bernard Hoekman. 1988. Conceptual Issues Relating to Services in the International Economy, in Chung H. Lee and Seiji Finch Naya, (eds.), *Trade and Investment in Services in the Asia-Pacific Region*, Boulder, Colorado: Westview Press, pp. 7-26.

<sup>12</sup>See Karsenty and Mattoo, op. cit., p. 4 for examples.

<sup>13</sup>Ibid., p. 3.

<sup>14</sup>See Karsenty and Mattoo, op. cit. p. 5.

purposes of GATS the concept of foreign ownership corresponds to cases where 50 percent or more of equity interest is foreign, whereas foreign direct investment (FDI) statistics are based upon 10 percent or more foreign equity interest. Thus, a potentially severe problem for AFAS negotiators is the lack of statistical data on international services transactions in ASEAN and the fact that negotiated commitments will not be matched by existing trade and FDI statistics. This will make it difficult for negotiators to know the relative magnitude of various modes of supply in each service sector and the scope for competition or complementarity these would imply. Comparison of the existing situation and free trade in services is fundamental to evaluation of the impact of liberalization. In getting at these issues, more than one classification scheme is likely to be needed.

International services transactions may be categorized by the relationship to international trade in goods or investment. One may distinguish services complementary to trade in goods (shipping services) from services substitutable for trade in goods (repair, leasing, franchising), as well as from services unrelated to trade in goods (certain types of financial services, telecommunications and travel). Shelp (1981) distinguishes three main services transactions groupings based on the typical mode of international delivery of the service: investment-related services, trade-related services and trade and investment-related services.<sup>15</sup> Increasingly, multinational corporations will take advantage of opportunities to improve efficiency and lower costs by conducting international transactions in services. As globalization gathers momentum, international transactions in services are likely to become more important whether or not such transactions are conducted within the firm or between

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<sup>15</sup>Shelp, Ronald. 1981. *Beyond Industrialization: Ascendancy of the Global Service Economy*. New York: Praeger Publishers. See United Nations Conference on Trade and Development (UNCTAD) and World Bank. 1994. *Liberalizing International Transactions in Services: A Handbook*. New York: United Nations, particularly chapter one, for a discussion of various approaches and classification schemes for services.

multinationals and independent service suppliers.. Local affiliates of multinationals may act as trade intermediaries and facilitate international trade in services. It is likely services trade liberalization will increase the significance of Asplintering $\cong$  or slicing up the value-added chain for services and, therefore may spur additional investments in service sectors in ASEAN.

## II. Significance of Services Trade in ASEAN

Given the dearth of basic data on intra-ASEAN services trade, it will be important to improve data collection in order to gain some insights into the likely first-order effects of liberalization of various service sectors. For example, presently we lack any quantitative measures of the tariff equivalent of protection of services<sup>16</sup>.

World Bank data (1980 and 1995) on services as a share of GDP in each ASEAN member is reported in **Table 1**. In the five countries with observations for the two years, services increased as a percentage share of GDP. The ASEAN average (weighted by GDP) is consistent with the average of all developing economies in the World Bank database. It is worth noting that the GDP share of services in Singapore, like the level of income (GDP per capita), is in line with the high-income economies. Laos has the lowest share of services of all ASEAN members with observations in 1995. The Philippines has had the largest increase in the services sector share of GDP over the period.

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<sup>16</sup>The OECD Trade Committee, Working Party, has been studying the issue and recommends applying the ATrade Restrictiveness Index $\cong$  (TRI) developed by Anderson and Neary. See Anderson, James E. and J. P. Neary. 1994. A Measuring the Restrictiveness of Trade Policy, $\cong$  *World Bank Economic Review*, Vol. 8, No. 2, p. 151-169.

Employment in services as a percentage of total employment in ASEAN members (**Table 2**) has increased between 1980 and 1995 with the exception of Myanmar, where the share fell from 25 to 23 percent<sup>17</sup>. The share of Thai employment in services is suspiciously low given the high share of services in GDP shown in Table 1. One suspects that services employment is substantially underestimated in much of ASEAN. The structure of services employment in ASEAN is examined using ILO figures (**Table 3**). It can be seen that the share of construction in Thai service employment is quite large (14 percent). Use of a conventional measure (excluding construction) would lead to even lower estimates of the share of Thai services in total Thai employment. Breakdowns of service sector employment that were consistent with the ILO=s were not always available for all members. It can be seen that wholesale and retail trade and restaurants and hotels is the largest employer of service workers in Indonesia and Singapore and is equal to the share of community, social and personal services in Malaysia. The share of employment in financing, insurance, real estate and business services has increased in ASEAN, though the figures for Myanmar are probably too high in both years reported. One would expect an increase in merchandise trade-related services, yet the shares of transport, storage and communication do not provide much support for this expectation. In contrast, another study found that employment in Indonesian

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<sup>17</sup>These numbers are derived from International Labour Office, Yearbook of Labour Statistics, Geneva, 1996, 1989-90 and 1988 issues. In these data I have classified construction workers as a part of services, since construction is included in AFAS and has priority in the negotiations. For that reason, these figures could not be compared with the breakdown of employment shares by sector in all developing economies in the World Development Reports of the World Bank, as those figures classify construction employment as part of industrial employment. A further problem is that those figures in the *World Development Report, 1997* do not specifically identify services employment.

transportation and communication grew by 7.5% per annum between 1989 and 1993.<sup>18</sup>

Services have become increasingly important in ASEAN exports (**table 4**), rising from 16 percent of total exports in 1984 to 18.6 percent in 1995.<sup>19</sup> Growth of exports of services of 14.6 percent per annum between 1984 and 1994 slightly outpaced growth of exports of goods of 14.2 percent for ASEAN. However, the relative performance of services exports varied from country to country, with Indonesia, Malaysia and the Philippines services exports rising faster than goods, with the opposite situation in Singapore and Laos. In Thailand both goods and services exports grew by 20 percent per annum from 1984-1995. Imports of services (**table 5**) dipped from 18.2 percent of total imports in 1984 to 16.2 percent in 1990 but recovered to 18 percent in 1995 for ASEAN as a whole.<sup>20</sup> Growth of imports of services between 1984 and 1994 in ASEAN was 13.1 percent per annum, slightly less than for goods, which grew by 13.7 percent. Imports of services outpaced total imports in Thailand, Indonesia, the Philippines and Laos, the reverse was the case in Malaysia and Singapore.

Credits and debits of non-factor services transactions in the balance of payments of ASEAN members are presented for transportation (**table 6**), travel (**table 7**) and other services (table 8). With the exception of Singapore, it can be seen that ASEAN members are

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<sup>18</sup>James, William E. 1997a. *Directions for Future ASEAN Economic Cooperation: Trade and Investment in Commercial Services. Indonesia*, Bangkok: Thailand Development Research Institute. Mimeo.

<sup>19</sup>These data are derived from IMF, Balance of Payments Statistics Yearbook, 1996 and 1992. Non-factor services flows are recorded as service exports in IMF compilations of exports of goods and services or what we refer to as total exports. The 1995 figures for Malaysia were taken from International Financial Statistics as noted in Table 4. If 1994 figures are used services as a share of total exports are 17.4 percent for ASEAN.

<sup>20</sup>Again 1995 data for Malaysia were taken from IFS and not BOPS. In 1994 the share of services in total imports of ASEAN was 17.5 percent.

large net importers of transportation services. However, all ASEAN members are large net exporters of travel services. Indeed, among all developing countries in IMF compilations, Singapore (2), Thailand (3), Indonesia (5) and Philippines (21) ranked highly in travel services credits in 1995. Malaysia has also been very successful in promoting its tourism industry and ranked 7<sup>th</sup> in travel receipts among developing countries in IMF compilations in 1994.

Other services transactions of ASEAN members are quite substantial (**table 8**) with Indonesia, Malaysia and Thailand being large net importers and Singapore and the Philippines being net exporters. Much of other services transactions are thought to be within ASEAN. Singapore and the Philippines provide many business and professional services to Indonesian residents and companies. Unfortunately, there are no statistics on intra-ASEAN flows of services presently available. Factor services in the form of investment income and compensation of employees credits, debits and balance are presented (**table 9**). It can be seen that the Philippines and Singapore have positive balances from capital and labor services flows (as does Laos on a small scale) whereas Indonesia, Malaysia and Thailand have deficits.

As measured in conventional statistics trade in services thus accounts for a little under 20 percent of all international trade of ASEAN members. This is slightly lower than the average for all developing countries in 1994 (services accounted for 21 and 24 percent of total exports and imports of developing countries). Of course, as can be seen in tables 4 and 5, there is a good amount of variance in the importance of recorded services transactions of ASEAN members. This is somewhat misleading. For one reason, Singapore's re-exports add substantially to exports of goods in ASEAN, when in reality, Singapore's role is that of an entrepot--clearly a service-type activity. In addition, all goods trade embodies some

services component and this component is probably rising as a proportion of international trade.<sup>21</sup> Within ASEAN, Indonesia, Malaysia and Thailand (as well as Laos, Myanmar, Brunei, and Vietnam) are net importers of services. In contrast, the Philippines and Singapore have substantial net service exports. It may be thought that the latter countries would gain most from ASEAN liberalization of international transactions in services. However, one must consider the likely future trajectory of services trade in the ASEAN economies before reaching any conclusions on the distribution of the benefits of liberalization.

### **III. Conceptual Framework for ASEAN Preferential Trade in Services**

The logic of comparative advantage applies to international transactions in services according to economists seeking to establish a conceptual framework in which to analyse international services transactions and related issues.<sup>22</sup> If one accepts the view that international services transactions, in the absence of distortions, with perfect competition and constant returns to scale technology, are subject to the principle of comparative advantage, then services trade welfare effects can be examined using a similar framework to that used for goods. The presence of imperfect competition and increasing returns technologies may in

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<sup>21</sup>Grubel, Herbert. 1988. A Direct and Embodied Trade in Services or Where is the Service Trade Problem? in Chung H. Lee and Seiji Naya (eds.), *Trade and Investment in Services in the Asia-Pacific Region*, provides estimates of embodied trade in services for the case of Canada.

<sup>22</sup>See for example, Stern and Hoekman (1988) in Lee and Naya (eds.) op.cit., pp.15-18 and Hoekman (1994), op. cit., pp. 509-21.

some cases alter the outcome, however, such cases are unlikely to justify government imposed barriers to international services transactions from either a static or dynamic viewpoint<sup>23</sup>. A key consideration in evaluating the economic effects of liberalization of international services transactions is that government-imposed restrictions such as high barriers to entry and other anti-competition devices and regulations are more serious in the case of services than in goods. This implies that the efficiency gains brought about by liberalization of international services transactions may be quite substantial. As Stern and Hoekman point out:

AGains from liberalization arise from improvements in the efficient allocation of resources between and within countries, the lowering of prices, and the expansion of choices afforded to consumers and firms.<sup>24</sup>

Hoekman (1994) develops a simple model to demonstrate the theoretical outcome of net welfare gains from services trade liberalization under free trade and perfect competition. The model demonstrates that global free trade in goods and in services coupled with free movement of service providers is unambiguously net welfare enhancing. Unfortunately, partial or incremental liberalization implemented over a long time period, rather than any sudden move to free trade in services is the reality. The question we seek to answer is under

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<sup>23</sup>See UNCTAD and World Bank (1994) op. cit., p. 27. There are issues of sequencing of liberalization that may provide justification for maintaining some restrictions on the inflows of capital, particularly short-term portfolio investment. However, such restrictions do not imply that domestic financial firms should be protected from competition from foreign financial firms in the domestic market.

<sup>24</sup>See Stern and Hoekman (1988), op. cit., p. 18.

what conditions will preferential liberalization of services among a subset of economies, enhance the region=s welfare with no net loss to non-members. Traditional analysis of preferential trading arrangements focuses on the relative size of trade creation versus trade diversion following Viner.<sup>25</sup> To the extent that increases in allocational efficiency outweigh losses in efficiency through trade diversion, such arrangements confer net welfare gains. However, it is presumed that for evaluation of preferential trade in services, it is not sufficient to simply measure trade creation and trade diversion, particularly in the case of non-separated services where investment or commercial presence is involved in supplying the service.

The distribution of net gains (or losses) from a preferential trading arrangement in services will vary according to the investment regime that is chosen. Indeed, if investment in services industries is open to firms of non-members of the grouping and, if such firms are allowed to establish within the group and to benefit from the preferential liberalization, then non-members may be more likely to derive net benefits from the arrangement compared with the results that would obtain under a closed investment regime. However, if ownership is used to determine origin (rather than incorporation or establishment of facilities within the region) for purposes of enjoying the preferences in international transactions in services, then non-members are subject to discrimination, even when they invest inside the grouping=s services industries for intra-regional transactions. It is difficult to judge whether or not non-members would suffer net welfare losses under rules of origin that prevent such firms from enjoying the preferences enjoyed by firms owned by members=nationals.

Another important distinction to make in the ASEAN context is that the net gains from

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<sup>25</sup> Viner, Jacob. 1950. *The Customs Union Issue*, Carnegie Endowment for International Peace, New York.

preferential liberalization of services transactions may be difficult to distinguish when members continue to liberalize on an MFN basis as has been the case for trade barriers on goods. In the case of goods, it is a simple matter to measure margins of preference by comparing MFN with CEPT tariffs. At most the ASEAN margin of preference will be ten percent in 2003, and in many cases will be 5, 2.5 or zero percent. However, no such ready measure can be applied to international services transactions. Therefore, it is important to consider the specific implementation of services preferences in AFAS in evaluating effects on member and non-member economies.

Indices of Revealed comparative advantage $\cong$  (RCAs) for two definitions of international services transactions were calculated for ASEAN members and ASEAN as a whole (**Table 10**) for the years 1993-1995.<sup>26</sup> These indices for narrowly defined non-factor services have increased and exceeded unity in 1995 for ASEAN, though the values of RCAs show large variation within the group. RCAs for non-factor services are rising in the case of members without a revealed comparative advantage (Indonesia, Singapore and Malaysia). The Philippines, Laos and Thailand in each of the three years have a revealed comparative advantage in exports of non-factor services. For an expanded definition of services including income flows in the current account of the balance of payments (factor service payments) ASEAN is shown to not have a revealed comparative advantage, though the group ratio rises each year compared with the previous year. Only the Philippines has RCAs above unity for the expanded services definition. These aggregate measures of revealed

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<sup>26</sup>See Hoekman (1994) op.cit. for the methodology and analytical basis for use of RCAs of the type calculated here. The RCA is  $(X_{ij}/Y_j/X_{iw}/Y_w)$  where  $X_{ij}/Y_j$  is exports of services of country or region  $j$  over total exports of country or region  $j$  and  $X_{iw}/Y_w$  is world exports of services over total world exports.

comparative advantage do not imply that ASEAN members with ratios below unity have no comparative advantage in specific services sectors. For example, Indonesia in 1995 has an RCA of 1.31 for travel services. Other examples can easily be found.

The RCA analysis indicated that plausibly ASEAN members are likely to be able to gain from preferential liberalization of trade through trade creation within the group. The scope of these gains would seem to be marginal at best if they are limited to services provided by ASEAN nationals alone. For example, one might ask how much of an efficiency gain is likely to result from Thailand allowing Indonesian banks to operate there? A study of impediments to trade and investment in APEC (including the six ASEAN members committed to AFAS) indicates that non-tariff barriers in services are abundant and that the cross-sectoral incidence of such obstacles varies across member countries. The frequency measures used to evaluate the degree of impediments to service provision by foreigners may tend to exaggerate the problems of market access.<sup>27</sup> For example, a restriction may be partial in nature, and may allow foreign service providers market access with certain conditions (e.g., require that they be incorporated in the region). Nevertheless, the findings indicate that the member states have ample scope for negotiations, but that the negotiations have a long way to go if they are to truly open up trade in services in the region.

However, it is also important to keep in mind most ASEAN members are very open to foreign direct and portfolio investments. If foreign service suppliers are free to establish themselves in ASEAN through investment, depending on the rules of origin selected,

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<sup>27</sup> Pacific Economic Cooperation Council, *Survey of Impediments to Trade and Investment in the APEC Region*, A Report by the Pacific Economic Cooperation Council for APEC, Singapore: APEC Secretariat, 1995.

they may also benefit from net trade creation. The scope for efficiency gains resulting from all service suppliers operating in the ASEAN region having access to the market could be substantial. If, for example, banking affiliates of U.S. or European Banks are able to provide services under AFAS, the competitive impact and resulting efficiency gains could be substantial. A related question is whether or not having region-wide access within ASEAN will confer non-trivial benefits in the form of lower cost service inputs to foreign investors. If it is the case that getting access to duty free inputs within ASEAN helps to lower costs, then the logic is that AFAS could enhance the competitiveness of ASEAN industries.

ASEAN members that are net importers of services, therefore could reap large gains from lower cost services, greater choice for consumers of services and improved allocation of resources that will enable them to expand exports and imports of both goods and services according to comparative advantage. If certain principles are observed in implementing AFAS, such a result is plausible.

In carrying out preferential liberalization of international services transactions, ASEAN is cognizant that AFAS must be consistent with GATS.<sup>28</sup> Just as CEPT has sought to be consistent with the spirit of Article XXIV of GATT, AFAS is conceived to seek the same consistency with GATS and the WTO. The following principles derived from existing literature on international services and liberalization in recent years are suggested:

1. Provide for comprehensive coverage of services. New services are bound at free trade.

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<sup>28</sup> AFTA itself has not been formally notified to the WTO. Hence, one may question the credibility of the promise that AFAS itself will be consistent with international rules as in the General Agreement on Trade in Services. ASEAN members have, however, been supportive of efforts to advance negotiations at the multilateral level in GATS.

This principle of broad coverage of service industries is consistent with the requirements of GATS Article V. Broad coverage is more likely to be achieved through a negative list approach than a positive list approach. The limited initial achievements of the GATS negotiations are indicative of the pitfalls of a positive list approach. An additional advantage of a negative list approach is that it is natural to agree that new services can generally be bound at free trade.

## 2. Liberalize all modes of supply

This principle is consistent with GATS Article I which identifies the modes of supply and with Article II on unconditional MFN treatment. Exemptions from Article II must be specified in each contracting party's annex on Article II Exemptions. Evidence of such an approach is the right of non-establishment in the delivery of a service within the free trade area, guaranteeing that services can be provided through various modes of supply.

## 3. Develop a national treatment principle that provides foreign service suppliers with no commercial disadvantage vis-a-vis domestic suppliers of like services.

Article XVII of GATS deals with national treatment. Unfortunately, ambiguities remain in GATS, particularly in relation to market access (Article XVI).<sup>29</sup> Hence, it is possible national treatment may become meaningless if there is no corresponding commitment to provide market access. AFAS does not explicitly provide for national treatment, but extends preferences on an ASEAN most-favored nation basis. It provides for a standstill on new discriminatory measures and limits on market access by members.

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<sup>29</sup>See Aaditya Mattoo. 1997. 'National Treatment in the GATS: Corner Stone or Pandora's Box?' *Journal of World Trade*, April, pp. 107-35.

4. Avoid protectionist use of technical regulations.

Technical standards and conformity assessment systems, certification procedures, rules of origin, and licensing requirements can be used in a protectionist manner. Such uses should be avoided as much as possible.

5. Adopt a mutual recognition principle rather than attempting to harmonize regulatory frameworks in the near-term. Leave convergence to the long-term.

Mutual Recognition Agreements (MRAs) applying to technical standards and conformity assessment can be an important means of circumventing potentially thorny problems in liberalizing trade in areas such as telecommunications.<sup>30</sup>

#### **IV. Technical Aspects of Preferential Liberalization of Services Trade and Policy Questions.**

The following technical aspects of establishing preferential trade in services will be addressed: 1) Rules of Origin; 2) Technical Standards; 3) Investment Regime; 4) Regulatory Framework; and 5) Competition Policy.

**Rules of origin** are a necessary accompaniment for any form of trade agreement that stops short of unconditional MFN treatment and are particularly important in establishing Afree trade≅ agreements or what are more accurately referred to as preferential trading

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<sup>30</sup>Wilson, John S. 1996.≅Eliminating Barriers to Trade in Telecommunications and Information Technology Goods and Services: Next Steps in Multilateral and Regional Liberalization Efforts,≅ OECD, Paris, July.

arrangements. ASEAN members that expect reciprocity in extending preferential treatment to service providers of other members will have to set rules for determining the country of origin of an internationally traded service and for determining the country of origin of service providers that supply the service through other modes of supply than cross-border arms length transactions. Even if reciprocity is not demanded, ASEAN members will have to have rules to distinguish service providers of ASEAN origin from non-ASEAN origin service providers. Rules of origin for services transactions will necessarily differ from the principle of Asubstantial transformation<sup>≡</sup> that is applied to goods.<sup>31</sup>

In AFAS it is recommended that a simple residency test be adopted to determine if the origin of a service provider whose mode of supply requires commercial presence or presence of a natural person is of an ASEAN member and hence eligible for preferential treatment. Residency is easy to determine in the case of services provided by natural persons. In cases where investment or commercial presence is required origin by residency is again rather straightforward. Residency can be ascertained by the place of incorporation of the firm, provided the firm has a substantial presence in that location. For cross border trade in a service, particularly network services, difficulties similar to determining the country of origin arise. However, it is recommended that ASEAN adopt a zero MFN tariff on information technology products and services to obviate the need for a rule of origin. In other cases (repair services for example), a simple residency or ownership rule can be applied. It is not

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<sup>31</sup>For discussion of various types of rules of origin that may be applied to internationally traded goods and services see James, William E. 1997b. AASEAN Economic Cooperation and Commercial Services: Regulatory and Technical Issues in Expanded Liberalization,<sup>≡</sup> in Mari Pangestu, Syahrir and Sri Mulyani, (eds.), Feistschrift Volume for Professor Suhadi Mangkusuwondo. Singapore: Institute for Southeast Asian Studies.

recommended that ownership rules be used to exclude foreign service firms that have established a commercial presence within ASEAN from receiving AFAS preferences.

**Technical Standards** such as registration requirements for software and certification requirements for certain occupations and professions may be used to inhibit international commerce.<sup>32</sup> One way to handle this problem is to attempt to harmonize standards. However, that approach is probably unrealistic. The U.S. and E.U. have adopted an alternative approach known as mutual recognition. Mutual Recognition Agreements (MRAs) are possible where member countries have adopted their own national standards. ASEAN has indicated in Article V of AFAS that it may encourage use of this approach, though not requiring members to do so. It is likely that MRAs can expedite licensing of service suppliers provided certain minimal requirements are met. MRAs should avoid redundant licensing and certification requirements as these burden firms with extra unnecessary costs. MRAs also require rules of origin and these have proved a stumbling block in the U.S.-E.U. negotiations.

**Investment Regimes** vary significantly among ASEAN members. Ownership restrictions on foreign investors are present in some cases. Preferential market access to service providers originating within ASEAN where commercial presence through investment is an important mode of supply may require some special investment provisions. In general it is desirable for ASEAN to avoid strict ownership requirements for purposes of enjoying market access under AFAS. Article VI on Denial of Benefits to service suppliers who are not natural persons of a member state or a firm owned or controlled by persons of a non-member

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<sup>32</sup>See Wilson, John S. 1996. *op.cit.*

state appears to open up the possibility of foreign owned or controlled firms that have substantial business operations in at least member state being offered the same preferences as domestic firms. The rules for determining ownership or control should be kept simple and be combined with a simple residency requirement based on a firm=s incorporation and substantial presence in at least one member country.

**Regulatory Frameworks** in service industries tend to be rather restrictive though regulatory regimes vary across service sectors and between countries. Some services are provided exclusively by state enterprises or other public entities (e.g., basic telephone services). In many service industries there is a trend towards deregulation and an easing of barriers to entry. It makes sense that such deregulation in areas such as telecommunications, finance and insurance, other business services, and transportation at the domestic level be complemented by efforts to reduce barriers to international transactions or to foreign firms supplying like services. Currently all ASEAN members use regulatory restrictions on the type, number and duration of stay of foreign personnel. With the exception of Singapore, foreign ownership restrictions apply in service industries of ASEAN members. Other regulatory restrictions, such as on land ownership, length of leases of land and discriminatory licensing or other regulations exist in Indonesia, Malaysia, the Philippines and Thailand<sup>33</sup>. Efforts to phase out such regulatory barriers within ASEAN within a reasonable time period is a worthy goal. In the meantime, ASEAN members will also need to improve prudential regulation of financial services. As ASEAN members are among the countries with the fastest growing trade in international business services, which encompass a wide and diverse

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<sup>33</sup>For example foreign banks have higher minimum capital requirements in Indonesian than domestic banks. See James 1997a, op.cit.

range of service activities, efforts to ease requirements for visas and work permits within ASEAN could stimulate further expansion of these sectors.<sup>34</sup> Deregulation and liberalization efforts are equally necessary to realize efficiency gains. It is important to keep in mind the fact that many service activities are complementary to one another, hence gains can be enlarged when barriers are eased for clusters of such service industries.

**Competition Policy** is particularly significant in some services industries that have been characterized by monopoly suppliers such as state telephone monopolies. In most ASEAN countries, commitments are being made to encourage greater competition and monopolies are being gradually rescinded, particularly in telecommunications. The advance of new technology is helping to push forward policies geared to opening markets that were formerly subject to monopoly. The fact that some services appear to be characterized by natural monopoly and increasing returns to scale (particularly telecommunications and information technology) does not necessarily provide governments with an ironclad case for intervention. However, there are concerns over possible anti-trust violations by powerful private service providers, particularly in the lucrative global computer software and information technology sector. Given the rapid technological changes and continuing cost reductions in the information-based service industries, it may be unwise for governments to seek to intervene and set additional rules and standards that divert resources from market-determined uses. ASEAN members can couple deregulation with open policies towards trade and investment to help promote a competitive environment.

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<sup>34</sup>United Nations. 1996. *World Economic and Social Survey*, New York. See especially *Business Services in International Trade* (Chapter XII), pp.280-1.

## V. **Conclusions and Policy Implications for ASEAN**

Thirty years have passed since ASEAN was first established as an anti-Communist bulwark. In its thirtieth year, ASEAN enlargement has brought formerly hostile countries, particularly Vietnam, into the fold.

Merchandise trade liberalization under AFTA is to be completed by 2003. And now services are to be liberalized under AFAS. Preferential liberalization of services in ASEAN can move at a faster pace than multilateral liberalization under GATS.

However, ASEAN will benefit more if it adopts an outward looking approach to services just as it has done for goods. By allowing all service suppliers that are established within ASEAN to benefit from preferential treatment, competition, efficiency and investment will be maximized. Hence, rules and regulations would not attempt to distinguish between ASEAN and foreign-owned service providers that are already present or that invest in new facilities within the region.

Modification of schedules of commitments and provision for safeguard actions are allowed under the GATS and are provided for in AFAS. Therefore, the framework agreement takes into account the concern that domestic service suppliers will be unable to compete with foreign suppliers. It would be preferable for ASEAN to forge ahead in negotiations as a means of strengthening overall economic efficiency and competitiveness of the member states' economies. Keeping this goal in mind would be wise in advancing the negotiations.

ASEAN commitments under the GATS are very limited. AFAS can and should go much further in liberalization commitments than most ASEAN members committed to in the

GATS. For one thing, sectoral coverage under AFAS goes farther than Indonesia, Brunei, and the Philippines committed to in the GATS.<sup>35</sup>

Some liberalization of services on an MFN basis has been accomplished already as in telecommunications and tourism. Efforts to liberalize further on a MFN basis should continue so that the margin of preference for services supplied within the region does not become too large as AFAS is implemented.

There is no doubt that a group of nine countries that are close in proximity and that have already agreed to a free trade area for goods, can move ahead with services liberalization at a brisker pace than can be done under GATS. However, ASEAN will have to overcome difficulties, including weak or non-existent data on services trade and transactions and opaque and varying regulatory and investment regimes. Liberalization of commercial service transactions is essential for the adjustment of ASEAN economies to the new realities of the global economy in the 21st century.

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<sup>35</sup>Vietnam, Myanmar and Laos are not yet members of WTO and have no commitments under the GATS.

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Table 1. Services in GDP in ASEAN and All Developing Economies, 1980 and 1995

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Country/Region	1980	1995
Indonesia	34	41
Laos	na	30
Malaysia	40	44
Philippines	36	46
Singapore	61	64
Thailand	48	49
Vietnam	na	42
ASEAN	38	47
All Developing Economies	37	48

Notes: na means not available, hence, ASEAN in 1980 excludes Laos and Vietnam.  
In 1980, lower-middle income economies are excluded from all developing economies.  
Source: World Development Report 1997, World Bank, Table 12.

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Table 2. Employment in Services in ASEAN (% of total labor force employed)

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Country/Region	1980	1995
Indonesia	25	34
Malaysia	52	56
Myanmar	25	23
Philippines	36	45
Singapore	68	72
Thailand	23	28
ASEAN	28	35

Indonesia data are for 1979 and 1992, first observation for Malaysia is 1982, second observations for Myanmar and Thailand are for 1994 and 1991, respectively.

Source: International Labour Organization, Yearbook of Labour Statistics, 1996, various issues.

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**Table 3. Structure of Services Employment in ASEAN (% of all services employment)**

Service Sector and Country	1980	1995
<b>Construction</b>		
Indonesia	10	9
Malaysia	14	8
Myanmar	6	8
Philippines	10	11
Singapore	8	9
Thailand	9	14
<b>Wholesale and Retail Trade, Restaurants and Hotels</b>		
Indonesia	43	42
Malaysia	32	32
Myanmar	39	37
Singapore	34	32
<b>Transport, Storage, and Communication</b>		
Indonesia	10	10
Malaysia	8	8
Myanmar	14	11
Philippines	12	13
Singapore	17	15
Thailand	9	10
<b>Financing, Insurance, Real Estate and Business Services</b>		
Indonesia	0	2
Malaysia	8	9
Myanmar	24	32
Philippines	5	5
Singapore	11	15
<b>Community, Social and Personal Services</b>		
Indonesia	37	38
Malaysia	39	37
Myanmar	18	12
Singapore	31	30
<b>Memo Item: Total Services Employment (thousands of employees)</b>		
Indonesia	12626	26511
Malaysia	2712	4257
Myanmar	3251	3912
Philippines	6223	11583
Singapore	727	1150
Thailand	5152	8715

Totals may not sum to 100.0 due to rounding errors

Indonesia data are for 1979 and 1992. First observation for Malaysia is for 1982. Second observations for Myanmar, Singapore and Thailand are for 1994, 1993 and 1991 respectively.

Source: International Labour Organization, Yearbook of Labour Statistics, 1996 and various issues.

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Table 4. Share of Non-Factor Services in Exports of Goods and Non-Factor Services in ASEAN Members (%)

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Country/Region	1984	1985	1990	1993	1995
Indonesia	2.7	4.4	8.8	9.8	11.1
Laos	25.5	28.8	22.0	25.8	25.3
Malaysia	11.1	11.9	11.8	10.5	13.5
Myanmar	na	na	29.4	na	na
Philippines	23.3	32.6	28.4	29.1	34.9
Singapore	25.1	22.8	19.0	19.2	19.8
Thailand	21.1	22.4	22.0	23.3	21.1
ASEAN	16.0	16.9	17.0	17.0	18.6

Note: na means not available.

Malaysia figure for 1995 is from International Financial Statistics.

The ASEAN figure is trade weighted.

Source: International Monetary Fund, Balance of Payments Statistics Yearbook, 1992 and 1996.

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Table 5. Share of Non-Factor Services in Imports of Goods and Non-Factor Services in ASEAN Members

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Country/Region	1984	1985	1990	1993	1995
Indonesia	22.0	28.8	22.0	25.8	25.3
Laos	11.8	11.9	12.3	19.6	18.8
Malaysia	24.8	25.9	17.3	15.7	16.7
Myanmar	na	na	12.1	na	na
Philippines	16.1	14.3	12.6	14.9	20.8
Singapore	13.1	14.0	13.3	12.2	12.4
Thailand	16.8	17.4	17.6	23.5	22.9
ASEAN	18.2	20.2	16.2	17.5	18.0

Note: na means not available.

Malaysia figure for 1995 is from International Financial Statistics.

The ASEAN figure is trade weighted.

Source; International Monetary Fund, Balance of Payments Statistics Yearbook, 1992 and 1996.

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Table 6. Transportation Services Transactions of ASEAN Members (mil. US \$9)

Country		1984	1985	1990	1993	1994	1995
Indonesia							
	credit	49	42	70	44	na	na
	debit	-2010	-1716	-2795	-3667	-3913	-4747
Laos							
	credit	4	5	na	3	2	1
	debit	na	na	-18	-34	-46	-41
Malaysia							
	credit	846	809	1198	1613	1876	na
	debit	-1792	-1529	-2531	-3433	-4352	na
Myanmar							
	credit	na	na	10	na	na	na
	debit	na	na	-27	na	na	na
Philippines							
	credit	154	204	246	218	233	274
	debit	-452	-378	-980	-1425	-1457	-2051
Singapore							
	credit	2932	2641	2191	3160	4028	4932
	debit	-2102	-1508	-2964	-3231	-3880	-4888
Thailand							
	credit	470	472	1327	1964	1842	2455
	debit	-1294	-1223	-3576	-5005	-5862	-7780

na means not available.

Source: International Monetary Fund, Balance of Payments Statistics Yearbook 1996 and 1992.

Table 7. Travel Services Transactions of ASEAN Members (mil. US \$)

Country		1984	1985	1990	1993	1994	1995
Indonesia							
	Credit	460	548	2153	3651	4575	5449
	Debit	-362	-591	-836	-1539	-1900	-2172
Laos							
	Credit	na	na	3	34	43	51
	Debit	na	na	na	-11	-18	-30
Malaysia							
	Credit	608	622	1684	2190	3376	na
	Debit	-1141	-1158	-1450	-1838	-1737	na
Myanmar							
	Credit	na	na	20	na	na	na
	Debit	na	na	-16	na	na	na
Philippines							
	Credit	366	506	466	1178	973	1136
	Debit	-19	-37	-111	-130	-196	-422
Singapore							
	Credit	1859	1660	4649	6327	7223	8294
	Debit	-601	-613	-1830	-3145	-3960	-5140
Thailand							
	Credit	1155	1169	4235	5638	6063	8035
	Debit	-309	-281	-1432	-3040	-4065	-3780

na means not available.

Source: International Monetary Fund, Balance of Payments Statistics Yearbook 1996 and 1992.

Table 8. Transactions in Other Services of ASEAN Members (mil. US \$)

Country		1984	1985	1990	1993	1994	1995
Indonesai	credit	61	254	265	264	222	232
	debit	-1579	-2703	-2425	-4640	-5603	-6556
Laos	credit	4	5	13	34	33	31
	debit	-9	-8	-8	-52	-45	-55
Malaysia	credit	484	521	927	1414	1294	na
	debit	-1386	-1248	-1503	-2782	-2794	na
Myanmar	credit	na	na	64	na	na	na
	debit	na	na	-30	na	na	na
Philippines	credit	865	1152	2532	3277	5562	7938
	debit	-652	-413	-670	-1535	-3001	-4453
Singapore	credit	2682	1983	5971	9027	12116	16149
	debit	-1883	-1813	-3877	-4821	-5715	-6605
Thailand	credit	232	256	767	3457	3735	4356
	debit	-200	-193	-1301	-4424	-5469	-7244

na means not available.

Source: International Monetary Fund, Balance of Payments Statistics Yearbook 1996 and 1992.

Table 9. Factor Income Flows in ASEAN Members (mil. US \$)

Country	1984	1985	1990	1993	1994	1995
Indonesia						
credit	828	768	409	1028	1048	1345
debit	-4889	-4310	-5599	-6015	-5741	-7123
balance	-4061	-3542	-5190	-4987	-4693	-5778
Laos						
credit	0	0	2	9	7	7
debit	-3	-2	-3	-6	-6	-7
balance	-3	-2	-1	-3	-1	0
Malaysia						
credit	306	591	1849	2006	2343	na
debit	-2885	-2780	-3721	-5214	-5897	na
balance	-2579	-2188	-1872	-3208	-3555	na
Myanmar						
credit	na	na	2	na	na	na
debit	na	na	-192	na	na	na
balance	na	na	-190	na	na	na
Philippines						
credit	984	1053	1598	2824	3782	6067
debit	-2432	-2370	-2470	-1900	-1932	-2405
balance	-1448	-1317	-872	924	1850	3662
Singapore						
credit	1603	1814	6509	8085	8803	11043
debit	-1252	-1183	-5502	-6678	-7945	-9428
balance	351	631	1007	1536	858	1615
Thailand						
credit	1113	1122	2059	2140	2562	3801
debit	-1604	-1764	-2913	-3546	-4293	-5915
balance	-491	-642	-853	-1406	-1731	-2114

na means not available.

Source: International Monetary Fund, Balance of Payments Statistics Yearbook 1996 and 1992.

Table 10. RCA Indices for International Services Transactions of ASEAN Members

Country/Region	1993	1994	1995
Non-Factor Services:			
Indonesia	0.46	0.51	0.56
Laos	1.25	1.08	1.11
Malaysia	0.48	0.50	na
Philippines	1.37	1.60	1.77
Singapore	0.91	0.92	0.94
Thailand	1.10	1.00	1.07
ASEAN	0.81	0.83	1.02
Expanded Services:			
Indonesia	0.35	0.39	0.41
Laos	0.82	0.73	0.72
Malaysia	0.29	0.30	na
Philippines	1.18	1.33	1.47
Singapore	0.74	0.76	0.78
Thailand	0.79	0.73	0.78
ASEAN	0.65	0.67	0.81

Source: IMF, Balance of Payments Statistics Yearbook 1996 and author's compilations.